



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.	5/20 2002
Bonds					
Short-term	4.6	6.7	5.8	5.5	1.0
S-T Global	3.7	6.7	5.9	7.3	1.6
Intermediate	-3.6	13.5	8.2	7.1	2.0
Long-term	-7.9	16.6	8.2	8.1	0.8
U.S. stocks					
Large Market	20.8	-9.3	-12.1	13.3	-4.4
Large Value	4.8	10.2	3.8	14.1	6.9
Small Micro	29.8	-3.6	22.8	14.8	9.0
Small Market	25.4	2.5	12.7	12.6	4.1
Small Value	13.1	9.0	22.7	15.6	15.5
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	3.5
Large Value	16.3	-0.2	-15.3	8.6	11.8
Small Market	21.9	-5.4	-10.5	3.1	15.7
Small Value	19.0	-3.1	-4.6	3.6	16.9
Emerg. Mkts.	71.7	-29.2	-6.8	5.1	9.3

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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Markets Update Tuesday, May 21, 2002

Timing Lessons From a 401(k) Plan

Jeff Troutner, TAM Asset Management, Inc.

The temptations of the late 90's bull market were not limited to novice investors. Some of the smartest and most experienced investors I know bought into the new era hype and loaded up on "can't miss" stocks such as Cisco, Qualcomm, Dell and others. They also committed much more of their assets than normal to speculative stocks in the Internet and biotechnology industries. Mutual funds investors increasingly rejected asset class diversification and indexing to concentrate their portfolios in large growth funds and those specializing in the technology sector. Fund managers with the "hot hands" saw the assets of their funds skyrocket.

I've reminded *Asset Class* readers of all of this before, but I bring it up again because I had the occasion to review a decision—at the height of the bull market hysteria—of a former 401(k) plan client. I believe that real life case studies are the best lessons for investors and this one is particularly useful because it involved the unrealistic expectations and misconceptions of average investors. It also illustrates why there is renewed debate in the 401(k) industry today about whether the individual participants of a plan or a corporate fiduciary (such as an investment committee) is best suited to make investment decisions on assets targeted for an employee's retirement.

Prior to hiring a new advisor in mid-1999, this company was making decisions on behalf of the plan participants through an investment committee and had decided on a balanced portfolio of 65% stocks and 35% bonds. They diversified the stocks among large, small, U.S. and foreign using the DFA funds. Offsetting the fairly conservative overall stock allocation was a decision to invest exclusively in value stocks. As most of you know, this allocation produced significantly lower returns than the S&P 500 from 1995-1999 and had much less exposure to technology than the average portfolio.

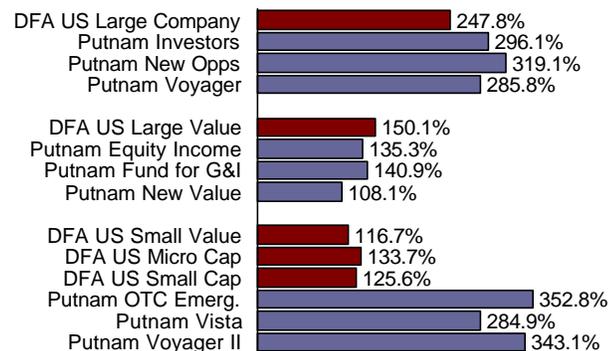
As I will illustrate in a moment, the plan's U.S. stock funds weren't doing badly over this period, they just weren't producing the supercharged returns of the large growth-heavy indexes and many active-managed mutual funds. Also, I was reporting performance on a *total portfolio* basis to the committee and underemphasizing, as always, the performance of individual mutual funds. As the company grew, new employees came to the firm with little, if any, exposure to a long-term asset class-based strategy and a conflict arose between what returns they *thought* they should realize and what they were actually experiencing.

Most of the newer employees also had experience with "self-direction" of their 401(k) assets and as the bull market in large U.S. growth stocks raged, there was more and more pressure on the investment committee to change the plan to participant direction and "daily valuation." A stockbroker with a relationship with one of the company's executives made a presentation to the committee and won the business using a Putnam Funds 401(k) platform.

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In making his case, the broker most likely did a performance comparison of the Putnam and DFA funds. Below is an example of such a comparison (to save space and illustrate a later point, I'll use the full 1995-1999 period). As you can see, except for the large value category, the DFA funds did not compare favorably to the Putnam funds, which did particularly well during the last half of 1999—proof to the investment committee, I'm sure, that they had made the right decision six months earlier.

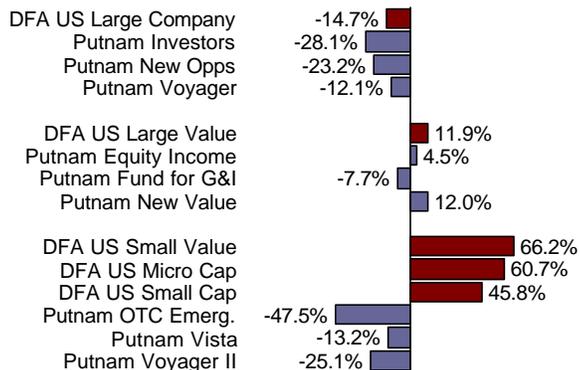
Chart 1: Jan. 1995 - Dec. 1999 (Prior to change)



Total returns for funds with starting dates of 1/95 or earlier.
Source of all data is Morningstar Principia Pro

But had they? Chart 2 shows the performance of the same Putnam and DFA funds from June 1999 when they made the change to the end of last month. The supercharged Putnam funds tanked, the laggards hung in there, and the DFA funds (with the exception of Large Company) kept chugging along.

Chart 2: June 1999 - April 2002 (After change)



It's a classic tortoise and hare story. Not only did the DFA funds outperform over the total period (Chart 3), but the two worst performing Putnam funds at the end of 1995 turned out to be the winners in the end.

You have to wonder at this point how many plan participants compounded their misfortune by shifting more of their assets to stocks (from the 65% allocation set by the committee) and to the high-flying funds of 1999 (see Chart 4). After twenty years of experience in this business and having seen and heard of so many portfolio disasters over the past year and a half, I

can only guess that a large number of participants felt like kids in a candy store and loaded up on the hot funds.

Chart 3: Jan. 1995 - April 2002 (Total period)

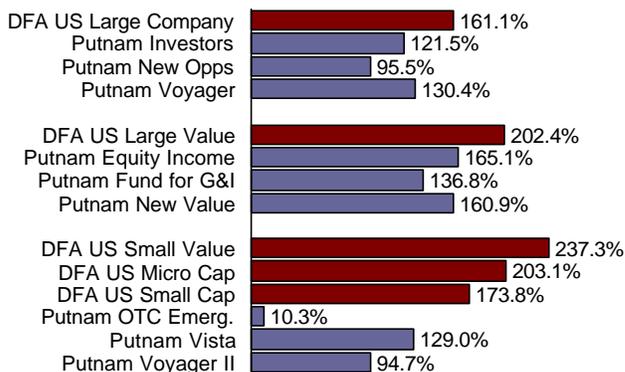
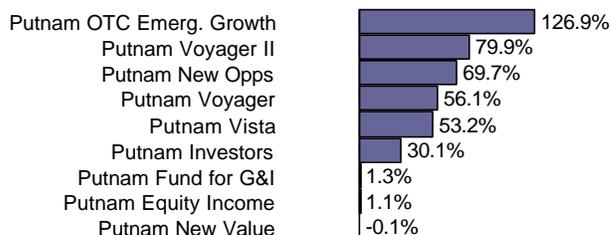


Chart 4: 1999 Putnam Fund Returns (Who could resist?)



The point of this illustration is not to disparage the Putnam funds or to be overly critical of the investment committee that made the change to self-direction. I can't even blame the participants who may have jumped to the high octane funds. In fact, a good case could be made that I failed as their advisor in preventing these changes, particularly at such a critical time in the market cycle. Ultimately, however, I think it was the momentum of the market, the strength of the Wall Street marketing machine, and the trend toward daily-valuation 401(k) administration that proved impossible to overcome.

The Putnam funds are no better or worse than any other active fund family and the investment committee for the company was simply trying to give the participants what they wanted. And for all I know, the new investment advisor successfully discouraged participants from making significant changes in their allocation and over-concentrating in the hot funds.

The bigger point is that the more often than not the tortoise wins the investment race. It was a misunderstanding of this concept that caused the participants to call for the plan change and may have tempted them to buy the hot funds at exactly the wrong time. We know that indexing adds value and that the DFA funds capture the asset class risk and return characteristics better than most passively-managed alternatives. But the biggest value-added to a portfolio is the discipline to stay with your allocation through the good and bad times—active funds or not. In other words, it's very important that you not lose your head when all those around you are losing theirs.