The DFA Model

Daring to be different.
John Rekenthaler, 01/07/2014
Academically Speaking
In the current issue of Barron's, Beverly Goodman profiles Dimensional Fund Advisors, the nation's eighth-largest mutual fund company. It's a good read.

Dating back to the early 1980s, DFA is the most self-consciously academic of fund companies, having been founded by two former University of Chicago graduate students, David Booth and Rex Sinquefield, who had studied under efficient-markets theorist Eugene Fama. Other fund companies trumpeted star managers; DFA would trumpet star research.

It began operations with a small-company U.S. stock fund, based on data that showed that smaller-company stocks outgained their larger peers over time. It later added a second factor of emphasizing value stocks, as opposed to high-priced growth companies, and recently has discussed adding a third factor of profitability. The company also has greatly expanded its asset classes and now offers international-stock, fixed-income, allocation, and real estate funds, along with a commodities portfolio.

(Indirectly, DFA influenced the development of the Morningstar Style Box, which sorts funds according to the same two criteria of value-growth and size. DFA was not the only company to view U.S. stocks by the value-growth and size perspectives, but it was an influential voice in the process.)

The company coupled its unusual, academically inspired fund lineup with an even more unusual distribution strategy. Whereas the fund industry traditionally featured no-load funds selling directly to investors, or load funds selling through financial advisors, DFA mixed fish with fowl. It launched only no-load funds, to be used only by financial advisors. Not just any financial advisors, either. To use DFA funds, a financial advisor must be screened by the organization and must attend a two-day educational seminar.

I always thought of DFA as an index-fund company, and I think everybody else did, too. After all, its funds not only bought and held entire market segments and were inspired by Gene Fama, who has been called the "father" of index-fund investing (a distinction that must irk Jack Bogle), but they also were supported by advisors who argued the merits of passive, indexing-based strategies rather than active management. In recent years, though, DFA has maintained that, despite appearances, it is in fact an active manager.

The first part of the claim is because DFA believes that its funds will outperform the overall market. With U.S. stocks, for example, it expects a portfolio built with DFA's tilts toward value and smaller companies to beat the S&P 500. In the Barron's article, Booth states, "I recoil when people think that what we do is being passive, because it has nothing to do with being passive. We are trying to beat the market without forecasting in the usual sense."

Hmmm, well. That's a different definition of passive than the one to which I am accustomed. By that definition, many if not most exchange-traded funds are actively run. But never mind the semantics--DFA's ambition is clear. Vanguard is for those who are happy to settle for market performance. DFA aims for more.

The second claim for active management lies with DFA's implementation of its quantitative strategies.

To minimize trading costs, DFA will let its funds' holdings drift from their theoretical benchmarks. Indeed, DFA claims that it often enjoys positive trading costs, in that its patience permits it to sell stocks when demand is hot and prices are rising and to purchase securities when few other buyers are present and the stock is sold at a discount.

DFA also employs quality screens and will let portfolio managers use their judgment with problem securities. It may hold off on buying a stock that becomes eligible for its small-company portfolios, for example, if the reason for the eligibility is that the stock is plunging in price due to a scandal or major business concerns. As the adage goes, DFA is leery of trying to catch a falling knife.

Goodman is clearly impressed with DFA; it's a very positive article.

I share her enthusiasm. Although mutual funds are generally priced as if they are highly differentiated products, in reality the mutual fund industry is very much a commodity business. Companies tend to offer much the same funds, labeled and sold in the same way. It would be difficult indeed to make an elevator pitch for the vast majority of fund companies. What is special about the company? What does it do better? Little and not much, generally speaking.

DFA, though, really is different.

In that, it echoes industry-leader Vanguard and former industry leader American Funds. I've written previously about how

Vanguard and American Funds look little alike at first glance but are similar at a deeper level. Both companies move slowly and deliberately, being strategic in temperament rather than tactical. They launch relatively few funds, with those funds that they do create being part of a long-term plan rather than a response to current marketplace demands. As a result, their lineups can look incomplete--no Internet funds in the late 1990s, for example, nor managed-futures funds today. Both companies keep their fund expense ratios low and their senior managements in place.

All applies to DFA, as well. (Mostly, that is--DFA is rather too attentive to advisor feedback, with the result that it launched its emerging-markets stock fund in 1994, its international real estate fund in the mid-2000s, and its commodities fund in 2010. Hot asset classes, cold initial performance. DFA might wish to take the opposite approach next time, and launch a new asset class at a time when nobody is requesting it.)

Also applying is a point that I underemphasized in the Vanguard/American Funds article--the companies are willing to walk away from business. Vanguard can't be on No Transaction Fee platforms because it won't pay distribution fees. American Funds for years eschewed the popular B share class because it believed it wasn't right for investors. DFA is the most extreme of the three, not only skipping direct investors (as has American Funds) but also not offering load shares in the early years when almost all advisors sold load funds.

The previous industry leader in assets, the current industry leader in assets, and a fund company now eighth in assets and rising. You'd think there would be a lesson there, somewhere. You'd think that more fund companies would decide that having a unique strategic plan, one that makes the company look like no other, is better than being a commodity supplier by giving the marketplace what it desires.

You would think. I doubt that DFA's success will have much effect, however, just as American Funds' and Vanguard's have not. Bypassing a dollar today for more dollars tomorrow does not seem to come naturally to many fund-company executives. Perhaps that is because, as Jack Bogle argues, their corporate structures do not permit them the luxury of forgoing short-term profits. DFA is closely held, Vanguard is a nonprofit, and American Funds is a private partnership. In that respect, too, the three companies diverge from the norm.

One item of concern for DFA: investor behavior. As a general rule, shareholders use broad-based funds better than they do narrowly constructed funds. Broad-based funds, particularly those made up of several asset classes (such as balanced or strategic allocation funds) rarely post remarkable performances. Which is a good thing from the behavioral perspective, as remarkable performances tend to entice investors to buy high and sell low. DFA's funds may contain many holdings, but many are nonetheless relatively narrow in their focus. Even with the assistance of advisors, they can be difficult to use wisely.

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