TheStreet.com

Mutual Fund Monday - Beverly Goodman

The Best Fund Family You've Never Heard of -- and Why It Doesn't Want Your Money

By Beverly Goodman
Senior Writer

08/26/2002 07:11 AM EDT

Dimensional Fund Advisors might be one of the best-kept secrets in the mutual fund industry.

DFA manages $36 billion, of which about $23 billion is for institutions, with some $13 billion through funds sold to individual investors through financial advisors. It has no retail offerings -- you can't buy into their funds the way you would at Vanguard, Fidelity or any other retail fund company.

A retail presence isn't all the firm lacks: DFA doesn't employ a single stock analyst. The firm keeps a coterie of some of the finest minds in economics as advisors or consultants -- but not so they can make bets on which way the economy's heading, rather to ensure the firm keeps current on relevant academic research.

Sound unusual? It is. In fact, DFA may be unique in that it's the only fund company of its size that employs the strictures of structured management -- a strategy that lies between active and passive management -- to its investments. (For more on passive management, see Passive Management: It's Not an Oxymoron.)

DFA's approach is rooted in the belief that markets are "efficient" and that investment returns are determined principally by asset allocation -- not market timing or stock picking. According to the efficient market theory, stock analyses and economic predictions are irrelevant -- no one person can add value to what the market has priced into any given security.

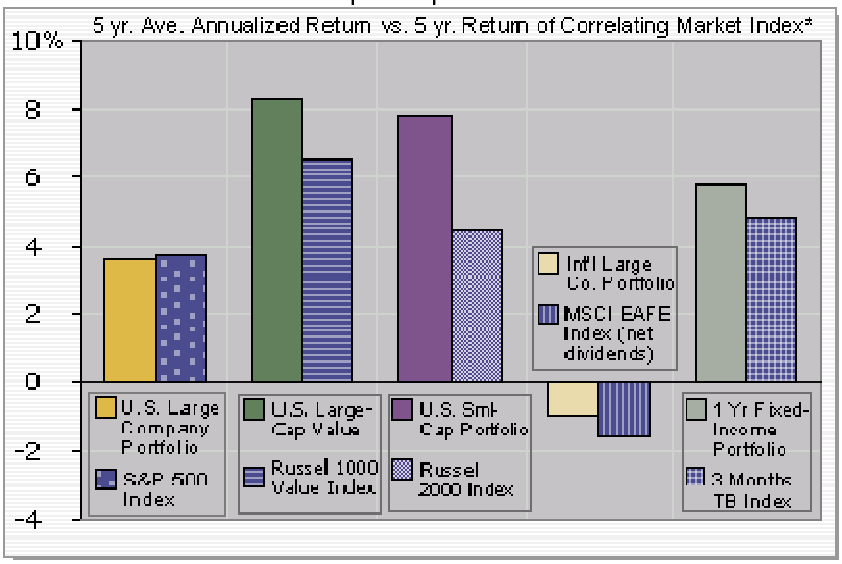
That doesn't mean you have to settle for less-than-market returns. DFA's portfolios are structured to capture the returns of an entire asset class -- they don't just ape an index. Structured management differs slightly from passive management in that it recognizes that indexes are not designed to serve as model portfolios. Rather, most were created to serve as mere signposts of financial performance for an asset class.

DFA's structured approach uses academic research to isolate risk characteristics and eliminate them from their portfolios. That means, for instance, that a DFA fund may not look like the best-known index for that asset class. Instead of matching an index that may somewhat arbitrarily represent an asset class -- think about accusations that the S&P 500 is merely an actively managed fund -- DFA funds strive to achieve the highest risk-adjusted returns for that asset class. In other words, investors get the same or better returns for any give asset class, while incurring much less risk -- and at far less cost.

"It's a concept that's difficult to explain to the average retail investor," says Larry Swedroe, director of research for Buckingham Asset Management and author of *Rational Investing in Irrational Times: How to Avoid the Costly Mistakes Even Smart People Make Today.* That's why DFA relies on financial advisors to explain its strategy to clients.

Multi-Dimensional Figures

DFA is about as close as one can get to matching or beating the market consistently, as this sampling of fund performance indicates, and all of the funds sport expense ratios below 0.46%



Source: DFA Securities Inc.
*As of June 30, 2002
Note: Funds expense ratio is as of Nov. 30, 2001

"What we want are investors who share our philosophy," says John Siciliano, director of global institutional services for DFA. "In the past 10 or 15 years, people have become active traders, even with their mutual funds. That raises a fund's expenses. We'd rather deal with people who appreciate our style and can stick with it."

Passive or structured investing, after all, requires patience and temperance. You won't double your money in five years with DFA. In fact, DFA's funds often (but not consistently) trail the Morningstar category average. But active management is a loser's game. Only 25% of actively managed funds beat their relevant benchmark over time, and fully half of those do so just as a matter of statistically probability. The rest inevitably underperform the benchmark within five years -- usually by far more than they outperformed the index. (For more on why active management doesn't make sense, see Active Mismanagement: The Case for Indexing.)

But DFA's funds aren't structured simply to simulate an index. Indeed, unlike the universe of retail funds, the fund managers at DFA are not concerned with minimizing tracking error (or by how much the portfolio out- or underperforms its relevant index). By minimizing risk, trading costs and taxes, investors over time can achieve the best risk-adjusted return for an asset class. Combine that with proper asset allocation within your portfolio and you'll achieve returns that are at least consistent with the overall market while losing less sleep.

Their strategies can be deceptively simple -- it's the tomes of research that emphasize the validity of their strategies, and the scientific data that demonstrate its effectiveness. For instance, DFA won't invest in initial public offerings, for instance, since academic research has shown to be a loser's game. The firm will also only invest in stocks that have at least four market makers -- ensuring liquidity, low trading costs and some fraud protection. You won't find any companies with qualified financial statements, either. In addition, DFA's requirements for investing in a stock are stricter than the National Market System's listing requirements -- while at least 5% of National Market stocks delist every year, less than 1% of DFA's stocks have delisted. (Interested in a course in finance? Check out DFA's website, which has reams of more detailed information on academic theory, the firm's philosophy and their own strategy.)

Small Moves, Big Differences

Structured management also minimizes costs. Take the case of small-cap stocks. To track an index such as the Russell 2000, for instance, a fund would purchase the correct number of shares of each stock in the index to equal their weighting in the index. That strategy generally works fine for large companies; but small companies are less liquid and more prone to high trading costs. Those factors are negatively compounded when indexing, since small-cap indexes turn over far more often than large-cap indexes. (Ideally, because the companies are growing.) The Russell 2000 index, for instance, added 486 companies and dropped 371 in its annual reconstitution in July.

Alternatively, DFA will use its own definition of small cap, which allows for investments moderately over- or under-weight the index. (For U.S. stocks, DFA defines small-cap as the smallest 12.5% of the total market universe.) Managers will stop buying stocks when they go past, say, the fourth percentile of market capitalization, but not start selling until they reach the fifth percentile. Stocks are bought when they reach attractive prices, rather than paying too much simply to match an index weighting.

The trades that funds inevitably have to make are done so in an innovative way. DFA emphasizes price over timing with a large network of brokers who are encouraged to buy at or below existing bids and to sell at or above existing offer prices. To combat illiquidity, DFA -- the largest trader in small-cap stocks -- evaluates more than 900 block trades per day to suss out discounts. This strategy of initiated (working order) trades and uninitiated (discount/block) trades means that DFA has kept the impact of trading close to zero -- in some years up to 80% of purchases have actually been executed in a way that incurred *negative* trading costs.

Interest Piqued? Or Is Your Head Spinning?

The firm is slowly bringing its strategy to a wider audience, although its hesitation is palpable -- you certainly won't be seeing any clever television ads or splashy magazine spreads. "Few people are willing to turn down business the way we do," Siciliano says. "But it's much more important to us to have investors that share in our philosophy and aren't chasing returns. Look what happened to Janus and Putnam."

Then again, Siciliano points out, investors are much more conscious of risk these days. Virtually everybody overestimated their tolerance for risk in the bull years; now they're fleeing to gold. Eventually, though, investors will remember what drew them to the equities market in the first place: the best returns. A risk-adjusted approach to achieving those returns should sound mighty appealing.

That won't likely translate into any direct retail offerings, though. Rather, DFA expects indirectly to reach more circumspect retail investors through DFA's increased participation in company 401(k) plans and subadvising mutual funds. "We see big growth in that area," Siciliano says.

Stay tuned.
