



Index Fund Strategies

ASSET CLASS[®]

A monthly update of asset class performance, trends, & topics for long-term investors

Index Returns

	1999	2000	2001	Last 9 yrs.	4/25 2002
Bonds					
Short-term	4.6	6.7	5.8	5.5	0.8
S-T Global	3.7	6.7	5.9	7.3	1.2
Intermediate	-3.6	13.5	8.2	7.1	1.7
Long-term	-7.9	16.6	8.2	8.1	1.9
U.S. stocks					
Large Market	20.8	-9.3	-12.1	13.3	-4.6
Large Value	4.8	10.2	3.8	14.1	5.9
Small Micro	29.8	-3.6	22.8	14.8	9.5
Small Market	25.4	2.5	12.7	12.6	5.2
Small Value	13.1	9.0	22.7	15.6	15.7
Real estate	-2.0	28.4	13.2	9.6	7.6
Int'l stocks					
Large Market	28.5	-14.0	-20.8	6.3	1.5
Large Value	16.3	-0.2	-15.3	8.6	8.4
Small Market	21.9	-5.4	-10.5	3.1	11.6
Small Value	19.0	-3.1	-4.6	3.6	12.4
Emerg. Mkts.	71.7	-29.2	-6.8	5.1	10.7

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
S-T Global bonds	DFA Five-Year Global Fixed
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Long-term Bond Index
U.S. Large Market	DFA US Large Co. (S&P 500)
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA US 9-10 fund
U.S. Small Market	DFA US 6-10 fund
U.S. Small Value	DFA US 6-10 Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Int'l Large Cap fund
Int'l Large Value	DFA Int'l Large Cap Value fund
Int'l Small Market	DFA Int'l Small Company fund
Int'l Small Value	DFA Int'l Small Cap Value fund
Emerging Markets	DFA Emerging Markets fund

"Last 9 yrs." returns are ended 12/31/01 and for U.S. Large Value (3/93), U.S. Small Value (3/93), Int'l Large Value (3/93), Int'l Small Market (10/96), Int'l Small Value (1/95), and Emerging Markets (5/94) include simulated data prior to fund inception (in parentheses).

This information is obtained from sources we believe are reliable, but we cannot guarantee its accuracy.

Past performance does not guarantee future returns.

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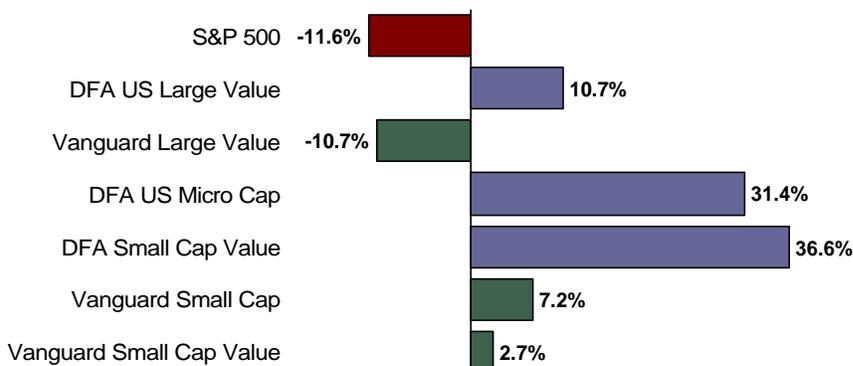
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Markets Update Friday, April 26, 2002

"We told you so..."

We were always pretty confident that once the bloom came off the large growth stocks, the portfolio engineering at DFA would pay off in the small cap and value asset classes. So far, it has.

January 1, 2001 to March 31, 2002



The Science of Investing Has Its Limits

Jeff Troutner, TAM Asset Management, Inc.

The science of active management, which is based on company and economic research and technical and quantitative systems for market timing and sector rotating, has been fairly well discredited over the years while the principles of efficient markets and Modern Portfolio Theory (MPT) have emerged as more prudent guidelines for long-term investors. But as I have pointed out in previous newsletters, we now have some proponents of MPT attempting to extend the power of this research to predicting absolute returns for stocks and even individual stock sectors. Using this information they conclude that certain asset classes aren't worth the risk of owning.

The irony of this morphing of efficient market thinking into active management-like market timing decisions hit home for me as I read the Berkshire Hathaway annual report and its accompanying narration of the Q&A part of its annual meeting.

If Berkshire's stock had been only half as profitable over the years (in other words, in line with the general market's performance) all of Warren Buffett's humor and exceedingly wise advice would fall on deaf ears. But Buffett has been extremely successful and his analysis of *why* not only impresses his shareholders, but also all those who read the many books and articles outlining his principles and beliefs. Buffett's success also motivates the legions of

continued on back...

fund managers and independent advisors who try to emulate his track record. Despite the fact that most fail to even beat the market, let alone get close to Buffett's track record, these money managers feel intellectually superior to investors who wisely seek to achieve market-like returns.

But the wide acceptance of the science of active management has actually led to its demise as anything but a gigantic fee generator for its adherents and entertainment and ad sales for the mass media. Today's enlightened graduates of the Vanguard/DFA school of investment science know that the "Warren Buffett Way" cannot be duplicated by mere mortal investors on their own, nor can it be copied by most mutual funds. Even Buffett has acknowledged that by stating that most investors would be better off indexing.

On the other hand, some people take the science of MPT too far—whether in trying to discredit it or promote it. The antagonists use the period from 1995-1999 to illustrate how irrational and inefficient markets can be and how "bubbles" can form in the financial markets. That they failed to predict this in advance or take steps to preserve their precious track records in the face of it is (evidently) irrelevant. Thus we are now told how "being selective" and "prudently analyzing developing opportunities" strengthen the case for active management once again.

We are also seeing some past proponents of efficient markets claiming unsubstantiated merit in the ability of MPT to predict future returns. Mathematical formulas and ratios, back tested systems, and observations of past bubbles are used as support for actively changing portfolio allocations in the face of changing "realities." In language reminiscent of Orwell, we are told that changing allocations in response to changing *expected* returns isn't market timing or attempts to beat the market. They are "rational and prudent responses to one's need to take risk."

But this concept of "need to take risk" really only applies to someone who has met their retirement goals earlier than expected because of the ultra-high returns of large growth stocks from 1995-1999. (Of course, this suggests that the investor had an over-concentrated portfolio of lower expected return/lower risk stocks to start with and they performed far better than expected. So evidently their *need* to take risk—or their *desire* to take risk—wasn't that high in the first place. But I digress.) The fact is, for most people saving for retirement, the need to take risk hasn't changed. Moving into low-return bonds or money market funds in response to projected low expected returns for certain stocks over some

unknown period won't get them any closer to their goals.

What these investors are really being asked is to change their *perception* of risk based on what happened recently and what these simplistic market timing systems are now telling them. In other words, the risk of holding stocks of large, established, and generally profitable U.S. corporations is no longer worth the lower expected returns that are projected. I guess they were only worth holding when they were generating a return (unexpected) above 20%. But the 1995-1999 period was an historic anomaly (thus, the rarely used term "bubble"). Maybe those who are now advocating selling or not holding these stocks are simply acknowledging that they and their clients got used to the much wider margin between actual returns and perceived risk. Unless they can "see" a risk premium of X% (using systems that always seem to work in hindsight), they don't want to play the game. Ah, if only things were that simple and predictable.

Interestingly, even Warren Buffett—the chief antagonist of MPT—is hard pressed to give up on stocks of large U.S. companies. On the contrary, he continues to hold some of the biggest names in the S&P 500 and, by his own admission, must continue to buy large companies to sustain Berkshire's growth. He isn't selling stocks to buy inflation-protected Treasuries. He's lowering his and his shareholders' *expectations*. He's also continuing to search for good companies at good prices (value investing) and readily (and humbly) acknowledges one of his disciple's superior results from purchasing smaller cap stocks (Lou Simpson at Berkshire's GEICO subsidiary). Buffett even stated at his annual meeting that "we want to have all of our money working in decent businesses."

So, while investors can throw out a lot of the old school science of active management as unproductive while also acknowledging the extraordinary success of Buffett (who also possess special advantages and extraordinary wisdom), they should also reject the notion that one can extend Modern Portfolio Theory's power to predicting future market returns. It can't. But it provides a pretty sound basis for expecting *over time* that stocks will beat bonds, value will beat growth, and small will beat large. In other words, we can expect the *relative* risk and return relationships to work in the future, but we cannot determine *absolute* returns for the overall market or individual asset class in advance. The only absolute is that investors can always expect the unexpected.