



TAM ASSET MANAGEMENT, INC.

# ASSET CLASS<sup>SM</sup>

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

August 2005

## Asset Class Returns

	2002	2003	2004	Last 10 yrs.	7/31 2005
<b>Bonds</b>					
Short-term	3.9	1.6	0.9	4.9	1.0
Five-Year	10.4	3.0	2.9	7.5	1.5
Intermediate	15.0	2.5	4.3	7.9	1.0
Long-term	16.7	2.7	7.1	9.3	5.4
<b>U.S. stocks</b>					
Large Market	-22.2	28.5	10.7	11.9	2.8
Large Value	-14.9	34.4	18.2	14.5	8.0
Small Micro	-13.3	60.7	18.4	16.4	4.7
Small Market	-19.1	51.5	17.9	14.2	5.5
Small Value	-9.3	59.4	25.4	18.0	7.1
Real estate	4.2	35.6	32.1	14.9	14.5
<b>Int'l stocks</b>					
Large Market	-14.6	36.7	18.8	6.2	1.4
Large Value	-8.5	49.4	28.8	8.8	3.3
Small Market	1.9	58.8	30.9	N.A	7.0
Small Value	5.8	66.5	34.8	8.1	9.4
Emerg. Mkts.	-9.4	60.2	29.9	6.0	11.0

### 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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## Saving Investors From Themselves

Jeff Troutner, TAM Asset Management, Inc.

Several years ago DALBAR, Inc. published an update to their study entitled, "The Quantitative Analysis of Investor Behavior," which showed that the return realized by the average investor in stock mutual funds was substantially lower than the reported official average return of the funds (Chart 1). DALBAR was able to do this by observing cash flows in and out of the funds and calculating a dollar-weighted rate of return for the mutual fund investors. Dollar-weighted returns show how well investors timed their purchases and sales. (A minor issue DALBAR left out of the original study, since it was funded by Merrill Lynch, is that the S&P 500 returned 12.2% over the period—almost 3% better than the average stock fund and 9.6% better than the average stock fund investor!)

Predictably,  
DALBAR

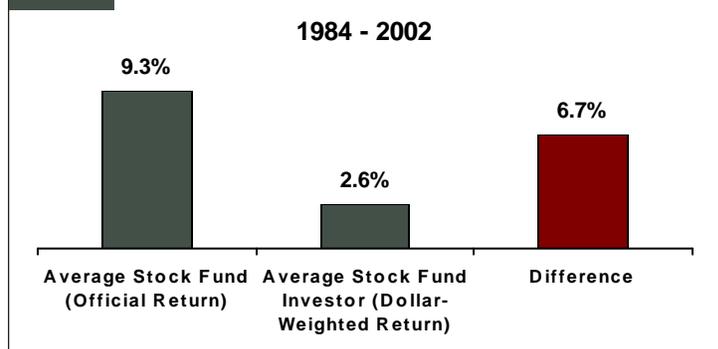
concluded that the difference in returns is due to investors chasing hot funds—they tend to move in to top performing funds *after* the great performance and head to the exits *after* the fund has performed poorly for a stretch of time.

The DALBAR results have been questioned consistently by industry pundits since their release due to questions about the methodology the company used to support its conclusions. Well, it appears now that they may not have been far off the mark (as many of us who have worked with individual investors for over twenty years already knew). Morningstar, the most widely-followed mutual fund evaluation service, recently published a study that appears to corroborate DALBAR's. In their study, Morningstar also calculated the dollar-weighted returns versus the official returns for fund categories (asset classes), sectors (technology, health, etc.), and individual funds. Table 1 on the next page shows some of the results.

DALBAR's study was from 1984-2002, included all U.S. stock funds as a group, and concluded the difference in dollar-weighted vs. official return was -6.7%.

Morningstar's study is more detailed, but it only covers the 10 years ending April, 2005 and the difference between dollar-weighted and official appears to be about half of what DALBAR concluded.

Chart 1



Source: DALBAR, Inc.

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Nevertheless, an additional 2%-4% off the average investor's return due to bad timing moves is a huge cost compounded over time.

We can draw a couple of important conclusions from the Morningstar data. First, it's clear that the largest differences between the official and dollar-weighted returns occur in the categories, sectors, and funds that were subject to the greatest booms and busts over the period measured. During the booms it appears that investors arrive late to the wildest parties and have so much fun that they forget to leave before the coroner arrives to pick up the fund carcasses.

We can see this in the returns and cash flows of the Janus Mercury and White Oak Select Growth funds for the five years 1998-2002 (Table 2). Money was flowing in during the hot years and staying through much of the decline—leaving only after much of the damage was done. Both funds have fewer assets today than they did at the end of 2002, despite relatively strong returns in 2003 and 2004. What's really surprising is that there is still over \$5 billion of assets left in these funds.

The second conclusion we can draw from the Morningstar data is that individual investors using index funds are not immune to bad timing decisions. As we see in Table 1, the reported return for the Vanguard 500 Index fund was 10.2% over the ten-year period, but the average investor in the fund realized a dollar-weighted return of 6.5%—a very significant difference of 3.7%. This illustrates some points I have made many times in the past:

- 1) Many investors who “discovered” indexing in the late-90's did so from a *performance* perspective, not the long-term philosophical perspective we believe is the foundation for rational investing.
- 2) Despite the “purist” cries that either an S&P 500 or Total Market index fund is the only way to index, many investors realized too late that these indexes are dominated by large

Category	Official 10-Yr. Return	Dollar-Weighted 10-Yr. Return	Difference
Large Growth	7.8%	4.4%	-3.4%
Large Blend	9.1	7.5	-1.6
Large Value	10.0	9.6	-0.4
Small Growth	8.4	5.4	-3.1
Small Blend	11.3	9.0	-2.4
Small Value	13.6	11.6	-2.0
<b>Sector</b>			
Health	12.5	8.5	-4.0
Communications	8.4	3.0	-5.4
Technology	7.7	-5.7	-13.4
<b>Fund</b>			
Vanguard 500	10.2	6.5	-3.7
Janus Mercury	10.1	-3.9	-14.1
White Oak Select Growth	8.2	-14.7	-22.9

Source: Morningstar, Inc. Returns are ended April 30, 2005.

growth company stocks. Those seeking greater balance among the over 9,000 publicly-traded stocks in the U.S. must look beyond these funds for asset class diversification.

- 3) The 3.7% *cost* index fund investors incurred from their bad market timing mistakes could have been eliminated, or at least significantly reduced, with the help of an investment advisor who emphasizes greater portfolio balance and diversification and is committed to a disciplined buy-hold-rebalance philosophy.

This last point is something advisors like me know from experience, but are forced to talk about anecdotally as one of the intangibles of an advisor relationship. It can be an especially touchy subject for an investor who believes he or she possesses the discipline to survive market ups and downs on their own—whether they are broadly diversified in the first place (like TAM clients) and occasionally experience returns very different from “the market” or they are riding the inevitable roller coaster that concentration in one asset class can produce. Most investors believe they are disciplined; our experience is that few are.

This opinion is reinforced by the fact that we know of many

*advisors* who lost their focus and commitment to a disciplined strategy during periods like the late-90's and made the same mistakes as individual investors. If full time investment professionals lack discipline when it is needed the most, what should we realistically expect from the average “do-it-yourself” investor?

Year	Janus Mercury % Return	Total Assets (in billions \$)	White Oak Sel. Growth % Return	Total Assets (in billions \$)
1998	58.4	3,112	39.5%	1,092
1999	96.2	13,543	50.1	2,725
2000	-22.8	13,345	3.6	5,503
2001	-29.8	8,438	-39.1	3,487
2002	-29.0	4,879	-40.0	1,804
5-Yr.	3.7		-4.5	

Source: Morningstar, Inc. Returns are for calendar years.