



Investing Strategies

ASSET CLASSSM

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

Asset Class Returns

	2000	2001	2002	Last 10 yrs.	11/25 2003
Bonds					
Short-term	6.7	5.8	3.9	5.3	1.3
Five-Year	6.7	5.9	10.4	7.6	2.7
Intermediate	13.5	8.2	15.0	7.9	2.3
Long-term	19.7	4.3	16.3	9.1	5.2
U.S. stocks					
Large Market	-9.3	-12.1	-22.2	9.3	21.6
Large Value	10.2	3.9	-14.9	10.8	25.0
Small Micro	-3.6	22.8	-13.3	11.6	55.0
Small Market	2.5	12.7	-19.1	9.0	47.0
Small Value	9.0	22.6	-9.3	12.8	50.4
Real estate	28.4	13.2	4.2	9.1	30.8
Int'l stocks					
Large Market	-14.0	-20.8	-14.6	4.0	25.7
Large Value	-0.2	-15.3	-8.5	6.8	37.4
Small Market	-5.4	-10.5	1.9	3.0	47.8
Small Value	-3.1	-4.6	5.8	3.8	54.3
Emerg. Mkts.	-29.2	-6.8	-9.4	3.5	43.5

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 November 26, 2003

(Due to limited space, a Markets Update has been omitted. Happy Thanksgiving!)

It's The Culture

Jeff Troutner, TAM Asset Management, Inc.

The latest scandals to rock Wall Street—late day trading and market timing—are merely the latest symptoms of a greedy, “me first” culture that has existed on Wall Street for decades. Before these latest scandals, investors were shocked to find that Wall Street analysts were making stock recommendations based on pressure from their firm’s investment bankers; favored investment banking clients were being allocated IPO shares at the expense of “retail” clients; and stockbrokers were selling mutual funds in a way to avoid triggering lower fees from their customers.

In a culture that only a politician can love, most stockbrokers, mutual fund companies, and active money managers are engaged in a common pursuit—redistribution of wealth from your pocket to theirs. I experienced this culture as a stockbroker with Shearson Lehman Brothers in the 80’s and it is the primary reason I preach the investment philosophy I do today.

Late Day Trading

Late day trading involves allowing certain investors to buy or sell securities (usually mutual fund shares) after the close of a trading day while making the transactions appear as though they occurred before the market close. Mutual fund companies and certain custodians have allowed “favored” investors to engage in this behavior, sometimes in exchange for higher fees.

This is an advantage since news released after the market close will dictate the next day’s stock prices. If the news was bad, the favored investor would sell the fund anticipating a drop in price the next day or buy if the news was good. In contrast, Joe Average investor who bought before the market close based on the information at that time can’t call the fund company and say, “Based on what Mr. Rather just said on the 6:00 news, I would like to rescind that buy order please.”

Market Timing

Market timing, on the other hand, isn’t the black and white no-no that late day trading is. Although it involves very frequent buying and selling of mutual funds shares, usually by a hedge fund or other active trader, it is not illegal. What’s illegal is telling investors they can’t market time with a company’s fund shares and then allowing some favored investor or the firm’s own employees to engage in the practice. The reason it’s illegal is that when market timers move in and out of a fund, shares of stock held by the fund must be bought or sold. In the process, the fund incurs transaction costs that all fund shareholders must bear. It’s a matter of disclosure and equal treatment for *all* shareholders.

Some fund companies, like Rydex, design their funds for market timing and disclose this in their prospectuses. Others, like Janus, Putnam, Strong, Alliance Capital, U.S. Trust, and Nations Fund’s restrict market timing in one way or another. Unfortunately, they let some of their friends (and even the founder of Strong, Mr. Strong himself) engage in market timing at the expense of their other shareholders. Not good.

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Greed & Fear

So what drives successful, well-known institutions to engage in what are clearly unethical, if not illegal, practices? Well, let's take Janus for example. Janus was the high flying fund company of the 1990's. They could do no wrong until they wrongly held on to all those high flying growth stocks too long. The money flowing out of the Janus funds after the March 2000 market peak was staggering. As pressures mounted at the firm to increase fee revenue, their greed and fear lead to their current SEC scrutiny. Same thing happened at Strong, Putnam, Alliance, etc.

What investors need to realize is that the fear and greed culture has existed at these firms all along. These fund companies have been playing games with investors' money forever, whether by launching multiple "incubator funds" to cherry pick high performers, paying exorbitant fees to fund managers and directors, paying "soft dollars" to brokerage firms for IPO allocations, introducing multiple classes of fund shares to extract hidden sales loads, paying brokerage firms for "preferred" status on their buy lists, extracting 12b-1 fees from investors for "marketing expense" even when the fund has closed to new investors, etc., etc. Investors didn't mind these ethical breaches when funds were returning 30% per year. For some odd reason, they're sensitive to them now.

A Different Culture

There are a couple of mutual fund companies that have a vastly different culture than those named above and I would be shocked if they were implicated in these scandals in any way. Not surprisingly, since I wrote about them in last month's *Asset Class* ("The Problem With Indexing"), the firms are Vanguard and Dimensional Fund Advisors (DFA).

To discourage market timing, Vanguard has imposed reimbursement fees on many of their funds. These fees are paid by investors who sell the funds too soon after purchase and are paid back into the *fund* to compensate the remaining shareholders for the costs of redemptions. Personally, I'm not fond of reimbursement fees because they can get in the way of legitimate purposes like rebalancing and tax management.

DFA has taken a different approach than Vanguard's. Up until the early 90's they just didn't let retail investors anywhere near their funds since these investors tend to move in and out of funds (a behavior based more on ignorance and emotion than on some market timing system). In the early 90's, DFA allowed non-institutional investors in, but only through approved investment advisors who pledged their first born child if caught market timing (my wife and I had four kids just in case).

DFA recognized early on the costs of market timing to long-term shareholders. No one in the investment business doubts that DFA could have \$400 billion under management rather than \$40 billion if they would just "relax" and let everyone buy and sell their funds. Their disdain for market timing as a strategy and their protection of current shareholders (to say nothing of their utter dislike of 800 # phone banks) says a lot about where their principles *and* principals come down on the important issue of putting the client first.

Is the Cure Worse than the Disease?

Although the current scandals are far from over, I am left at this point with the feeling that the punishment could be far worse than the crime. I'm not about to defend the people at the mutual funds, brokerage firms, and custodians who are responsible for these fiduciary breaches. Using existing laws, they should be prosecuted, fined, and banned from the securities industry for life. But it seems that the financial costs of the actual unethical behavior to existing shareholders was fairly minor and could be reimbursed through fines. In the meantime, I'm afraid the SEC just threw a bunch of fresh meat to the jackals.

How so? Well, we should check the number of BMW's sold over the past several months for our answer. My guess is that most of the money flowing out of Putnam, Strong, Alliance, and Nation's funds was guided by "sympathetic" brokers to new load funds. Let's hope they remembered the breakpoints.

Let's also hope the politicians don't pile on a bunch of new regulations that restrict investor flexibility and options or increase costs. Examples are earlier cutoff times for mutual fund orders, mandatory reimbursement fees for funds, or real time intraday pricing of mutual fund shares. It seems to me that we have more than enough regulations on the books now. They just need to be aggressively enforced.

Avoiding the Scandals

A famous cartoon of the 1920's depicted a couple of New Yorkers admiring the yachts of J.P. Morgan and other Wall Street moguls while asking the question, "Where are the customers' yachts." Not much has changed since then. Wall Street's modus operandi has always been to extract as much revenue from the golden goose as it can without killing it.

Recent scandals have put the golden goose (uninformed investors) on life support, but the Wall Street spin machine is already pumping new life into the patient. In one ironic twist, Charles Schwab introduced new commercials touting their unbiased, anti-Wall Street stock ranking service just prior to news that their U.S. Trust subsidiary has been implicated in the current scandals, followed by a story pointing out that Schwab's "F" rated stocks have significantly outperformed their "A" rated stocks. Now *that's* calling the kettle black.

The following traits do not guarantee ethical and honest behavior, but they certainly lessen the chances of being fleeced. Not surprisingly, they are common to Vanguard and DFA funds:

- * Low costs
- * No loads (back, front, deferred or otherwise)
- * Restricted access (DFA)
- * "Passive" management (no ties to Wall Street analysts)
- * A reputation and culture of integrity and shareholder trust

TAM's commitment is to seek out strategic alliances with firms like Vanguard and DFA and apply investment principles that put the odds squarely in favor of the client. Only then should I look forward to that yacht.