

A Different Dimension

BY BEVERLY GOODMAN

It was 7:30 on a sunny October morning in Austin, Texas, and class was about to start. Most students were finishing their coffee and chatting about how they were looking forward to hearing professor Eugene Fama, the University of Chicago economist who a week earlier had won the Nobel Prize. The program, however, wasn't your typical grad-school seminar. It was orchestrated by Dimensional Fund Advisors, the \$332 billion mutual-fund firm whose investment strategy is based on Fama's early and ongoing research; and the students were the financial advisors who sell its funds.

This was no boondoggle business trip. The College, as it's known, is a two-day, biannual event that draws more than 100 advisors from all over the nation for some very academic presentations, held in a lecture hall the firm built just for this purpose. The advisors are already sold on the veracity of the efficient-market hypothesis pioneered by Fama in 1965 -- they have to be in order to sell Dimensional's funds -- but they come to hear about new research, and new products and strategies, and for the chance to hear the gospel from the prophet himself.

Dimensional Fund Advisors is unusual. Its fans are true believers, bordering on evangelical, yet it is hardly a household name like other fund firms of its size. (About 85% of DFA's assets are in mutual funds, making it the eighth-largest fund family, sandwiched between JPMorgan and Oppenheimer Funds.) That relative anonymity is by design: The firm doesn't advertise; it sells its funds only through advisors who have undergone a rigorous screening; it doesn't sell its funds on most brokerage platforms; and it's privately held. Because its funds are essentially quantitative -- driven by computer models, rather than by individual security selection -- there are no star managers. Though it doesn't eschew the press,

it's careful to work only with reporters who "get" what it does; this was the first time a reporter had been invited to the College.

And yet its overall performance is headline-worthy. More than 75% of its funds have beaten their category benchmarks over the past 15 years, and 80% over five years, according to Morningstar -- remarkable for what some investors wrongly dismiss as index investing. Its process is simple and repeatable -- and yet no other firm has tried emulating it. When asked why, co-founder, chairman, and co-CEO David Booth, 67, draws a surprising analogy to Star Wars, and Luke Skywalker's inability to harness the power of the Force until his devotion was deep and unwavering. "We are believers down to our toes," Booth says.

The force, in this case, is the theory of efficient markets, first put forth by Fama in 1965. Dimensional's funds all operate on the same principles -- that it's hard to beat the market, and impossible to do it consistently, by stock-picking. There are, however, various factors that can be exploited to provide market-beating returns. That, along with sophisticated trading strategies, a keen eye toward tax-efficiency, and low expenses (the average DFA fund charges just 0.39%) has led to Dimensional's success.

But don't liken what DFA does to indexing, and definitely don't call it passive: "I recoil when people think that what we do is being passive, because it has nothing to do with being passive," Booth says. "We are trying to beat the market without forecasting in the usual sense."

DAVID BOOTH met Fama while a Ph.D. student at the University of Chicago in the fall of 1969. (His alma mater is now known as the Booth School of Business, thanks to a \$300 million donation he made in November 2008.) Booth took Fama's class "the very first quarter"

and, in his second year, worked for him. "We've been associates for 44 years," Booth says.

Booth graduated in 1971, and 10 years later, along with Rex Sinquefeld, another student of Fama's, launched Dimensional Fund Advisors from his apartment in Brooklyn, N.Y. Sinquefeld served as chief investment officer until 2005, when he left to devote more time to his political causes. He served on the Dimensional board until last summer, when he retired completely from DFA.

From the beginning, Booth wanted to put Fama's findings into practice. "Gene describes himself as taking an idea and beating it to death," Booth says with a laugh. "That's not me. I want to apply the idea."

Dimensional's director of investment strategy is Kenneth French, an economist and professor at Dartmouth College, and a collaborator with Fama for nearly 30 years. The Fama-French "three-factor" model is the root of Dimensional's strategy, and their ongoing work has informed the development of new strategies and products for decades. "They expect Ken and I to say exactly what we think about things, and we do," Fama says. "Other firms use our work; they just do it without our input. Dimensional is the only business that will tolerate me."

Fama and French are not the only academics on Dimensional's board, and Fama isn't even the only Nobel Prize winner. Myron Scholes of Stanford University, who won in 1997 for the Black-Scholes method for valuing derivatives, lends his expertise to the funds' board. Also on the board are Roger Ibbotson, the founder of research firm Ibbotson Associates, a current hedge-fund manager, and Yale professor, and four other academics, from Chicago and Stanford. "That lineup is unbelievable," says co-CEO Eduardo Repetto. "When you talk to the board about investments, you're not talking to

marketing people. You're talking to the people who wrote the book on investing." Repetto is no slouch in the academics department himself -- in fact, he's a rocket scientist. He joined Dimensional almost 14 years ago, shortly after completing his Ph.D. in aeronautics at the California Institute of Technology and, like Booth, deciding that a career in academia was not for him.

THE FIRM TAKES its academic bent seriously. DFA began where Fama's research began -- on the assumption that stock-picking is too inconsistent and unpredictable to be a reasonable method of beating the market. Sure, every year, some active managers will outperform; some will even outperform several years in a row. But that doesn't indicate skill, Fama says. "With 3,000-plus active managers, some are going to look good -- but that's what you'd expect as a matter of chance," he says. "It's very difficult to tell luck from skill." Even to the extent that skill is involved, stock-picking is not a repeatable process with the consistency and persistence of returns that would enable investors to anticipate which managers are likely to outperform -- especially given the cost of making those bets. "Active management is a zero-sum game, and that's before costs," Fama says. "That's not opinion. That's math."

The firm began with a focus on small and micro-cap stocks, a specialty that it's still best known for. Small stocks underperformed for the first nine years of its existence, yet DFA grew to a \$4 billion firm by 1990.

In 1992, Fama and French published their three-factor model, which incorporated and expanded on the established capital asset-pricing model, demonstrating that low-priced (value) stocks and small-company stocks have higher average returns. Dimensional incorporated the three-factor model into its funds right away.

Dimensional is overwhelmingly equity-driven, with 78% of its assets in stocks. Though most of Fama and French's work has been in equities, their method can be applied to fixed income -- bonds have two factors, maturity and credit quality -- and Dimensional offers 20 bond funds. But many advisors use other firms for their fixed-income allocation.

DIMENSIONAL'S FUNDS aim to capture the returns of an asset class -- be it small or large companies, developed or emerging markets -- without slavishly adhering to an index. And they do. For example, take the Vanguard Small Cap Value index fund (VISVX), which is

based on the S&P 600 Small Cap Value index and is the counterpart to Dimensional's DFA US Small Cap Value (DFS VX). The DFA fund has a much smaller tilt -- its average market value is \$1.1 billion, versus Vanguard's \$2.7 billion -- and on all measures is much more value-oriented. So the Dimensional fund better captures the market-beating advantage of small and value stocks. In fact, a lot better: The DFA fund returned 42% in 2013, beating 88% of its peers in Morningstar's small-cap value category, versus the Vanguard fund's 36% return, which beat just 53%. Over 15 years, which includes periods that were less favorable to small and/or value stocks, DFA's fund returned an average of 12% a year, beating 80% of peers. The Vanguard fund returned 10% on average, beating just 37% of peers.

The Dimensional fund costs twice as much as Vanguard's -- 0.52% versus 0.24% -- but the significant out-performance more than makes up for that difference.

TRADING IS ALSO a crucial factor in DFA's outperformance. Index funds trade in baskets -- whenever a stock is added or dropped from the index, it's bought or sold almost immediately, which can drive the price up or down. Similarly, active managers often want to get into or out of a stock quickly. DFA, however, takes a more methodical, opportunistic approach to trading. There's never pressure to buy or sell a fund within a certain time frame. Instead, it serves as a market-maker for the 14,000 stocks it owns, offering to sell when frenzied buying has sent the bid higher, and taking a stock off another trader's hands when the shares can be acquired cheaply. Every morning, traders get a list of stocks the firm wants to buy or sell, but instead of mandated trading orders, the trading desk determines if conditions are good for each transaction. "We go into the market and see where the most anxiety is and where we can trade at favorable prices," says Booth. "We provide liquidity."

Trade execution is critical to another factor that Fama and French added to their model more recently: Stocks that are falling tend to continue to fall, and those that are rising tend to continue to rise. "So you want to trade slowly," Booth says. "We are slow to trade most of the new names that have recently fallen into the value category, because they are negative-momentum stocks. We're also slow to sell positive-momentum stocks. We'll hold on for years."

Trading costs have also influenced portfolio construction, as have the sharp

advisors that work with the firm. Dimensional's 5,000-stock international core funds, for instance, were created at the behest of the firm's largest client, \$22 billion Buckingham Asset Management. The international core fund combines developed and emerging markets, minimizing the trading costs that would occur, say, when a country like Israel or South Korea "graduates" from the emerging to the developed category. Rather than one fund selling and another buying, advisors who want exposure to both asset classes can get it in one fund. "That eliminates risk and costs, and we don't have to rebalance," says Larry Swedroe, a principal at Buckingham. "That's a huge advantage, and a big innovation." Dimensional also has a 3,000-stock U.S. core fund.

Dimensional has 76 funds, many of which overlap because of its willingness to work with advisors to meet their needs. "We have several versions of our core portfolios to accommodate advisors who want more or less of a small or value tilt," Repetto says.

The latest factor, profitability, has been steadily implemented since being introduced in four funds a year ago; it will be a factor in all DFA funds by early this year. The profitability factor incorporates firms with higher profitability relative to price, cash flow, or other metrics. That's essentially the secret behind Warren Buffett's success. Investors tend to pay too much for -- or, in other words, not apply enough of a risk discount to -- "lottery" stocks. Think of a bell curve of stock returns: You'll see far more returns to the left of the mean, and a few outsize winners on the right. That market's willingness to pay for the small chance of outsize gains means that other profitable firms, relatively speaking, have lower prices.

DIMENSIONAL'S FRATERNITY of 1,900 advisors manages 60% of its assets. Though advisor-sold, all its funds are no-load, and Dimensional doesn't have any revenue-sharing agreements. But advisors can't simply decide to start working with DFA; they first must overcome several hurdles.

"We have a lengthy front-end process," says Dave Butler, who oversees DFA's advisor network. "Our goal is to be a consultant to the advisors." First, they attend a small conference that explains the research that the firm is based on, and how Dimensional operates. After that, a DFA regional director makes an office visit to discuss the advisor's investment philosophy, the plan for DFA funds, and how the transition will be communicated to clients.

It took Bud Kahn, a Pittsburgh advisor managing \$150 million, nearly six months to be "permitted" to sell DFA funds. That was seven years ago. Now 90% of his firm's assets are in DFA funds. "DFA adds value to my practice," he says. "They serve as a board of directors. They help evaluate my models, help me plan the future of my business; they even helped with a new Website."

Advisors aren't required to sell only Dimensional funds, but they are expected to generally run their business in accordance with the broad philosophy of market efficiency, a long-term view, and an emphasis on low-cost products. That's good for the investor, and also good for Dimensional. "Advisors who have gone through our process, who have the right language, and approach the market the way we do, have a much better ability to keep client assets deployed in the market," Butler says. "Look at 2008 and 2009 -- we had positive cash flows in both years. I don't think there's any other money manager that can say that. I credit the advisors; they kept their clients on track."

Advisors selling DFA funds have monthly or quarterly meetings with one another, facilitated by a DFA manager, to discuss portfolio and practice management. And there's the College, held every two years. This year, as usual, Fama and French spoke, with Fama presenting 18 pages of data arranged neatly in columns (later referring to it as "pretty low-level stuff"), and French explaining it all. Behavioral-finance expert Brad Barber also spoke, as did an array of Dimensional execs to tie it all into the business. "DFA has far and away the best educational conferences," says Rick Ferri, who manages \$1.3 billion, \$100 million of which is with DFA. "They put Ph.D.s in front of you. Everyone else gives you marketing people."

THE CHIEF CRITICISM -- and it's a fair one -- is that the very nature of the way Dimensional operates can keep their funds out of reach for investors with assets too low to pique the interest of most advisors. Booth acknowledges the problem, saying that eventually advisors will have Web-based services that allow them to take on smaller clients. "We're working with advisors to address that market," he says. "I won't hold my breath, but I think there's hope."

Even for investors who work with advisors, it's not easy to get into a Dimensional fund. There's no shortcut to the advisor-approval process, and DFA doesn't work with any full-service brokerages, though it does work with certain

advisors at independent broker-dealers, such as LPL Financial and Raymond James. For many, investing with Dimensional requires hiring a new advisor.

The firm is expanding its reach, however, hoping for a larger piece of the \$18 trillion 401(k) market, of which it has just \$25 billion. Its 2010 purchase of SmartNest, a software platform developed by MIT economist and Nobel laureate Robert Merton and Boston University professor Zvi Bodie, serves as the engine for Dimensional's "managed DC" product.

Managed DC is a simple Web interface that takes the focus off accumulation and asset allocation and instead puts it on the likelihood that an individual's plan will generate the income he or she will need in retirement. Instead of choosing funds and making asset-allocation decisions, investors input their contribution amounts and expected income needs. Dimensional adjusts each individual's portfolio mix -- made up of one global stock fund and two inflation-protected bond funds of different durations.

NO MATTER how investors access their funds, Booth says, Dimensional's strategy requires staying the course. "Where people get killed is getting in and out of investments," Booth says. "They get half-way into something, lose confidence, and then try something else. It's important to have a philosophy."