



Investing Strategies

# ASSET CLASS<sup>SM</sup>

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

## Asset Class Returns

	2000	2001	2002	Last 10 yrs.	3/17 2003
<b>Bonds</b>					
Short-term	6.7	5.8	3.9	5.3	0.4
Five-Year	6.7	5.9	10.4	7.6	0.9
Intermediate	13.5	8.2	15.0	7.9	1.1
Long-term	19.7	4.3	16.3	9.1	1.8
<b>U.S. stocks</b>					
Large Market	-9.3	-12.1	-22.2	9.3	-1.5
Large Value	10.2	3.9	-14.9	10.8	-4.6
Small Micro	-3.6	22.8	-13.3	11.6	-4.8
Small Market	2.5	12.7	-19.1	9.0	-5.1
Small Value	9.0	22.6	-9.3	12.8	-7.7
Real estate	28.4	13.2	4.2	9.1	-0.2
<b>Int'l stocks</b>					
Large Market	-14.0	-20.8	-14.6	4.0	-7.3
Large Value	-0.2	-15.3	-8.5	6.8	-7.0
Small Market	-5.4	-10.5	1.9	3.0	-3.1
Small Value	-3.1	-4.6	5.8	3.8	-2.9
Emerg. Mkts.	-29.2	-6.8	-9.4	3.5	-5.4

### Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
Five-Year bonds	DFA Five-Year Global Fixed
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Long-term U.S.Treas.
U.S. Large Market	DFA US Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA US Micro Cap fund
U.S. Small Market	DFA US Small Cap fund
U.S. Small Value	DFA US Small Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Large Cap Int'l fund
Int'l Large Value	DFA Int'l 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 10 yrs." returns are ended 12/31/02 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.**

This newsletter is published by  
**TAM Asset Management, Inc.**  
 1100 Mar West St., Suite D  
 Tiburon, CA 94920  
 Phone: 415-435-5045  
 eFax: 781-623-4691  
 email: trout@tamasset.com  
 Web Site: www.tamasset.com  
 Editor: Jeffrey C. Troutner

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## Markets Update March 18, 2003

### "We are, I regret, captives of recent history..."

Jeff Troutner, TAM Asset Management, Inc.

"...In late 1999 and early 2000, the crowd loved stocks, because stocks fared well. Today, investors hate stocks, because stocks have lost money for three consecutive years."

So wrote Jonathan Clements in the March 12 *Wall Street Journal*. I think these words sum up the single greatest challenge investors face in managing portfolios for the long-term. The seductiveness of "recency" is very powerful and leads to one of the most destructive behaviors an investor can engage in—market timing.

Changing long-held views based on recent market returns is not the sole province of inexperienced individual investors. Unfortunately, recency has afflicted many prominent investment experts throughout history. Probably the most famous blunder came from a very influential financial thinker of the first half of the last century. Irving Fisher was a distinguished professor at Yale and author of the highly regarded investment book, *The Theory of Interest*. However, he will always be remembered first for his statement just prior to the 1929 Crash: "Stock prices have reached what looks like a permanently high plateau." Ouch.

Recently, another highly respected investing sage, Peter Bernstein—the author of *Against the Gods: The Remarkable Story of Risk* and one of my favorites, *Capital Ideas: The Improbable Origins of Modern Wall Street*—flip flopped on whether investors should stay with a diversified "policy" portfolio over the long-term or engage in a form of market timing known as tactical asset allocation. In a January/February 2002 article in *Bloomberg Personal Finance* entitled "The 60/40 Solution" Bernstein asks the question,

Should investors consider shifting—**on a permanent basis**—to a conservative stance, where the allocation to stocks is smaller than it might have been in the recent past? [my emphasis]

And he answers:

Yes!—but not for the reasons you might imagine. I don't recommend cutting back because the bad economic news and the war on terrorism are promoting a bearish view of the market. I'd say the same thing whether I were bearish or bullish. This is not a question of **market timing**. If it were, you could stop reading now, because market timing recommendations have an impressive track record of being harmful to an investor's financial health. [my emphasis]

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In an interview with Weeden & Co. just one year later Bernstein changes his tune. Consider this exchange:

**You're challenging that investment gospel [that stocks outperform in the long run]?**

*My point is that we've reached a funny position where the long run doesn't work. Where long run evidence doesn't fit circumstances as they are today.*

**So institutions should trash their strategic asset allocation policies?**

*Yes, if you consider that the purpose of a policy portfolio has been to establish an asset allocation structure that would remain in place until circumstances changed so fundamentally that a revision in the policy portfolio would be necessary.*

It's important to note here that Bernstein is *not* talking about a change in an investor's objectives, but rather a change in market conditions. He goes on to say:

*You have to be much more unstructured, opportunistic and ad hoc than you have been in the past.... Yes, I am talking about that dirty word, market timing. But why has market timing been considered a dirty word?*

Uh, I don't know, Peter. Maybe because you said it was "harmful to an investor's health" just one year ago? You now have a better idea of why this business is so frustrating and why investors are so in need of "a firm hand on the tiller." If the experienced, reputable, highly respected experts can't stay focused on the long run and avoid decisions based on the recent past, how can we expect more of individual investors?

Focus on the short run, of course, is also the driving "principle" of most commission-based stockbrokers. Without a proclivity toward recency, investors could never be seduced by the sales pitches of brokers. It would actually take logical, well-researched, and fact-based arguments to move them from their long-term investment strategies—an investment in time and effort most brokers find wholly untasteful and unnecessary.

Fee-based advisors also allow recency to drive their recommendations to clients. This goes without saying for advisors who use actively managed funds. "Five Stars" and "top-10%" performance over the past three years makes selling a strategy infinitely easier than presenting the conclusions of Modern Portfolio Theory, the Efficient Market Hypothesis, The Fama/French Three-Factor Model, or even Bill Sharpe's simple "The Arithmetic of Active Management."

Within the world that TAM inhabits, however, it doesn't get much worse than situations where advisors employ-

ing passive asset class strategies violate principles due to "client pressure." We see portfolios like this almost every week. They started out in the mid-90's with a good balance of US and foreign large, small, growth, and value stocks only to shift too heavily to US large growth stocks in 1998 or 1999. The worst cases saw money shifted from small cap and value stocks to the now infamous QQQ's (NASDAQ 100 exchange traded funds). One advisor actually told a client that he felt pressured to make these changes for "business reasons"—the risk of losing accounts if the advisor failed to jump on the large growth train barreling down the tracks. The lure of recency convinced the advisor that the risk of losing clients from "inaction" was greater than the risk of the train crashing and losing the clients for bad performance.

All advisors are faced with these pressures and challenges. However, it's one thing to proactively change allocations in an attempt to cash in on short-term market trends, attract new clients, or avoid client defections. It's another to take a direct order from a client to change an allocation in response to the fear/greed emotion. Despite our best efforts to educate our clients, prepare them for the inevitable market cycles, and continuously manage their expectations, we are sometimes forced to make changes we know are not in the client's best interest or we must terminate the relationship. For us, terminating a relationship means more than losing a good client and an advisory fee. It's a last resort because we know what temptations lurk outside our doors.

An investor's best defense against the lure of recency is a small investment of time to learn and understand the principles of asset class investing, the risks of market timing, the history of markets and manias, and the most common emotion-driven investment mistakes. Two books that can help immensely in this regard are William (not Peter) Bernstein's *The Four Pillars of Investing* and Larry Swedroe's *Rational Investing in Irrational Times*.

Ironically, Peter Bernstein's *Capital Ideas* should also be required reading for those who wish to understand the origins and foundation for TAM's asset class investing principles—principles this Mr. Bernstein has evidently forgotten.\*

\*It's probably not coincidental that shortly after the Bloomberg article appeared, Bernstein co-authored a paper with one of the most prominent market timers (tactical asset allocators) in the business—Robert Arnott of First Quadrant, an institutional money manager.