



ASSET CLASSSM

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

February 2006

Asset Class Returns

	2003	2004	2005	Last 10 yrs.	YTD 1/2006
Bonds					
Short-term	1.6	0.9	2.3	4.3	0.3
Five-Year	3.0	2.9	1.7	6.1	0.1
Intermediate	2.5	4.3	1.6	6.2	-0.1
Long-term	2.7	7.1	6.6	7.1	-0.9
U.S. stocks					
Large Market	28.5	10.7	4.9	8.9	2.7
Large Value	34.4	18.2	10.2	11.9	4.7
Small Micro	60.7	18.4	5.7	13.6	9.1
Small Market	51.5	17.9	6.1	11.8	9.1
Small Value	59.4	25.4	7.8	15.9	8.8
Real estate	35.6	32.1	13.2	15.1	7.7
Int'l stocks					
Large Market	36.7	18.8	13.5	6.2	5.8
Large Value	49.4	28.8	15.3	9.2	6.8
Small Market	58.8	30.9	22.0	N.A	6.9
Small Value	66.5	34.8	23.2	10.2	7.3
Emerg. Mkts.	60.2	29.9	29.9	8.5	9.5

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 12/31/05.

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Past performance is no guarantee of future results.

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Stewards of Capitalism

Jeff Troutner, TAM Asset Management, Inc.

“We are, or ought to be, the stewards of our clients’ capital. And to do that job right, we have to be stewards of capitalism, i.e. free-market economics...” So stated Nick Murray, a long-time consultant to the investment industry, in the January 2006 issue of *Financial Advisor* magazine.

I couldn’t agree more. In fact, since our asset class investing style benefits from one of the most successful pillars of our capitalistic system—an extremely efficient and active securities market—it would be irresponsible to *not* promote free-market principles to our clients. Phil Jonckheer, president of Dynamic Funds Management (DFM), did this very well in an article for DFM’s version of *Asset Class* last November. In that article he reminded us of the successful transition from socialism to capitalism that the early Plymouth and Jamestown colonies experienced in the early 1600’s. I thought it would be useful to bring the discussion up to the current times given the exceptional growth in our economy over the past few years. This growth has been fueled in no small part by classic free-market thinking. But before I go on, let’s define “capitalism” and “free-markets.”

Capitalism

An economic system in which the means of production and distribution are privately or corporately owned and development is proportionate to the accumulation and reinvestment of profits gained in a free market. *Source: The American Heritage® Dictionary of the English Language, Fourth Edition Copyright © 2000 by Houghton Mifflin Company.*

Free-Market

A market economy based on supply and demand with little or no government control. A completely free market is an idealized form of a market economy where buyers and sellers are allowed to transact freely (i.e. buy/sell/trade) based on a mutual agreement on price without state intervention in the form of taxes, subsidies or regulation. *Source: Investopedia.com Copyright © 1999-2005*

The stock markets of the U.S. and developed countries are probably the best examples of capitalism and free-markets at work. Except for the impact of taxes on capital, which I’ll get to in a moment, these markets reflect the free exchange of shares in public corporations among willing buyers and sellers. The prices that result from this exchange are as close to fair value for these companies as can be expected. One proof of this is the failure of the vast majority of professional stock pickers (upwards of 80%) to outperform an unmanaged index like the S&P 500 over time.

In other words, just as intellectual elites in countries such as the former Soviet Union and China failed in their efforts to centrally-plan and manage the means of production and distribution in their economies (while managing to starve millions of their citizens off and on for decades), so too have the intellectual elites among highly-educated investment professionals found it difficult to beat the free-market pricing of all other investors acting in their own best interests. This is why Rex Sinquefeld of Dimensional Fund Advisors has often said that the only people in the world who do *not* believe in free-markets are the North Koreans, Cubans, and active money managers.

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TAM clients are direct beneficiaries of free-market capitalism through our investment in asset class index funds and we are, in effect, exploiting all those investors who still cling to the false promise of active management. But the benefits of indexing, indeed all forms of investing, are reduced by government interference. The most obvious examples of this are taxes on capital. The double taxation of dividends—first at the corporate level and then at the shareholder level—is not only immoral; it has also discouraged corporations from paying out higher dividends to shareholders. This has the effect of allowing an intellectual elite in the boardrooms of America to make decisions on how best to allocate surplus capital, rather than the shareholders they are charged to serve.

Shouldn't professional managers know how to spend shareholder money more wisely than the shareholders themselves? In many cases, perhaps. But far too often excess capital is wasted on excessive compensation packages for executives or on misguided mergers and acquisitions. How many Enrons, Worldcoms, GMs, etc. do we need before we're convinced that the money might be better placed in the hands of shareholders? It's not unlike the problem we have with excess tax "capital" in the hands of politicians.

The economy would benefit greatly from the pass-through of more surplus capital to shareholders who can then decide whether to invest in additional shares of the company or provide capital to other companies—either indirectly through the secondary market or via initial public offerings or private investments. This barrier to efficient capital flow is contrary to free-market principles. And lo and behold, after Congress voted to reduce the tax on dividends to 15% from 39.6% in 2003 corporations have increased their dividend payouts *threefold*.

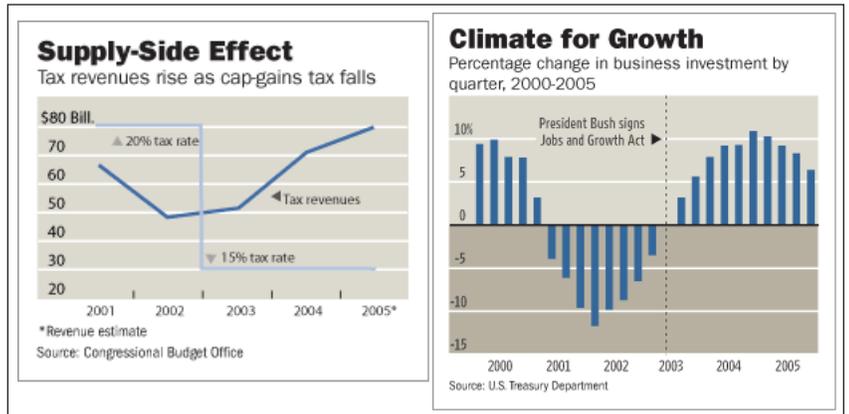
The tax cut on capital gains in 2003 has had a similar effect. A central tenet of supply-side economics (too often a politically-charged term) is that government revenues can actually increase as tax rates are cut. After the capital gains rate dropped from 20% to 15%, the government has seen capital gains tax realization increase from \$269 billion in 2002 to \$539 billion in 2005, resulting in additional revenues to the Treasury of \$80 billion last year, up from \$49 billion in 2002. Part of this gain is due to the overall increase in stock prices, which no doubt responded to a more positive tax environment. The "unlocking" effect of investors selling low cost-basis stock has also been dramatic.

There is little doubt in my mind that much less money would have been lost during the meltdown in large growth and technology stocks after the market peak in 2000 if investors had been able to realize their gains without significant tax burdens. Many investors recognized the ridiculous levels some stocks had reached, but they made the error of believing that the tax hit would be worse than any market decline. They were wrong. Allowing investors to reallocate capital to sectors that were not experiencing historically high price inflation might have kept the lid on prices overall and prevented such a devastating correction later on.

Ah, but tax cuts on capital are "tax cuts for the rich," right? Well, not really. Rich people who own stocks benefit, of course. But so do the millions of investors who own stocks through mutual funds in 401(k) plans. Although these investors do not pay taxes on their investments in these plans (yet), they would undoubtedly benefit

from the positive effect on stock prices that more efficient allocation of investment capital would generate. And millions of *middle-class* investors own stocks and mutual funds in taxable accounts and have benefitted by these tax cuts.

The positive effects of reducing the barriers to capital flow and cost of capital have been fairly dramatic since they were implemented in 2003. The first chart below shows the rise in tax revenues since the capital gains rate was cut to 15% and the second chart shows economic growth since then.



The former Soviet Union and the other failed socialist states are the extreme examples of what anti-capitalistic and anti-free-market principles can do to economies. It isn't surprising then that several of the old Eastern Bloc nations have adopted relatively low *flat tax* systems. Unfortunately, "Old Europe" still suffers from the socialist influences that invaded their shores decades ago. The growth trends in the three largest European economies of Germany, France, and Italy are falling to levels relative to the U.S. that we haven't seen since the 1970's. Comparing Gross Domestic Product (GDP) per capita between countries, Jean-Philippe Cotis, chief economist at the Paris-based Organization for Economic Cooperation and Development (OECD), told the *Wall Street Journal*, "At current trends, with demographics the way they are, the average U.S. citizen will be twice as rich as a Frenchman or a German in 20 years."

No one in their right mind would advocate a free-market system without limits. Antitrust laws to prevent monopolies, accounting rules to prevent fraud, and reasonable taxes on income or consumption all provide benefits to our economy. But barriers to capital flow, restrictions on trade, industry subsidies, and other forms of "corporate welfare," all have negative effects that hold our economy down in varying degrees. As we continue to transition to more of a "knowledge" economy it is critical that our government leaders recognize this and fight the urge to try to manage the economy beyond what the Federal Reserve can do through Greenspan-inspired monetary policy.

