



TAM ASSET MANAGEMENT, INC.

ASSET CLASS<sup>SM</sup>

An update of performance, trends, research, &amp; topics for long-term investors

May 2005

## Asset Class Returns

	2002	2003	2004	Last 10 yrs.	3/31 2005
<b>Bonds</b>					
Short-term	3.9	1.6	0.9	4.9	0.2
Five-Year	10.4	3.0	2.9	7.5	-0.7
Intermediate	15.0	2.5	4.3	7.9	-1.0
Long-term	16.7	2.7			
<b>U.S. stocks</b>					
Large Market	-22.2	28.5	10.7	11.9	-2.1
Large Value	-14.9	34.4	18.2	14.5	0.2
Small Micro	-13.3	60.7	18.4	16.4	-6.4
Small Market	-19.1	51.5	17.9	14.2	-5.1
Small Value	-9.3	59.4	25.4	18.0	-2.9
Real estate	4.2	35.6	32.1	14.9	-6.9
<b>Int'l stocks</b>					
Large Market	-14.6	36.7	18.8	6.2	-0.4
Large Value	-8.5	49.4	28.8	8.8	0.3
Small Market	1.9	58.8	30.9	N.A.	5.0
Small Value	5.8	66.5	34.8	8.1	6.7
Emerg. Mkts.	-9.4	60.2	29.9	6.0	0.9

## 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 12/31/04.

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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## What Return Can We Expect From Stocks? (Part 2)

Jeff Troutner, TAM Asset Management, Inc.

*History actually is not formless, but a long view and a philosophical turn of mind are necessary to see its pattern.*

John Steinbeck

In the last *Asset Class*, I concluded that a simple historical perspective makes a case for an expected stock "risk premium" of around 6%. When added to today's Treasury Bill rate of about 2.5%, this implies an expected total return (before inflation) for stocks of 8.5%. This article will take this observation a step further by factoring in the historical risk premiums of small cap and value stocks, since all TAM portfolios have a greater-than-market tilt to these other asset classes.

Before we go there, however, I want to emphasize that these are only estimates intended to be considered along with recent academic studies arguing for much lower expected returns (Fama, Arnott, and others). I have always been, and remain, an advocate of focusing on *relative* returns and accepting whatever the financial markets deliver over time. From my experience working with individual investors since 1981, I know the inclination to fear stocks when markets aren't plowing ahead and to latch on to any information (or "expert") that appears to confirm this fear. This can lead to short-term changes in asset allocations that have the real potential to significantly reduce long-term portfolio returns.

On the other hand, I don't want to induce "bullish" sentiments that may result in the same kind of behavior. I believe that once an investor's asset allocation is set, changes should only be made based on changes in the investor's objectives, not on projections of future returns and certainly not based on fear or greed emotions.

This philosophy should also apply to recommended allocations by investment advisors. I believe it is just as wrong to encourage new clients to be more or less fully invested in stocks in one phase of a market cycle as it is to shift current client assets in or out of stocks during the same phase. Some investors will invest money in the market at a higher price level and realize a lower future return on those assets and others will enter at a lower price and realize a higher future return on those assets. Most, due to a structured discipline such as a 401(k) plan, will invest some dollars at higher prices and some at lower prices, thus realizing an average of risk premiums over time. The alternative—trying to pick low markets to enter and high markets to exit—is simply not a rational course. No one I know of has yet built a consistently successful market timing system, although it's easy to find any number of experts who will *suggest* otherwise.

## A Moving Target

Investors should also keep in mind that expected returns are a constantly moving target. Whether you wish to believe academics and their models, or use the historical record as your guide, the two components of the equation—the risk premium for stocks and the Treasury Bill rate—are constantly changing. For example, the current T-Bill rate is around

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2.5%. That is 1.6% above the rate a year ago. So for those of you looking for absolutes, the expected return for the overall stock market (using a 6% risk premium) rose from 6.9% in March 2004 to 8.5% today. And this is after the market rose by almost 7% from March 2004 to March 2005.

OK, enough caveats for now. Just think *relative* and *long-term* returns and you should be alright.

### The Small Cap & Value Premium

In order to simulate a small cap and value tilt relative to the total stock market (which is dominated by large growth stocks), I created a “Balanced Index” and ran simulated returns for this portfolio going back to 1927 (78 years). The Balanced Index consists of 30% S&P 500 Index, 30% Fama/French Large Value Index, 20% CRSP 9-10 Micro Cap Index, and 20% Fama/French US Small Value Index.

The tables below show the additional annual return over T-Bills for the Balanced Index and the CRSP 1-10 Market Index for various periods using monthly returns data and monthly rebalancing of the Balanced Index. The “Small Cap/Value Premium” is the difference between the Balanced Index and the CRSP 1-10 Market Index. The “High” and “Low” columns represent the highest and lowest spreads between each index and the Treasury Bill return for the period. The high and low premiums can all occur in different years.

**Table 1: Annual Risk Premium 1927-2004**

Balanced Index	8.8%
<u>CRSP 1-10 Market Index</u>	<u>6.4%</u>
<b>Small Cap/Value Premium</b>	<b>2.4%</b>

**Table 2: Average of Rolling 3-Yr. Periods 1927-2004**

	Premium	High	Low
Balanced Index	9.1%	64.7%	-51.1%
<u>CRSP 1-10 Market Index</u>	<u>6.5%</u>	<u>43.1%</u>	<u>-45.1%</u>
<b>Small Cap/Value Premium</b>	<b>2.6%</b>	<b>23.0%</b>	<b>-9.9%</b>

**Table 3: Average of Rolling 10-Yr. Periods 1927-2004**

	Premium	High	Low
Balanced Index	9.8%	23.8%	-6.2%
<u>CRSP 1-10 Market Index</u>	<u>7.2%</u>	<u>18.6%</u>	<u>-6.1%</u>
<b>Small Cap/Value Premium</b>	<b>2.6%</b>	<b>8.7%</b>	<b>-2.4%</b>

**Table 4: Average of Rolling 20-Yr. Periods 1927-2004**

	Premium	High	Low
Balanced Index	10.0%	20.6%	3.9%
<u>CRSP 1-10 Market Index</u>	<u>7.2%</u>	<u>15.3%</u>	<u>0.6%</u>
<b>Small Cap/Value Premium</b>	<b>2.7%</b>	<b>6.0%</b>	<b>-0.6%</b>

**Table 5: Average of Rolling 25-Yr. Periods 1927-2004**

	Premium	High	Low
Balanced Index	9.9%	19.8%	4.2%
<u>CRSP 1-10 Market Index</u>	<u>7.1%</u>	<u>15.0%</u>	<u>1.9%</u>
<b>Small Cap/Value Premium</b>	<b>2.8%</b>	<b>4.8%</b>	<b>0.8%</b>

**Table 6: Risk Premiums After Market Peaks**

	Balanced Index	CRSP 1-10 Index	Small/Value Premium
<b>1929 -</b>			
Next 10 Yrs	-3.1%	-3.1%	0.0%
Next 20 Yrs	4.8%	2.1%	2.7%
<b>1937 -</b>			
Next 10 Yrs	9.4%	5.2%	4.4%
Next 20 Yrs	12.6%	10.1%	2.5%
<b>1973 -</b>			
Next 10 Yrs	4.7%	-1.0%	5.7%
Next 20 Yrs	6.3%	3.7%	2.6%
<b>2000 -</b>			
Next 5 Yrs	4.4%	-4.5%	8.9%

Table 6 shows the annual premiums for periods after a market peak that was followed by a significant down period.

As with all of the tables, a negative number indicates a period when Treasury Bills beat the stock index. The verdict is still out on the risk premiums following the 1999 peak, but they are shaping up to be similar to prior periods.

This brief historical observation is not a substitute for an in-depth statistical analysis of past returns. It is simply an observation that *historically* the long-term market risk premium appears to float around the 6% level and the additional premium for a small cap and value tilt (in the percentages I have used in Balanced Index) hovers around 2%-2.5%. This suggests that a *patient* investor will be rewarded for taking these risks as long as he or she has a sufficiently long investment time horizon, is well diversified, holds costs to a reasonable level, invests periodically, and avoids the temptations of market timing—all of the things we strive for at TAM.

As I was writing this article, a paper by Arnott, Hsu, and Moore was published in the *Financial Analysts Journal* (“Fundamental Indexation,” Mar/Apr 2005) which challenges the traditional cap-weighted indexing method and proposes an alternative. Although I have not had time to thoroughly review the article, it’s interesting to note that their alternative indexes, which appear to create more balance among large, small, growth, and value stocks (our goal with TAM portfolios), produce a 2.0%-2.5% premium over the S&P 500 index.

Anyone interested in more information on long-term asset class returns should visit Ken French’s web site at <http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/> and the Dimensional Fund Advisors site at [www.dfaus.com](http://www.dfaus.com).

*Source of Data: Dimensional Fund Advisors, Returns Program.*

**Past performance does not guarantee future returns. This is especially true of model portfolios, which are not subject to specific market and economic factors.**