DFA Funds - Hard to Buy, Easy to Own

Dimensional Fund Advisors places its chips on risky stocks and lets them ride, resulting in superior returns uncompromised by high trading costs. Too bad you need a fortune to get in.

By Timothy Middleton

CNBC on MSN
June 2002

Call Dimensional Fund Advisors the anti-Long Term Capital Management.

The latter is the professor-run hedge fund that imploded because the risks it was trying to avoid bit it in the backside. DFA, likewise run by a coven of finance professors, doesn't avoid risk -- it relishes it.

And that's produced an excellent long-term performance record, which, alas, most individual investors can't take advantage of. DFA funds are sold only through fee-only financial planners -- and then only when DFA agrees to accept their business.

"I can't stand their attitude!" grouses a planner whom DFA turned down. "They've got great funds, and a great discipline, lots of deep thinking, but they've got an attitude."

Before Harold Evensky, a well-known planner, was allowed to invest in DFA funds, he had to trek to seminars it sponsors at places such as the University of Chicago. "I remember way back when they told me you had to be approved that I was incensed," he says. "But it's not elitist criteria they're pushing; it's professional criteria."

Today, DFA funds account for as much as 40% of a typical client's equity portfolio at Evensky, Brown & Katz, headquartered in Coral Gables, Fla.

DFA is run on principles developed in the nation's graduate schools of business, notably that of Chicago. They include the "efficient markets" theory, a phrase coined by DFA's director of research. They embrace “modern portfolio theory.” And they know frequent trading can be more costly to investors than a high expense ratio, so they refuse to deal with hyperactive investors.

Keeping you and me out makes DFA more economical to run, which boosts the returns of shareholders it is willing to accept.

Tapping academia's brain power

DFA was spawned at Chicago’s graduate school of business in the 1960s and ‘70s when new principles of money management were evolving. A breakthrough was the development of a massive database of market statistics made possible by the advent of computers. It remains the property of what became the Center for Research in Security Prices, or CRSP.

Rex Sinquefield, a 1972 graduate of the graduate school and a co-founder of DFA in 1981, once told the New York Times, “If I had to rank events, I would say this one (the original CRSP Master File) is probably slightly more significant than the creation of the universe.”

If that sounds like Thurston Howell III speaking, you’re on the right island. DFAers actually talk Locust Valley Lockjaw -- the language of "Gilligan’s Island's" Howell and that other “the third,” Louis Winthorpe of the film “Trading Places.”

“Mr. and Mrs. Johnson are just as concerned about investment outcome as a company like**BellSouth** is, but their portfolio is a lot smaller,” lectures Eugene Fama Jr., son of the professor who coined the phrase efficient markets and a DFA vice president. “We don’t have time to educate and coach these people.”

The senior Fama, on the faculty of the University of Chicago, is director of research for DFA. His research concludes that equities perform better than bonds, small-cap stocks better than large, and value stocks better than growth. In each instance, it’s because they are more risky.

Fama also described the efficient market as one in which all information is known and reflected in stock prices, so fundamental stock analysis is useless. This thesis also holds that day-to-day price movements are random, which makes technical analysis irrelevant. Passive investing is the only efficient strategy.

Modern portfolio theory describes how to construct an investment portfolio optimized to deliver the highest returns for the amount of risk the investor is willing to accept. DFA does this on a custom basis for institutional clients, and in a more generic way in its mutual funds.

The firm manages $40 billion in assets.

DFA has 30-plus portfolios, covering all the basic asset classes. Virtually all of DFA's small-company and value funds are among the top 25% of their Morningstar category, including a number of international funds, such as **DFA Continental Small Company**.

“We take a global view of everything,” says the junior Fama. “We use academic research as a kind of back office. Our research staff is the universities of America.”

DFA’s board of directors sounds like a Who’s Who of U.S. financial research; it includes Kenneth French of Dartmouth (who was Fama’s research partner), Roger Ibbotson of Yale (another database maven) and Myron Scholes, the Nobel laureate in economics who teaches at Stanford.

Strategizing risk

DFA’s brand of passive investing is not quite indexing. It eschews reliance on stock picking and market timing, which indexers also do, but it doesn’t tie itself slavishly even to its own custom-produced indices.

“The best negotiating position is not having to buy anything -- and that goes in every aspect of life,” Fama instructs. Traditional index funds are forced to buy the stocks in the index in direct proportion to their weight in the benchmark. DFA only looks at about two-thirds of the stocks in its various style universes and then “allows weights to vary all over the place,” he says.

DFA puts its money where the risk is. The Russell 2000 Index, widely used as a proxy for small-cap stocks, puts less than 4% of its weight in the smallest 20% of U.S. companies. DFA’s CRSP 6-10 Index allots nearly 25% of its money to those micro-cap stocks -- the riskiest, but also the most rewarding.

The securities it selects demonstrate, according to the firm’s black box, the purest attributes of their asset class. For example, real estate investment trusts are an important component of most small-cap indices, but they have bond-like characteristics, and DFA ignores them. The firm believes, along with most finance professors, that asset allocation accounts for nine-tenths of total returns, and securities selection for only the remaining 10%.

Passivity pays

The evidence bears out this powerful argument against active management. The average small-company mutual fund has returned an average of 12.2% in each of the last 10 years, according to Morningstar. **DFA U.S. Small Cap** has averaged 13.5%, and **DFA U.S. Micro Cap** has done even better, with annualized returns of 15.7%.

The 1.3% advantage Small Cap has over its average rival is, by no coincidence, little more than the difference between the fund's 0.56% expense ratio and the small-company average of 1.54%. The chief argument in favor of passive investing is that it is cheaper, and DFA's low-turnover approach makes it cheaper still.

"They have very low costs, so what you get is the return of the portfolio," says Diahann Lassus, a partner in Lassus, Wherley & Associates in New Providence, N.J., who also uses DFA funds for the core of client portfolios. "These funds are controlled by institutional investors like us. You don't have people moving in and out; hot money and market timers."

Of course, to enjoy these benefits, your money is nearly as much a captive as Gilligan was. You also have to meet Lassus's $6,300 minimum annual account fee, or the 1% of assets many other advisers charge.

But DFA's experience reinforces the argument advanced by two other low-cost fund providers, Vanguard Group and TIAA-CREF, that most people will do far better buying an index fund than hoping their manager is the next Warren Buffett.

Buffett has said he's lucky if he can find one good stock to buy every two years. The average actively managed equity mutual fund replaces its entire portfolio of more than 100 stocks every year. These trading costs, which are not included in a fund's expense ratio, make it that much harder for active managers to beat their benchmark. High ratios to support expensive research departments make it harder still.

You don't have to be a finance professor to figure out that DFA's approach gives you a head start in the race for returns.

At the time of publication, Timothy Middleton owned none of the securities mentioned in this article.