Investing Strategies

ASSET CLASS℠

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

Asset Class Returns

	2000	2001	2002	Last 10 yrs.	6/26 2003
Bonds					
Short-term	6.7	5.8	3.9	5.3	1.1
Five-Year	6.7	5.9	10.4	7.6	3.6
Intermediate	13.5	8.2	15.0	7.9	4.7
Long-term	19.7	4.3	16.3	9.1	8.1
U.S. stocks					
Large Market	-9.3	-12.1	-22.2	9.3	13.0
Large Value	10.2	3.9	-14.9	10.8	11.9
Small Micro	-3.6	22.8	-13.3	11.6	22.0
Small Market	2.5	12.7	-19.1	9.0	20.0
Small Value	9.0	22.6	-9.3	12.8	18.3
Real estate	28.4	13.2	4.2	9.1	13.4
Int'l stocks					
Large Market	-14.0	-20.8	-14.6	4.0	9.3
Large Value	-0.2	-15.3	-8.5	6.8	13.7
Small Market	-5.4	-10.5	1.9	3.0	22.3
Small Value	-3.1	-4.6	5.8	3.8	26.0
Emerg. Mkts.	-29.2	-6.8	-9.4	3.5	21.9

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.

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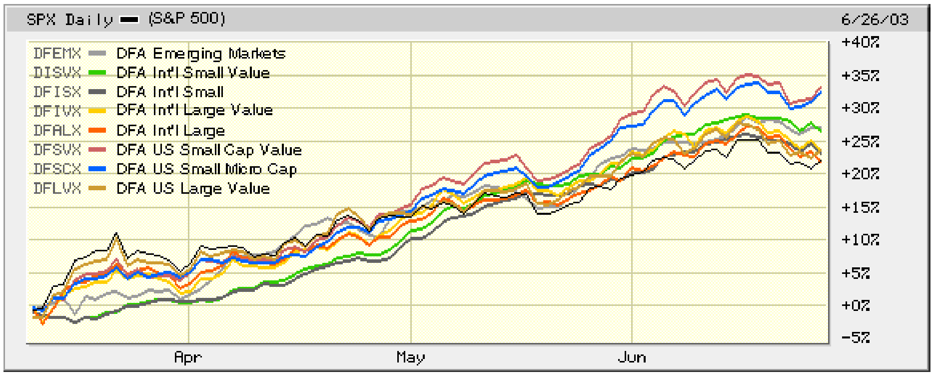
Markets Update June 27, 2003

It's been a nice ride since March 11, with some of the assets classes up over 30% since then. The laggard of the group is the S&P 500, up "only" 21.7%. So far, this is consistent with most bear market recoveries (if this is one), which tend to be heavily front-end loaded. One more reason to avoid market timing.



Ignore the Prudent Investor Rule, Follow the Herd, and Waste a Valuable Employee Benefit: The State of Most Corporate 401(k) Plans Today

Jeff Troutner, TAM Asset Management, Inc.

As anyone who has read this newsletter for any length of time can attest, I have very little patience for investors who spend more time planning their summer vacation than they do learning basic investment principles. I have always strongly encouraged every investor I meet to read—at a minimum—Charlie Ellis's book, *Investment Policy: How to Win the Loser's Game*. In fact, with Mr. Ellis's permission, I spoon fed his wisdom one chapter at a time in the first incarnation of this newsletter back in 1993. But if individual investors fail to heed my advice to learn the basic truths outlined by Ellis and others, they are usually only hurting one person—themselves. This isn't the case with individuals in charge of the assets of a corporate retirement plan.

Corporate decision-makers (executives, directors, trustees, etc.) have a legal responsibility to act as a "prudent man" would in selecting and monitoring the investments of their employees' retirement accounts. If they fail in this responsibility the result will be much lower retirement balances for their employees due to poor investment choices, misguided participant behavior, and lower contribution rates for employees who have "opted out" due to a perception of high risk, lousy fund management, or overall lack of guidance.

The concept of prudent investing has evolved from an initial court case in 1830 to The American Law Institute's 1992 publication of *The Restatement of the Law Third: Trusts, The Prudent Investor Rule*. Since 1992, most states have adopted the *Uniform Prudent Investor Act*, which is based on the revised Prudent Investor Rule and governs trust-investment law, including retirement trusts.

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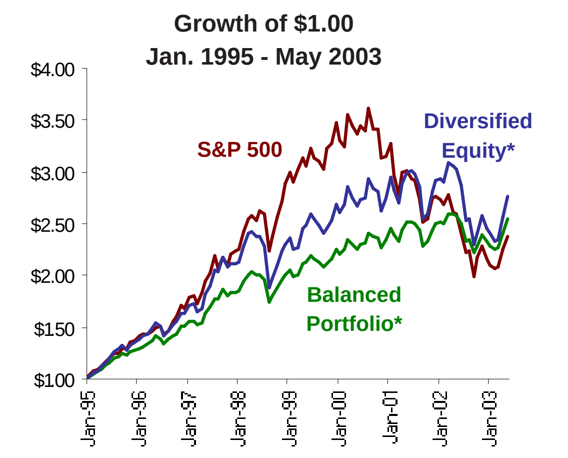
Anyone reading the 1992 revision of The Prudent Investor Rule with an open mind and a top priority of doing the best thing for trust beneficiaries would be hard pressed to implement anything but a broadly diversified, indexed strategy such as we employ. This is most evident in the language pertaining to "compensated" (market) and "uncompensated" (non-market) risks. These aren't words that The American Law Institute pulled out of thin air. They refer to the fact that over time investors are only rewarded for taking systematic market risk—risk that cannot be diversified away (i.e., the risk inherent in a broadly diversified and passively managed index or asset class funds). Risks introduced by active managers in their attempts to "beat the market" are not compensated over time by higher returns. *The research used by The American Law Institute to reach this conclusion is irrefutable.*

The American Law Institute was wise to also recognize that there are many different assets classes (or "markets") that involve varying degrees of compensated risks and are not perfectly correlated—they move in different directions and/or in different degrees at different times. By combining these asset classes in one portfolio, a prudent investor can attain a weighted average of the asset class returns for the portfolio with less than the weighted average risks of the individual asset classes. This is the smoothing out of the roller coaster investors observe with TAM-like asset class diversification.



*Diversified Equity: 30% S&P 500, 30% DFA US Large Value, 20% DFA US Small Micro Cap, 20% DFA US Small Cap Value; Balanced Portfolio: 35% Short-term Bonds, 19.5% S&P 500, 19.5% DFA US Large Value, 13% DFA US Small Micro Cap, 13% DFA US Small Cap Value

While the revised Prudent Investor Rule does not preclude active strategies (those that introduce uncompensated risks) it clearly places a heavy burden on trustees to justify taking such risks. The American Law Institute text includes the following passages:

"Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill." (Page 23)

"The greater the departure [from an ordinarily suitable, diversified portfolio], the heavier the trustee's burden to justify the strategy in question." (Page 25)

"The ultimate goal of diversification would be to achieve a portfolio with only the rewarded or 'market' element of risk." (Page 27)

So, you may be thinking: What does this all have to do with the rather provocative title of this article? It's simple. **Most corporate retirement plan fiduciaries today are thumbing their noses at the revised Prudent Investor Rule and their employees are paying a huge price for their imprudence.**

Some are doing it out of ignorance (which is no excuse), some are doing it out of administrative convenience, but most are doing it simply because "everyone else does it this way." This herd following mentality provides a certain level of comfort that only disgruntled employees and aggressive lawyers can break down. And it's starting to happen. Enron might prove to be the catalyst, but the lack of political courage on the part of our legislators to reform Social Security, the increased reliance on private, corporate-sponsored retirement plans for retirement savings, and an opening of the floodgate of employee lawsuits will ultimately drive fiduciaries to begin acting in a much more prudent manner.

Imprudence is in the eye of the beholder (which will increasingly be courts of law), but if I were an attorney there are several areas I would focus on to identify imprudence on the part of a corporate plan sponsor. I might start by asking for answers to the following questions:

What is the total cost of the 401(k) plan to the individual participants? **Implication**: Most costs are hidden by salespeople or ease of corporate administration of the plan was given higher priority than costs to participants.

What specific criteria did you use to select your investment options and what research do you have to support your selection process? **Implication**: "Superior" past 3- or 5-year performance or the presence of "brand name" funds is given greater importance than the correlation of these criteria to future returns.

What has been the worst, best, and average performance for your plan participants over the past three years, how do the returns compare to market benchmarks, and to what do you attribute the performance? **Implication**: Poor investment selection, too many choices, reliance on past performance, and/or bad investment education or advice are to blame.

These are just a start, of course. The state of 401(k) investing is so bad today that only the threat of class action lawsuits or government intervention will probably change things. Neither are preferable in my book. A genuine concern for employees' retirement security, more time and intellectual capital invested, and the courage to stop following the herd would all go a lot farther toward producing higher retirement fund balances for 401(k) plan participants.