

Lowly Analyst Newsletter

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CurtFey.com

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The Economy and the Markets Index Funds II

The Economy and the Markets

Nothing has fundamentally changed in the economy and the markets in the last few weeks except psychology. If you have a well diversified portfolio at an acceptable risk level you do not have to worry. The current abnormal low volatility increased. This may require portfolio adjustments to lower risk. Fundamentals and psychology compete. Don't know what will win.

The effect on world markets of the drop in Thailand's Bath and the China drop in Feb. show the growing influence of the developing markets.

The US economy is losing steam. Our GDP growth rate in 4Q '06 was a paltry 2.2%; inflation was 2.7%. Our consumer spending weakened. This performance does not seem to have affected the rest of the world. GDP growth is as follows: China 10.5%, India 8.3%, Argentina 7.9%, Russia 6.7%, Spain 4.8%, Japan 4.8%, Euro Area 3.6%.

Of course the real test will come next year when the economies slow down and the effect falling home prices will have fully influenced US consumer spending.

Asset Classes: For the 6 months up mid value 13 %, mid growth 11%. small value 10%, large value 10%, large growth 9%, micro 9%.

Sectors: For the 6 months, Real Estate up 21%, Basic Matrl.16%, Consumer Srv. 14%, Telecom 14%, Transportation 13%, Networking 13%, Industrials 11%, Tech. 11%, Utilities 10%, Software 10%, Gold 10%,.Financial 8%, Biotech.5%, Healthcare 3%, Energy 3%, Commodities 0%.

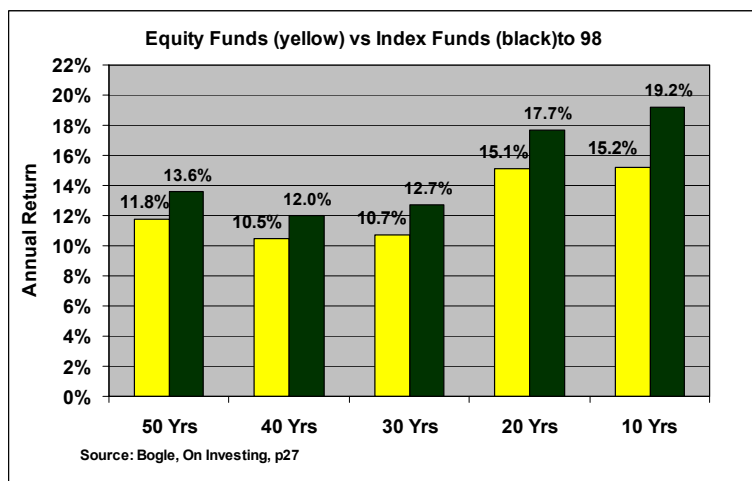
Foreign Investing: For the past 6 months Malaysia up35%, China 26%, Singapore 23%, Mexico 21%, Brazil 20%, Poland 18% Russia 17%, Latin America 17%, Denmark 17%, So. Africa 15%,China %, Indonesia 15%, Emerging Mrkts. 14%, Sweden 14%, Austria 14%, Germany 13%, Spain 12%, Taiwan 12%, Hungary14%, Australia 12%, Hong Kong 11%, Pacific Rim 11%, India 11%, Israel 10%, Czech Rep.10 %, Developed Mkts. 8%,Europe 8%, Canada 8%. Japan 6%, Britain 5%.

Index Funds II

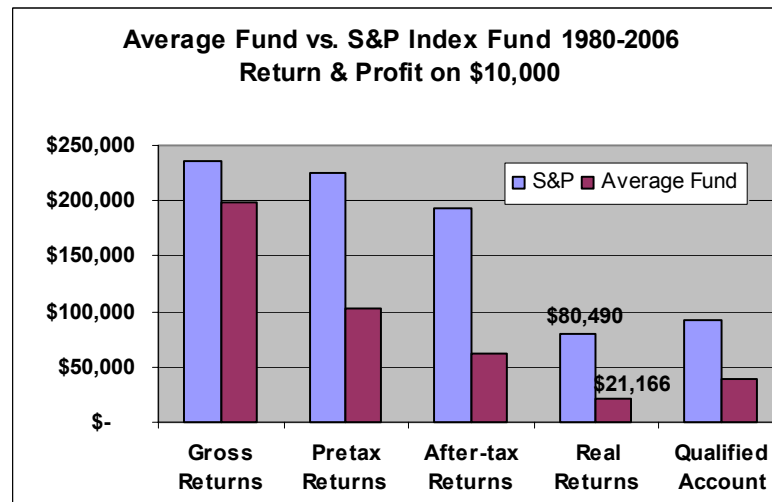
1. Introduction

This discussion is a continuation of examining various asset class funds. See my website www.CurtFey.com for past newsletters.

In a previous newsletter we showed that index funds have outperformed actively managed funds. (See chart below). We now examine which index funds perform best, in what asset classes they perform better and why index funds outperform.



Previously we showed that what matters is your return after inflation, taxes, and fees, i.e. what you can take home. Since much of your return is eaten by inflation, taxes and fees, the index fund advantage is leveraged. The amount of money you bank from index funds is many times that of actively managed funds. See chart below. A big part for the reduction in bankable returns is inflation.

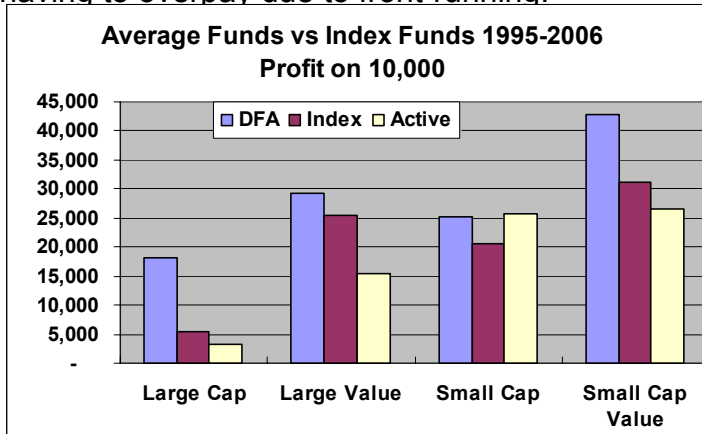


2. Not all Index Funds are Created Equal

In the current discussion we focus on the differences among index funds. We look at an outstanding family of funds--[Dimensional Fund Advisors Funds \(DFA\)](#). This is one of the largest and fastest growing family funds with \$70 Billion under management, primarily institutional money. You may not have heard of the family, since these funds cannot be bought by individuals. However, in addition to institutions, a few highly selected advisors (like myself) can use them

The funds are very academically managed, tied to the [U. of Chicago Business School](#) and its Nobel Prize winners. They are the only pure index funds, clearly defining the asset class, without asset class drift. They hold many more stocks in each class than the ordinary index fund. They perform exactly like the class. This performance attracts institutions.

DFA avoids calling their funds names like S&P fund, hence no licensing fees and signing licensing agreements. This means they do not have to buy stocks on the day they go in and out of the index, having to overpay due to front-running.



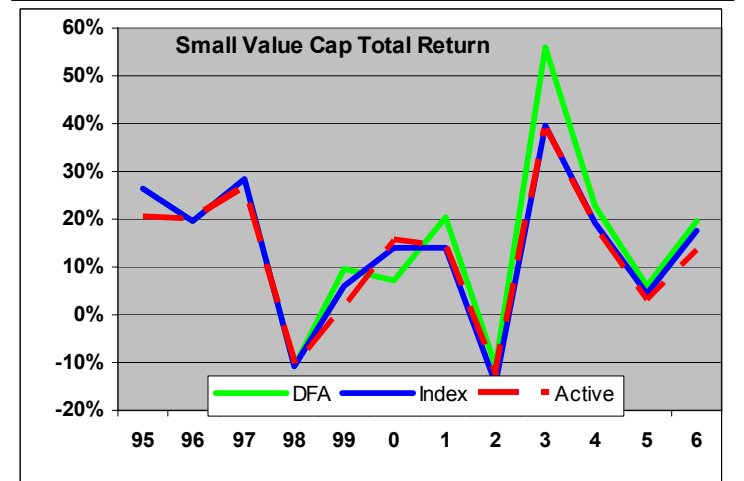
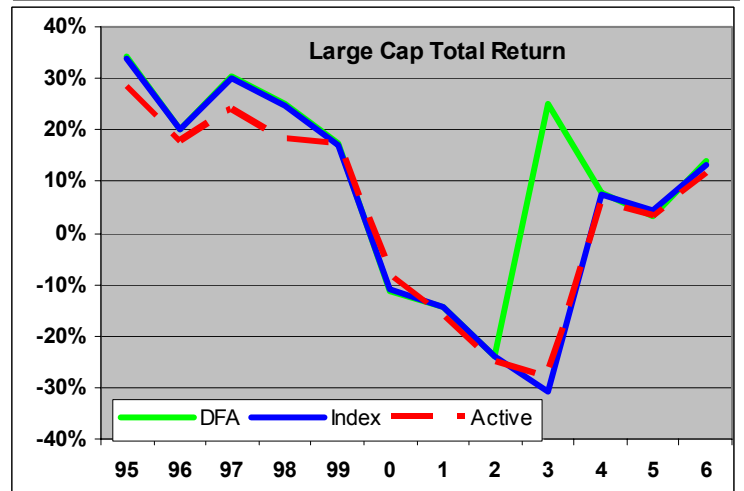
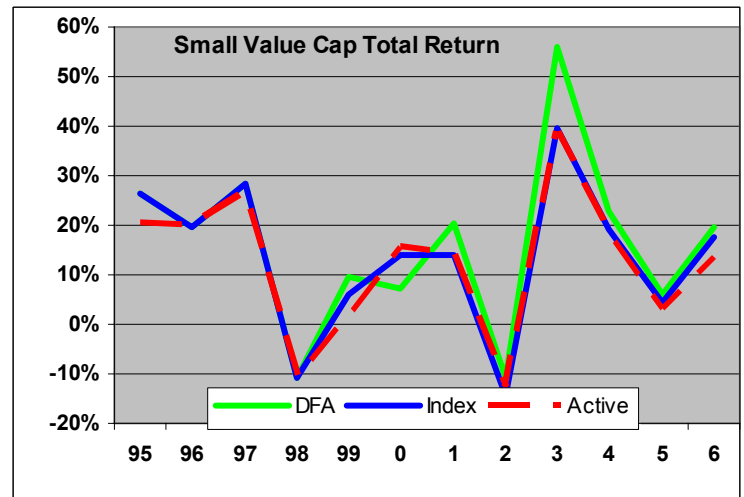
3. Where Do Index Funds Outperform?

Index funds outperform in efficient markets. Some markets like small cap growth stocks are not efficient since they contain a large share of very small firms with large insider holdings, with low trading volume, and very little public information.

4. Why Do Index Funds outperform?

Index funds in general outperform by a small amount but they do so substantially after large drops on the subsequent peak. See the charts below.

Actively managed funds sell stocks when the market falls and are late to buy them back. Index funds are always fully invested in all the stocks in the asset class so they are invested continually in any shares that later go up.



5. Summary

We showed that index funds outperform actively managed equity funds in most time periods, that the modest amount of outperformance makes a huge difference in your gain because inflation, fees, and taxes reduce your purchasing power. We also showed that some fund families are better than other and why index funds perform better in efficient markets.