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MUTUAL FUNDS MONTHLY REVIEW

The Dimensions of a Pioneering Strategy

Two Classmates Paired To Test Academic Ideas; Investors' 'Boot Camp'

By Joanna L. Ossinger

NESTLED BY the Pacific Ocean, in Santa Monica, Calif., money-management firm **Dimensional Fund Advisors** Inc. may be one of the mutual-fund world's least known revolutionaries.

For 25 years, Dimensional has walked a path between "active" money management—in which stock pickers use research to choose individual shares for a portfolio—and the passive investment style of **Vanguard Group**, which is best known for funds that precisely track stock-market indexes by buying whatever stocks are in them.

David Booth

Dimensional was founded in 1981 by Midwesterners David Booth, now 59 years old, and Rex Sinquefield, 62, who met as graduate students at the University of Chicago. There, both studied under Eugene Fama, the economist who coined the term "efficient markets" in the 1960s. Mr. Booth was Mr. Fama's teaching assistant. The firm's approach is largely based on the research of Mr. Fama and another academic, Kenneth French of Dartmouth College in New Hampshire, both members of Dimensional's advisory board.

The efficient-market hypothesis holds that markets, not individuals, are the best summarizers of information. The theory implies it is impossible to tell which stocks are cheap and which are pricey without either expensive research or extremely rare skill. Thus, it is better to seek to match the market's performance by buying broad buckets of stocks. Dimensional tweaks the formula by favoring small and "value" stocks.

"I'm not arguing that nobody can pick winning stocks—I'm arguing that few people can pick winning stocks," says Mr. French, who also is Dimensional's head of investment strategies. "Most people are just wasting effort."

As Mr. Sinquefield puts it: "North Koreans, Cubans and active money managers" are the only people in the world who want to ignore free-market pricing.

Dimensional long has had a cult following, and it has grown so large that the firm ranks as the nation's 20th-biggest fund company, with over $69 billion in mutual funds as of Aug. 31, according to Financial Research Corp. The growth of the firm, one of the youngest on the list, was aided in recent years by a strong rally in small stocks, an advantage that may disappear if the small-cap rally wanes as many market pros expect. Including assets such as group trusts, Dimensional said it managed $114.5 billion as of Oct. 31.

Rex Sinquefield

While Dimensional's executives are philosophically in line with the passive approach of index funds, they don't use indexes from firms like Standard & Poor's or Russell Investment Group. Instead, they turn to the academic world for inspiration, specifically the research of Professors Fama and French indicating that small stocks and value stocks deliver better returns over very long periods.

The concept is that these shares carry a risk premium to reflect that they aren't as immediately desirable as those of big, or usually flashier, and faster-expanding companies; some are deservedly cheaper because the companies are of low credit quality. Shares of less-attractive companies trade at a discount relative to higher-priced "growth" stocks in order to induce investors to buy them, the thinking goes.[1]

"Most people still want to invest in strong companies, and, almost by definition, value companies aren't strong," Prof. Fama explains, cautioning that the return reward can take a long time to show up—"an investment lifetime—35 years, 40 years."

"We don't think it's a free lunch," Mr. Booth says. "These are rewards for taking risks."

Kenneth French

The market's purported small-and value-stock bias has been debated over the years, including in opinion pieces this summer in The Wall Street Journal. In June, Wharton School finance Prof. Jeremy Siegel argued that investors could benefit from the market's bias for value stocks by buying dividend-focused index funds, because many value stocks offer dividends. Mr. Siegel is a senior investment-strategy adviser at WisdomTree Asset Management, New York, an ETF creator that sells dividend-weighted indexed ETFs.

That was followed by a piece by Vanguard founder John Bogle and Burton G. Malkiel, a Princeton University professor and author of "A Random Walk Down Wall Street" in which they contended that any return advantages for small and value stocks are temporary ones that an efficient market will arbitrage away. They also argued that the newfangled ETFs were much pricier than the typical index fund.

In an interview, Mr. Bogle says he has "great respect" for Dimensional, calling its approach "a good plan." But it isn't "a perfect plan" because "those kinds of advantages [for small and value] don't prevail [over the long term]. . . . Markets are great arbitrageurs" and will correct imbalances.

1. A portfolio that emphasizes smaller companies may experience greater price volatility as securities of small firms are often less liquid than those of large companies. As a result, small company stocks may fluctuate relatively more in price.

(over please)

"My reaction to all these new ideas is: I know that standard indexing will give you your fair share of returns," he says.

Dimensional started in the spare bedroom of Mr. Booth's Brooklyn, N.Y., apartment. Mr. Sinquefield had been working in the trust department at a Chicago bank, where in the 1970s he had helped fashion investment strategies for trust clients to match the returns of the big-company S&P 500-stock index. Mr. Booth had worked for Wells Fargo & Co., and was working at investment bank A.G. Becker when he decided to team with Mr. Sinquefield to put some of the academic ideas to work.

The pair focused on a fund that would own shares of tiny companies. By then, Mr. Booth says, S&P 500 funds "had gotten to be reasonably popular." (Vanguard's flagship fund for the masses opened in 1976.) The two former classmates observed that "institutional investors weren't holding stocks of small companies in a meaningful way," so their microcap fund was "initially a diversification argument," Mr. Booth says.

At that time, the term "small cap" wasn't even used widely, he recalls. They called their creation the DFA 9-10 Fund, as the stocks were of companies whose market capitalization put them in the New York Stock Exchange's bottom two deciles when ranked by size.[2]

They landed some institutional clients, and their microcap fund registered good returns for a few years—then small stocks went through the worst seven-year period since 1926, the starting point for Dimensional's data. "There were some extremely trying times," recalls Mr. Sinquefield, who retired from Dimensional in December and has co-founded a free-market think tank in St. Louis. But "most of the clients hung on," he says.

Meanwhile, they relocated to Santa Monica. Mr. Sinquefield didn't want to move to New York, and Mr. Booth didn't want to move to Chicago. Southern California was acceptable to both, and Santa Monica offered easy commutes and an accessible airport, Mr. Sinquefield says.

Inside Dimensional's headquarters, in a modern, airy building, Dimensional continues to tweak its strategy. The backbone of the effort is an 11-person research group, headed by Eduardo Repetto, an aeronautical engineer by training with a Ph.D. from the California Institute of Technology.

The firm uses market capitalization to sort stocks. It looks at ratios of share price to book value to distinguish growth stocks from value stocks, and it runs screens that seek to eliminate stocks for which the market may not be competitive enough. This includes recent initial public offerings and those with fewer than four market makers on the Nasdaq Stock Market.

This contrasts with the scene at most mutual-fund companies, where stock pickers and their analyst teams study companies' financial filings, quiz corporate executives, and do whatever other research they can to try to figure out which stocks have the best odds for outperformance. Dimensional's approach means it doesn't know much about the companies its funds end up owning, though it owns over 5% of outstanding shares of more than 500 small companies because its microcap portfolio is so big.

Dimensional Vice President Weston Wellington says he frequently fields calls from journalists asking what Dimensional thinks are plusses or minuses of holdings. Dimensional doesn't know anything special, so the answer is always the same: No comment.

Some additional decisions go into the increasing number of overseas funds, including debating in which countries stocks should be bought. "If we ever get accused of being active managers, this might be the one area," Mr. Wellington says. Dimensional invests in countries where there is "some determination that it's a reasonably fair market." The firm doesn't invest in Russia or China. Until tax-law changes several years ago, it didn't invest in India. The most recent addition is South Africa.

While Dimensional's ocean-view location may suggest extravagance, a key to understanding its approach is its parsimonious tendencies with investors' money. Minimizing trading costs is a priority, and its managers spend much time working out ways to trade optimally. For instance, if two Dimensional funds have the same stock slated for purchase, the firm will try to buy the stock in one transaction, and it will try to buy a large block of shares at negotiated, below-market prices.

They believe an advantage they hold over index-based funds is that they don't rush to buy or sell when an index kicks a company out of the lineup and adds a new one. Mr. French says Dimensional has about 300 stocks it plans to buy. The traders react "to what's available in the marketplace," he says. "We sit around and wait to see what's there. . . . Frankly, it's just fun to be able to tackle the problem in a way that you know you can add value."

Dimensional is focused more heavily on sales to institutional clients like pension funds and endowments than to individuals, which helps to keep staff and infrastructure costs down. It shuns advertising, and individuals must go through a financial adviser to buy its funds.

Dimensional puts its advisers through a two-day "boot camp" that teaches the theories behind the company's strategy, to ensure that clients they bring are buy-and-hold types. They don't want investors who will jump in and out of funds, driving up transaction costs.

The use of financial advisers means that individual investors must pay an adviser's fee, from 0.5% to a little more than 1% of the invested amount each year, Mr. Wellington says. The average Dimensional stock fund charges a 0.45%-of-assets expense ratio, compared with 1.45% for the average U.S. stock fund and 0.2% for the average Vanguard fund, according to Morningstar Inc.

"People have to be ready to hear this," Mr. Wellington says. "If you're convinced that you can pick stocks, or that you can find smart money managers, our approach makes no sense."

2. As of April 1, 2001 the DFA US 9-10 Small Company Portfolio has been renamed the US Micro Cap Portfolio. The Portfolio invests in securities of US companies whose market capitalization falls within the smallest 5% of the market universe comprised of companies listed on the NYSE, AMEX, or NASDAQ.

The following information is provided by Dimensional Fund Advisors ("Dimensional") and did not appear in the original publication:

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