

# Lowly Analyst Newsletter

Volume 6, Issue 7 July Free Newsletter  
Website [www.CurtFey.com](http://www.CurtFey.com)

## In this issue:

**The Economy and the Market**  
**The Best Small Cap Index Funds**  
**Xerox 401(k) Funds**

### The Economy and the Market

Most markets declined for 2 months. What should you do? If you have a diversified portfolio, stay the course. For the 20 years from 1986-2005 investing in the S&P 500 index provided an annual return of 11.9%, but the average equity investor obtained only 3.9% (Dalbar, *Quantitative Analysis of Investor Behavior*). The study shows that investors cannot gauge the direction of declining markets. The biggest mistakes investors make is fueled by seeking to avoid losses.

If you realize that your portfolio is riskier than you can tolerate gradually reduce the risk over time. This is not a good time to sell stocks.

Not only has the market gone down in the last month but volatility has increased by 30%.

Market neutral funds have sprung up aiming at making returns higher than money market funds both in up and down markets. Unfortunately no fund with a 5 year track record could do that. Stay away from them.

In client portfolios I continue to hold a diversified portfolio of institutional index funds, REIT's, and Natural Resources

**Asset Classes:** For the 6 months, small-value up 10%, mid value 6%, small growth 6%, large value 6%, micro-cap 5%, mid growth 2%.

**Sectors:** For the 6 months, Transportation 17%, Natural Resources 13%, Energy 12%, REIT's 12%, Telecom 12%, Basic Materials 8%, Industrials 7%, Healthcare 7%, Financials 3%, Utilities 3%, Consumer Services 2%.

**Foreign Investing:** For the past 6 months Peru 73%, Venezuela up 47%, China 42%, Russia 26%, Commodities 18%, Indonesia 15%, Poland 13%, Spain 12%, Latin America 11%, Developed Markets 10%, Brazil 9%, Pacific Rim X Japan 9%, France 8%, Belgium 7%, Germany 7%, Britain 7%, Sweden 7%, Italy 6%, European Monetary Union 5%, India 5%.

Canada 4%, Singapore 4%, Emerging Markets 3%, Japan -6%, Columbia -36%.

## Best Small Cap Index Funds

### 1. Introduction

This is a continuation of last month's discussion of large cap index funds and ETF's. In general index funds perform better than actively managed funds over long periods of time. But no one investment is best for all people or at all times. You can't go wrong by investing in any of the funds mentioned here. But index funds differ greatly in how they are constructed. The difference in construction is the key reason for differences in performance. The funds are listed in order of preference. Their long term performance is similar. Below is a review of the characteristics of small cap index securities for various situations.

Dimensional Fund Advisors funds are the only pure sector funds. They meticulously stay by their definition within the sector. Their definition differs from that of others. They have no sector drift. DFA funds can be bought by institutions and through a few select advisors like myself.

### 2. Mutual Funds vs. ETF's

See last month's letter for a discussion.

### 3. Small Cap Funds

It is best to have a diversified portfolio; hence you should include small cap and small cap value funds. Small cap stocks have better long-term risk adjusted returns than large caps and do not correlate well with large cap. Therefore they provide diversification but they are generally more volatile than large caps and their trading costs and management fees are higher. Adding small cap stocks, particularly micro caps to large caps should improve the portfolios risk return relationship.

The definition of small cap varies from fund to fund both in how large and how small a company is included.

For each of the funds a number of measures are shown. Risk grade is a measure of volatility. A volatility of 20%, the average volatility of the world markets, has a risk grade of 100. The risk grade is an exponentially smoothed average

over the last 151 days. The recent days count more. The risk grade of any security changes daily; it is a measure of the current risk.

Two other risk measures are provided. Bear market decile indicates how well the asset performed in bear markets; the lower the number, the better. The volatility is the 5 year standard deviation; it measures the long term risk. Finally the Sharp ratio provides the ratio of return to risk; the higher the better.

#### **4. Small Cap for Tax Deferred Accounts**

Some of the best index funds are listed here. In any one time period the performance ranking will change.

**Dimensional Tax-Managed US Small Cap (DFTSX):** Risk Grade 101, Bear Market Decile 8, Volatility 14.9%, Risk Return 1.23, Micro Cap 1%, Expense 0.55%.

**Dimensional US Small Cap Portfolio (DFSTX):** Risk Grade 100, Bear Market Decile 7, Volatility 14.8%, Risk Return 1.18, Micro Cap 24%, Expense 0.40%.

**Dimensional US Micro Cap Portfolio (DFSCX):** Risk Grade 96, Bear Market Decile 6, Volatility 15.4%, Risk Return 1.24, Micro Cap 61%, Expense 0.55%.

**Bridgewater Ultra-Small Company Market Fund (BRSIX):** Risk Grade 87, Bear Market Decile 2, Volatility 15.7%, Risk Return 1.32, Micro Cap 72%, Expense 0.25%.

**iShares Russell 2000 (IWM):** Risk Grade 111, Volatility 14.6%, Risk Return 1.10, Micro Cap 15%, Expense 0.20%.

**iShares Morningstar Small Core (JKJ):** Risk Grade 99, Volatility 12.3, Micro Cap 1%, Expense 0.25%. Only 2 years old.

**iShares S&P Small Cap 600 Fund (IJR):** Risk Grade 100, Volatility 13.6%, Risk Return 1.31, Micro Cap 8%, Expense 0.20%.

**Vanguard Small Cap Index Fund (NAESX):** Risk Grade 94, Bear Market Decile 7, Volatility 13.2%, Risk Return 1.30, Micro Cap 4%, Expense 0.23%.

**Vanguard Small Cap VIPERs (VB):** Risk Grade 95, Bear Market Decile 1, Volatility 13.2%, Risk Return 1.30, Micro Cap 4%, Expense 0.10%.

#### **5. Small Cap for Taxable Accounts**

Small Cap index funds do not usually have large tax consequences.

**Dimensional Tax-Managed US Small Cap Fund (DFTSX)** is the most tax effective fund.

#### **6. Small Cap Value for Tax Deferred Accounts**

Stocks are often divided into value and growth stocks. Contrary to what one may think, value stocks have in general higher volatility and higher return. Value stocks have low book to market value. In that sense they are bargains.

**Dimensional US Small Cap Value (DFSVX):** Risk Grade 99, Bear Market Decile 4, Volatility 15.2%, Risk Return 1.55, Micro Cap 30%, Expense 0.55%.

**Dimensional Tax Manged US Small Cap Value (DTMVX):** Risk Grade 100, Bear Market Decile 7, Volatility 14.7%, Risk Return 1.46, Micro Cap 25%, Expense 0.55%.

**streetTRACKS Wilshire US Small Cap Value (DSV):** Risk Grade 90, Volatility 13.0%, Risk Return 1.22, Micro Cap 5%, Expense 0.26%.

**iShares Russell 2000 Value (IWN):** Risk Grade 109, Volatility 13.2%, Risk Return 1.33, Micro Cap 16%, Expense 0.25%.

**iShares S&P Small Cap 600 Value (IJS):** Risk Grade 104, Volatility 13.8%, Risk Return 1.34, Micro Cap 10%, Expense 0.25%.

**Vanguard Small Cap Value (VISVX):** Risk Grade 83, Bear Market Decile 5, Volatility 12.0%, Risk Return 1.47, Micro Cap 5%, Expense 0.23%.

**Vanguard Small Value VIPERs (VBR):** Risk Grade 86, Bear Market Decile 5, Volatility 13.2%, Risk Return 1.33, Micro Cap 5%, Expense 0.12%.

**iShares Morningstar Small Value (JKL):** Risk Grade 90, Expense 0.30%.

**Dimensional Tax-Managed US Small Cap Value (DTMVX):** Risk Grade 99, Bear Market Decile 4, Volatility 19.2%, Risk Return 1.57, Micro Cap 33%, Expense 0.27%.

**Dimensional Small XM Value (DFFVX):** Risk Grade 91, Bear Market Decile 6, Volatility 14.0%, Risk Return 1.58, Micro Cap 8%, Expense 0.47%

#### **7. Small Cap Value for Taxable Accounts**

Small Cap value index funds do not have large tax consequences.

**Dimensional Tax-Managed US Small Cap Fund (DFFVX)** is the most tax effective fund.