



TAM ASSET MANAGEMENT, INC. ASSET CLASSSM

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

Asset Class Returns

	2002	2003	2004	Last 10 yrs.	5/31 2005
Bonds					
Short-term	3.9	1.6	0.9	4.9	0.9
Five-Year	10.4	3.0	2.9	7.5	1.4
Intermediate	15.0	2.5	4.3	7.9	2.1
Long-term	16.7	2.7	7.1	9.3	6.4
U.S. stocks					
Large Market	-22.2	28.5	10.7	11.9	-1.0
Large Value	-14.9	34.4	18.2	14.5	0.9
Small Micro	-13.3	60.7	18.4	16.4	-7.0
Small Market	-19.1	51.5	17.9	14.2	-4.9
Small Value	-9.3	59.4	25.4	18.0	-4.0
Real estate	4.2	35.6	32.1	14.9	1.6
Int'l stocks					
Large Market	-14.6	36.7	18.8	6.2	-3.0
Large Value	-8.5	49.4	28.8	8.8	-2.6
Small Market	1.9	58.8	30.9	N.A.	0.8
Small Value	5.8	66.5	34.8	8.1	3.0
Emerg. Mkts.	-9.4	60.2	29.9	6.0	1.3

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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Demographics, Commodities, & Pessimism

Jeff Troutner, TAM Asset Management, Inc.

Demographics and Stock Prices

Jim Davis, one of the research gurus at Dimensional Fund Advisors (DFA), wrote an article for investment advisors recently that pointed out some interesting perspectives on demographics and future stock market returns. The great fear on the part of some investors is that the Baby Boomers will retire, sell their stock holdings to fund their lifestyles, and contribute to a general decline in stock prices. Might this happen? Well, let's look at some facts.

The table below shows the US population breakdown by age group. The highlighted numbers represent the Baby Boomers. About 83 million Boomers will reach age 65 between the years 2010 and 2030. The question is, how many are likely to significantly reduce their stock holdings as they grow older?

The chart below shows the average stock holdings by age group according to the Federal Reserve's Survey of Consumer Finances, 1989-2001. All three age groups above 55 held more stock than their younger counterparts. As Davis points out, this suggests that people accumulate stocks during their peak earnings years and do not reduce their holdings dramatically after they retire.

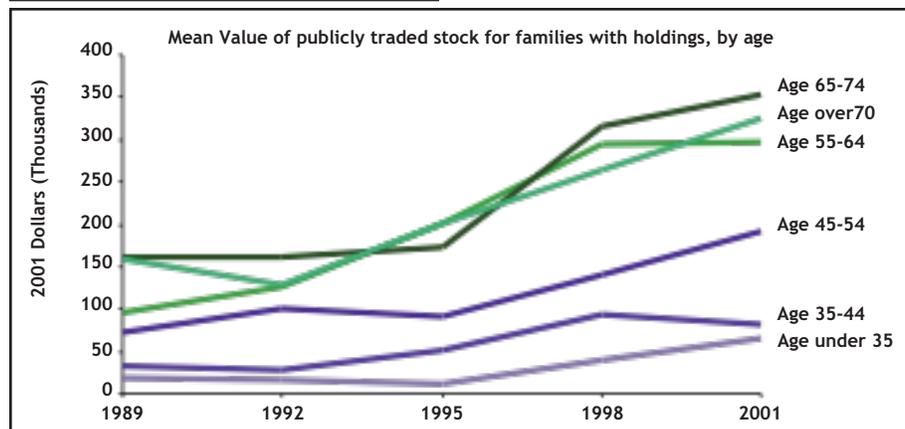
U.S. Population in 2000 by Age Group

Age Group	Population
Under 5 years	19,175,798
5 to 9 years	20,549,505
10 to 14 years	20,528,072
15 to 19 years	20,219,890
20 to 24 years	18,964,001
25 to 34 years	39,891,724
35 to 44 years	45,148,527
45 to 54 years	37,677,952
55 to 59 years	13,469,237
60 to 64 years	10,805,447
65 to 74 years	18,390,986
75 to 84 years	12,361,180
85 years and over	4,239,587

more stock than their younger counterparts. As Davis points out, this suggests that people accumulate stocks during their peak earnings years and do not reduce their holdings dramatically after they retire.

Could this behavior change in the future? Of course, but markets move on *unanticipated* events and since this issue has been covered extensively by the financial press and will continue to be a hot topic for some time, it's rational to believe that this risk is already built into stock prices. If stock sales by Boomers turn out to be higher than expected, prices may fall. If sales are less than expected, prices may rise. My guess is that many other *unforeseen* events

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will have a greater impact—positive or negative—on stock prices than the changing demographics of this country.

Commodities

So-called “alternative investments” have received a lot of attention from the financial press since the stock market meltdown began in the Spring of 2000. Surprisingly, the incredibly strong market since April 2003 (S&P 500 up 45%; small value stocks up 108%) has done little to dampen the “anti-stock” movement.

The most frequently mentioned alternative investments are commodities, hedge funds, private equity, and real estate investment trusts (REIT’s). I have written quite a bit in the past about my position on REIT’s (*might* be an asset class; good diversifier to large growth stocks; not a great diversifier for a TAM-like multi-asset class portfolio) and I’ll save hedge funds and private equity for another day. That leaves commodities, including an old favorite, gold.

Eugene Fama, Jr., another DFA guru, provided some nice insights on commodities recently in an article entitled, “Nowhere to Hide.” Gene pointed out that despite its greater price volatility gold has returned only 7.5% per year since January 1970 versus 11.3% for the stock market. If you omit the inflationary 70’s, gold has done even worse: 1.8% vs. 13.2% for stocks.

Past returns alone are not the best standard on which to base an investment strategy, however. Economic logic and sound portfolio theory should be the primary components. Modern portfolio theory teaches us that the primary components of a diversified portfolio should have an *expected return*. Only *earnings* can generate expected return.

Therefore, buying gold isn’t really *investing*. It’s *speculating*. Buyers expect gold to rise in value, either due to economic uncertainty or in step with inflation. But since no earnings are being generated that either increase the value or are paid out in dividends (like stocks) over time, all an investor can ultimately hope for is that someone else will pay a higher price for gold than the investor did. This is not unlike someone speculating in stocks. Earnings and dividends are not really relevant to the stock speculator. It’s all about short-term *price movements*.

Uncertainty, as Fama points out, is scary, but it’s a fact of life investors must accept. For rational investors, uncertainty (risk) is only worth taking if there is an expected return. Stocks represent capital invested to power enterprises that generate growth and productivity. This is what earns expected return. Simple commodities (such as corn, pork bellies, and gold) don’t create economic growth.

Rational investors never confuse the inevitable down periods for stocks with a failure of capitalism and free markets. They accept them as part of the deal (risk). Therefore, these investors should not seek “alternatives” or “protective” assets that will most likely reduce their overall expected return, nor should they flee stocks in times of uncertainty. They should become more aware of the underlying principles of prudent, long-term investing and develop the confidence to stay the course and allow this great economic system to pay off for them.

Pessimism

Investors who maintain an even emotional keel and reject over-

optimism and over-pessimism will prosper the most over time. We have seen what over-optimism can do to portfolios, and ultimately to life plans, during the late-90’s and early 2000’s. Over-pessimism caused many investors (and advisors) to bail out near the bottom and miss the stock market rally since April 2003. It seems that the pessimism continues today with the gloom-and-doom talk of the trade deficits, average household debt, the budget deficit, and other issues.

I thought it would be helpful, then, to offer some positive takes from a famous economic guru: Art Laffer of Laffer Associates. Here are some of his perspectives:

U.S. Household Debt

Yes, household debt is at a record \$10.3 trillion. But household net wealth is too: \$46.7 trillion. “Debt-to-income measures of solvency are inherently flawed. The proper measures are debt-to-wealth or debt service payments to income. Neither of these measures is reflective of imprudence. Home ownership now stands at a record 69%! Given that 70% of household debt is mortgage debt, and 81% of mortgage debt is locked in at fixed rates, fears that rising interest rates (including mortgage rates) will have a devastating impact on households and the housing market are unwarranted.”

Plummeting Dollar/Trade Deficits

“As the only growth country of the developed world, the U.S. is the choice destination for capital. The only way foreigners can invest in the U.S. is if we run a trade deficit, which is one and the same as our capital surplus. The dollar’s fall has run its course and is still well within its normal long-term range. In the not-too-distant future, we will see an inevitable sharp decline in the U.S. trade deficit.”

Budget Deficit

“The budget deficit is \$435 billion, or 3.7% of GDP. As a percent of GDP there have been other times in U.S. history when deficits were larger, especially times of war. To put the deficit into perspective, even if we ran a \$500 billion deficit for each of the next 10 years (\$5 trillion net new debt) and our economy grew at a modest 3.5% real rate (a 5% nominal rate), total debt as a share of GDP would be way below where it was in 1993. 1993 was the beginning of a long boom period for the U.S. economy.”

Laffer is famous for developing the “Laffer Curve,” which suggests that in any given economy, there is some optimal income tax rate which will bring in the most revenue possible. He was optimistic about the stock market in early 2003 and he remains optimistic today; suggesting that it might be as much as 60% undervalued. Whether you believe him or not, you gotta love his positive outlook.

And Lord knows, we could use some positive thinking, positive reporting, and positive progress among our corporate and political leaders today.