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INDEXING GETS A BOOST

A low-profile firm says it has a better way to run an index fund

BY DANIEL MCGINN

REGULAR OR DECAF? White or wheat? Shaken or stirred? Life is filled with binary choices, and for decades mutual fund investing has been no different. The either-or debate revolves around a simple question: passive or active? Passive investors believe financial markets operate so efficiently that it's folly to try to outguess other investors. Stock prices move in "random walks," they say, and the only sound strategy is to allocate dollars to different asset classes—large stocks, small stocks, value, or growth—and invest in index funds. Active investors think that's hogwash. If markets are efficient, how do you explain a Peter Lynch or a Warren Buffett—and why shouldn't investors rely on a stock-picker's judgment, in hope of finding a savant who will beat the market?

Choose which side you'll take. There is no in-between.

Or maybe there is. In this black-or-white world, Dimensional Fund Advisors is a shade of gray. The Santa Monica-based money manager lacks the name recognition of a Janus, Vanguard, or Fidelity. And with only $32 billion currently under management, it has just a fraction of their assets. But it offers a unique investing strategy: a passive philosophy with some active flourishes.

DFA holds true to the tenets of market efficiency but tries to increase returns by building more-focused portfolios and trading smarter. Despite its low profile, DFA is one of the country's biggest players in small-cap stocks, and when the market favors this asset class, observers say, DFA funds perform well. Intrigued?

The story gets better. The firm's founders are disciples of some of the country's smartest financial academics, who take an active role in shaping strategy. Walk through its corridors, and you may encounter a Nobel Prize–winning economist—or a future one—who's helping to guide DFA.

You may be tempted to place an order, but don't bother hunting for a toll-free number. DFA doesn't have one, and it won't accept money from just anybody. Individual investors can buy DFA funds only if they work with one of a select group of fee-based financial planners. It's a restricted distribution strategy that DFA says lowers costs and reduces the "hot money" that moves in and out of funds based on quarterly returns. Despite those limitations, in the last few

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years DFA has become very popular with financial advisers, so if you work with one, you may be asked to consider its funds. For do-it-yourself investors, DFA's distribution strategy raises a question: Does it make sense to use an adviser simply to gain access to products you can't buy on your own? It's a model that's de rigueur in the design world, where some upscale homeowners work with interior decorators simply to gain entrée to exclusive stores open only to the trade. If DFA's marketing model catches on in the fund business, investors may have to decide if they should do the same.

(Performance chart omitted.)

To understand DFA's philosophy, take a look at its beginnings at the University of Chicago, where David Booth and Rex Sinquefield were graduate students in the early '70s. The school was a hothouse of innovation. Professor Myron Scholes was about to invent the eponymous Black-Scholes formula for pricing options, which would earn him the 1997 Nobel Prize. A few years earlier, Eugene Fama, another hotshot prof, had coined the term "efficient markets," which helped form the theoretical underpinnings for index investing. "You had the energy and excitement of having this new paradigm—market efficiency—being introduced," Booth says. "We got caught up in the enthusiasm." Booth's grad school roommate, Roger Ibbotson, embarked on a historical study of stock prices that became the standard reference for why stocks outperform bonds over the long term. Sinquefield recalls first hearing about efficient markets in Economics 301 (taught by Merton Miller, another future Nobel laureate). "It was like an epiphany—this is so obvious, it has to be the way the world works," he says. "My interest quickly became 'I want to apply this stuff, because nobody else was doing it.' "

Booth and Sinquefield graduated and began building index funds for the banks where they took jobs. By the early '80s, they'd decided to start their own firm, catering to institutional investors. They'd already enlisted Fama as an adviser, but they needed a board of directors. "So Fama walked across campus, and Miller and Scholes were in that day; so we asked them to be on the board," Booth says. That relationship grew into a close association between DFA and some of the country's top financial economists—including Ken French at MIT, Roger Ibbotson at Yale, and Donald Keim at Wharton. "They basically take our research and try it," says Fama, who speaks with the firm daily. Fama's son Eugene Jr. helps market the firm to institutions, and the academic ties are a key selling point. "A lot of big firms have academics on their boards, but Dimensional is really different," says Fama Jr. "Our guys are really embroiled in engineering and maintaining the investment products."

The academicians helped refine DFA's hallmark strategies. Most index funds choose a benchmark—the Russell 2000 for small stocks, for instance—and buy every stock in it, attempting to mirror its return. DFA operates differently. Instead of relying on outside sources like Russell or Standard & Poor's to decide which stocks belong in an index, it creates its own asset classes. The firm starts by rank-ordering stocks by market capitalization, dividing the list into 10 groups by size, and then defining asset classes using these deciles *[1]. For example, the 6–10 Fund invests in deciles 6 through 10, which include the smallest 50 percent of U.S. stocks *[2]. The 9–10 Fund consists of the smallest two deciles, or the smallest 20 percent of U.S. stocks*[3]. DFA also offers large-cap, international, and bond funds, but they're more heavily focused on small-cap value stocks, a forte that results from academic studies showing that over the long term, small caps outperform large caps and that value stocks trump growth stocks. So in addition to size, they screen for value using price-to-book and other methods. By creating its own asset classes instead of following standard indices, DFA says its portfolios are more focused and "higher-octane" than traditional index funds. Its small-cap offerings feature smaller companies, on average, and its value offerings have a more pronounced value tilt.

So far, this sounds a lot like indexing, except DFA is using a different method for finding the prescribed list of stocks. But there are additional differences. Once DFA managers have the list of stocks that "fit" in each asset class, they start winnowing, excluding specific types of companies they feel don't belong. That's an active touch most pure indexers wouldn't use, but DFA's researchers say their decisions are data-driven, not discretionary. "We're not relying on anyone's judgment on a particular stock to make or break the strategy," says Robert Deere, a portfolio manager and head of the domestic equity group. For instance, regulated utilities and REITs are often included in value indices, but DFA says they don't really behave like value

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stocks, so it drops them. It also eliminates newly minted IPOs from its small-cap funds, because research shows they tend to underperform after quick run-ups during their first days of trading.

But the biggest deviation from pure indexing comes at the trading desk.

Most index funds operate as automatons, buying prescribed stocks every day. DFA's traders are more like frugal grocery store shoppers, going into the market with a list, but keeping a keen eye out for what's on sale and skipping stocks that look too pricey. That's especially important in the small-cap arena. "When you start indexing in small caps, there are problems because of liquidity," says Deere. "The costs of actually replicating an index can exceed the benefits of doing so. The pure indexer would say 'I'm supposed to be holding this stock because it's in the index—I don't care if it's costing me $5 in trading costs. I'm going to buy it.' We're saying for $5 in costs, it's not worth it, because on average that stock is no different than the rest." So it will own most—but not all—of the stocks on its list, because traders refuse to drive up costs simply to adhere to a list.

As one of the country's largest small-cap buyers, DFA uses size to its advantage. It encourages other institutions to approach it when trying to unload big blocks of their own small-cap stocks, which DFA will buy at a discount. The result: The firm says it sees 100 block trades a day and buys perhaps 15. Sixty percent of its small stocks are bought at a discount, which averages 4 percent of the price. Says Scholes, now an emeritus professor at Stanford who helped DFA devise the strategy: "They are not foolishly going into the market and acquiring shares just to replicate an index. They're prudent in how they acquire shares." That helps boost long-term results. "When the asset classes they favor are doing well, their funds have done very well," says William Harding, an analyst at Morningstar. But, true to a passive strategy, DFA doesn't try

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to blow away the indices; it just adds a little value at the margin. For instance, DFA's flagship fund, 6-10 Value, has returned 12.8 percent annually for the five years ending December 29, compared with 10.3 percent for the Russell 2000 and 12.2 percent for the average small-cap value fund *[4]. While DFA's expenses are higher than a pure index fund—DFA 6-10 Value charges 0.58 percent while Vanguard's Small Cap Index Fund charges only 0.24 percent—they are nearly a percentage point lower than the average small-cap value fund's expenses of 1.54 percent *[5].

So, why have so few investors heard of DFA? Partly because small stocks have been eclipsed by large stocks for most of the firm's history. When they launched in 1981, co-founder Booth says, "Little did we know that the next 17 years would be the worst period in history for small stocks relative to big." As Eugene Fama Jr. argues, "At the end of a period like this, everybody's faith [in the superiority of small caps] is a little shaken. But during the previous 18 years [before 1981], Treasury bills outperformed the S&P 500, so it wasn't worthwhile even being in stocks. Was the right move at that time to get out of stocks? No, because you would have missed the greatest run of the century." So if investors believe the long-term numbers, they shouldn't shun small stocks now.

The bigger reason for DFA's anonymity, though, lies in its clubby exclusivity. Do-it-yourself investors need not apply. That means there's no need for the retail advertising that provides name recognition. But DFA says the benefits outweigh the costs. "Our advisers behave like institutions—there's very little hot money," says Daniel Wheeler, a former CPA who launched DFA's fee-only adviser business in 1991. Sinquefield says even though many sophisticated investors eschew advisers, "it's a rare individual who shouldn't have a good adviser in some capacity. If nothing else, they keep you from doing something stupid, from giving in to impulses" to make unwise investments.

Advisers who've signed on to DFA's approach are big fans. In a survey last year of 1,500 fee-based financial planners by Dalbar, a Boston-based financial services research firm, Dimensional ranked as the planners' favorite company, besting big names like Janus and Vanguard. "DFA

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Past performance is no guarantee of future results and investment results and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Total return includes reinvestment of dividends and capital gains. The fund's portfolio may differ significantly from the securities held in the index. The index is not available for direct investment; therefore its performance does not reflect the expenses associated with the management of an actual portfolio. The purpose of the comparison is to show the performance of small stocks during the period. Funds that emphasize investments in smaller companies may experience greater price volatility.

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counts on the success of the planners they select to draw in more people and more assets," says Louis Harvey, Dalbar's president. He says that in the decade since they began expanding beyond institutions, their record is impressive. "DFA is in a very strong position to gain a huge chunk of the market," Harvey predicts. Paul Merriman, a Seattle-based financial adviser whose clients keep $40 million in DFA funds, says their concentrated approach makes sense for sophisticated clients. "It's not a matter of DFA having inside secrets—it's that they've designed a better set of asset classes," he says. DFA's small-cap funds really contain small caps, he says, whereas the Russell 2000 includes many mid-caps.

DFA's techniques may represent improvements on an old strategy, and that other firms may try to replicate these tricks. They won't create huge outperformance. But as the days when mutual funds were routinely posting 20 percent annual returns become rosy memories, every basis point counts. Those that find new ways to add a few points to performance returns will be worth their weight in gold. ■

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1. As of April 1, 2001, DFA asset-class definitions are based on a percentage of the aggregate market value of all operating NYSE, AMEX and Nasdaq listed companies.

2. As of April 1, 2001, the U.S. 6-10 Value Portfolio of DFA Investment Dimensions Group Inc. is now named the U.S. Small Cap Value Portfolio. The portfolio invests in the stocks of U.S. small cap companies which as of such date, DFA considered to be companies with market capitalizations in the lowest 8% of operating companies listed on the NYSE, AMEX or Nasdaq.

3. As of April 1, 2001, the U.S. 9-10 Small Company Portfolio of DFA Investment Dimensions Group is now named the U.S. Micro Cap Portfolio. The portfolio invests in the stocks of U.S. micro cap companies which as of such date, DFA considered to be companies with market capitalizations in the lowest 4% of operating companies listed on the NYSE, AMEX or Nasdaq.

4. Percentage annualized total returns for the period ending December 31, 2000 are as follows:

	U.S. Small Cap Value Portfolio	Russell 2000
1 Year	9.01	-3.03
5 Year	12.82	10.32
Since Inception (93 Months)	13.88	11.66

5. Data from Morningstar Report for December 2000. Expense ratio shown for the U.S. Small Cap Value Portfolio (formerly the U.S. 6-10 Value Portfolio) was as of November 30, 1999. As of November 30, 2000 the expense ratio for the U.S. Small Cap Value Portfolio was 0.56%.

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