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Attempting to beat the stock market through shrewd stock selection, argues Dimensional Fund Advisors, is like trying to determine which monkey in a million will accidentally type *Hamlet*. That hasn't stopped its funds from producing stellar results.

## Ditching the Monkey

by Eric J. Savitz

FOR A JOURNALIST WHO SPENDS MOST OF his time trying to ferret out alluring stock ideas and smart stockpickers, a trip to the Santa Monica, Calif., headquarters of Dimensional Fund Advisors poses certain philosophical challenges. DFA's approach to managing money starts with the idea that stock-picking is basically futile.

You can go to its office to admire the stunning view of the Pacific, but you won't walk away with brilliant investment ideas; DFA's members consider the whole stock-picking exercise a waste of time. So, it doesn't try to hire market-beating portfolio jockeys.

The way DFA executives see it, as a result of chance there always will be managers who beat the market, but there's no way to identify them. Sure, there will be a new Bill Miller or Peter Lynch, but seeking them before they do their thing is like trying to pick out which of a million touch-typist monkeys accidentally would produce *Hamlet*.

**If there's no point in picking stocks** or funds, you can only conclude that reading about stock picks and "must-own" mutual funds is a waste of time, too. Rex Sinquefeld, DFA's co-founder and just-retired co-chairman, has famously derided the kind of prognosticating that's the stock-in-trade of this and other business magazines as "financial pornography." Given all this, I might have been tempted to ignore DFA, if not for one fact: Its funds have been cranking out remarkably high returns.

With more than \$84 billion in assets under management,<sup>1</sup> most of that in stocks,

25-year-old DFA is built around the theories of Eugene Fama, a University of Chicago economist who is perhaps the leading proponent of the "random walk" theory. Fama, in essence, argues that the market's efficiency at discounting information makes it largely impossible to beat over the long term by picking stocks. Sinquefeld and co-founder David Booth, who studied with Fama at the University of Chicago in the 1970s, were among the earliest proponents of index funds, or "passive investing."

The two started DFA in the spare bedroom of Booth's Brooklyn Heights apartment. The fledgling firm had trouble getting New York Telephone to install six new phone lines in his apartment. Recalls Booth: "They thought we were bookies." Their first product was the DFA 9-10 Fund, named for its focus on companies that, ranked by stock-market value, were in the market's ninth and last 10ths.

That fund evolved into DFA's micro-cap fund; the spare bedroom in Brooklyn eventually gave way to the swanky offices by the sea. But the firm still ardently preaches the efficiency of the market. DFA's execs compare active money managers to socialists: both groups, they say, refuse to believe in the marketplace's power.

**Sinquefeld derides "behaviorists"** who theorize that markets offer anomalies that can be exploited by those with the best information. "They have no overarching theory," he scoffs. "They have a lot of ad hoc stuff based on empirical irregularities. If you look hard enough, you find patterns in the data. But they're

not real." What's worse, he adds, "The average individual is really persuaded by all this stuff, and then asked to make decisions he can't possibly make well."

Argue with Sinquefeld if you like, but there's no debating DFA's results. The two flavors of its flagship **U.S. Small Cap Value Portfolio** (tickers: DFAVX and DFSVX), for instance, rank in the top 20 of more than 1,700 general-equity funds in average 10-year returns, according to Morningstar.

So, even though DFA argues that you can't produce returns that beat the average mutual fund, it's done exactly that. But its success involves keeping fees low, being tax-efficient and investing with an eye on the only investment factors they believe can lift returns. Fama and his frequent collaborator Kenneth French, a Dartmouth finance professor, focus on small stocks, rather than large ones, and value, rather than growth. Both approaches, they assert, provide excess returns. (They define value stocks as those with a high book value-to-price ratio, a variation on low price-to-book.)

The firm starts with a simple screening procedure that begins with market capitalization. It sifts out stocks for procedural reasons, eliminating those with fewer than four market makers, for example, on the theory that it will be hard to get competitive pricing, while also avoiding companies in obvious financial distress, and shunning IPOs.

That still leaves plenty to buy: Their small-cap fund owns 3,000 stocks. For active managers, it's hard enough to run a fund with hundreds of names, let alone thousands. It's easier for DFA because it

<sup>1</sup> Assets under management are USD 86 billion as of December 31, 2005.

(over please)

## Putting Theory Into Practice

Dimensional's investment approach is based on the work of University of Chicago economist Eugene Fama and some of his colleagues and students. A quick look at some of the key players:

Name	Affiliation
<b>Eugene Fama</b>	A professor at the University of Chicago and an oft-rumored candidate for the Nobel Prize in economics. Fama's work on efficient markets lies at the core of DFA's investment approach.
<b>Kenneth French</b>	A professor at Dartmouth's Tuck School of Business, he is a frequent collaborator of Fama's. French has the title of DFA's head of investment policy, though he remains a full-time academic.
<b>Roger Ibbotson</b>	A professor of finance at Yale, the founder of Ibbotson Associates, and co-author with DFA-co-founder Rex Sinquefeld of the book <i>Stocks, Bonds, Bills and Inflation</i> . He is a member of DFA's fund boards.
<b>Robert Merton</b>	A Nobel laureate for his asset-pricing model, and a professor at the Harvard Business School, he is a director of DFA's U.S. funds.
<b>Myron Scholes</b>	A Nobel laureate for his options-pricing work, Scholes is a professor at Stanford's Graduate School of Business. He's a director of DFA's U.S. funds.
<b>Donald Keim</b>	A finance professor at the University of Pennsylvania's Wharton School, Keim is an expert on real-estate securities, and consults on DFA's real-estate securities strategy.
<b>Rex Sinquefeld</b>	Co-founder of DFA, and co-chairman until his retirement last month, Sinquefeld studied at the University of Chicago under Fama in the 1970s, along with Ibbotson.
<b>David Booth</b>	Co-founder and CEO of DFA, and a pioneer with Sinquefeld in stock-index funds. A University of Chicago MBA, Booth is now chairman of the school's investment committee.

Source: Dimensional Fund Advisors

spends no time doing things like meeting corporate managements, listening to quarterly conference calls, or creating earnings models. DFA has taken 5%-plus positions in more than 500 companies, but without any real consideration for what any particular one does.

Recently, a reporter called DFA Vice President Weston Wellington to ask what the firm might think about takeover talk brewing over theme-park operator Six Flags, for which DFA is the biggest institutional investor, with a nearly 9% position. Wellington says he replied that DFA hadn't looked at the situation, hadn't talked with Six Flags, and wasn't going to spend time

trying to figure it out. His advice: call someone else.

Where DFA does invest energy is in aggressively seeking to buy positions by acquiring large blocks of shares at negotiated prices below the market. Dimensional also uses only fee-based financial advisers to sell its funds.<sup>2</sup> It doesn't want investors who will jump in and out of the market. In fact, DFA requires its distributors to attend a two-day "boot camp" that lays out its academic underpinnings. It wants to do more than sell you a fund and collect a management fee; it wants you to believe that the right way to invest isn't the way most people do it.

"We don't proselytize," says Wellington,

who handles the firm's communications with financial advisers, giving them, among other things, regular presentations on terrible market calls made in the financial press, this magazine included.

"Our view is, people have to be ready to hear this story. When you've decided it's not so easy to ID winning stocks or managers, then come have a chat with us, and we'll explain why you would expect this outcome more often than not."

What they don't want is people lured by the historic returns who don't understand why the system works—and where the risks lie.

How to explain the Internet bubble, for instance? "Sure, I can look back and say it appears it might have been a bubble," Wellington says. "But could you have told me when it was going to burst? Most people who said we were in a bubble had been saying the same thing in '96, and '97, and '98, and '99. If someone got into the market for the first time in January 2000, I feel sorry for him. But over a 10-year cycle, people did fine. If you couldn't get your money out, I'm not so sure it was an inefficiency that you could have exploited."

Adds Booth: "The proof comes in the returns. We're like one giant test of market efficiency. And I can't think of any region of the market where active management has had better returns."

So why don't other people invest this way? "For one thing," Booth says, "people are over-confident. If you have a large group of people in a room, and ask them if they are above-average drivers, about 80% will say yes. In the financial markets, over-confidence leads to trading too much. We all have feelings, opinions and hunches." At the end of the day, he says, "you can't distinguish professional money managers from the universe of orangutans."

Indeed, based on DFA's record, investors have to wonder whether they'd be better off if they stopped trying to pick the next smart monkey. ■

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. Performance data represents past performance and does not predict future performance. The investment return and principal value will fluctuate so that an investment's shares, when redeemed, may be worth more or less than their original cost. Further, there can be no assurance that any of the portfolios will achieve its investment objective. Total returns include reinvestment of dividends and capital gains. Dimensional Fund Advisors Inc. is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of the Dimensional funds carefully before investing. For this and other information about the Dimensional funds, please read the prospectus carefully before investing. Prospectuses are available by calling Dimensional Fund Advisors Inc. collect at (310) 395-8005; on the Internet at [www.dimensionalfund.com](http://www.dimensionalfund.com); or, by mail, DFA Securities Inc., c/o Dimensional Fund Advisors Inc., 1299 Ocean Avenue, Santa Monica, CA 90401. Dimensional funds are distributed by DFA Securities Inc.

<sup>2</sup> Institutional Investors may also invest in the funds.