A Conversation with DFA's David Booth

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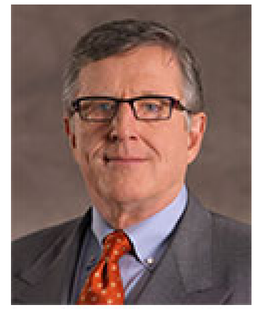
David Booth

It's possible for an airplane company to manufacture excellent jets that reliably and safely reach their destination, even if some of its engineers design questionable components. Indeed, its products may be among the best ever designed. That's my impression of Dimensional Fund Advisors (DFA), which was reinforced after meeting with DFA's co-founder and co-CEO, David Booth.

I spoke with Booth at the Tiburon CEO Summit, held in New York on April 8. He was joined by Alex Potts, the president, founder and CEO of Loring Ward, a San Jose-based turnkey-asset management provider and long-time DFA client.

DFA's funds have consistently outperformed virtually all similarly positioned actively managed funds and passive benchmarks in its roughly three-decade history. But what's enabled DFA to align its goals with those of its investors is the discipline it enforces throughout its advisor network. About two-thirds of DFA's funds are sold through advisors, who have been carefully vetted and trained to use a low-cost, low-turnover and highly diversified approach to portfolio construction.

DFA bases its approach on academic research that has argued, among other things, for weighting portfolios toward value (low market-to-book ratio) and small-capitalization stocks. Most recently – and this is where my skepticism begins – DFA has added profitability as an input to portfolio construction.

I'll come back to that point, but first let's look at all the things that DFA does right for advisors and investors.

The DFA edge

The mutual-fund industry in which DFA operates is highly competitive, characterized by aggressive marketing and product proliferation. The Industry emphasizes short-term performance, with the goal of gaining assets under management. I asked Booth how he positions DFA in that environment.

"We design investment strategies that we think are really important," he said, "and look around to see if somebody else is doing them. If someone else is doing them already at a reasonable cost, then we don't come out with it. We spend no time thinking about where the market is."

That philosophy has been in place since Booth co-founded DFA in 1981. At that time, he said, research was first being published suggesting that small-cap stocks had a performance advantage, which formed the basis of the first funds introduced by the firm. Back then, Booth said that institutions owned only large-cap stocks, plus a few formerly large-cap stocks that had since shrunk to small-cap size. Initially, Booth said, he didn't argue for overweighting small-cap but thought instead that clients should own the broader market.

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The emphasis on value stocks was added in 1992, he said, based on the landmark research by Eugene Fama and Kenneth French. DFA was the first to introduce both U.S. and non-U.S. versions of those strategies.

DFA has avoided investment fads. It didn't have any funds that sought to piggyback on the dot-com boom, and more recently, it has chosen not to offer exchange-traded funds (ETFs).

"ETF's are a good solution to a problem that our clients don't face," Booth said.

ETFs are great for those who demand intra-day trading, Booth said, but those are not his clients. His clients are long-term investors who appreciate the liquidity of the mutual-fund market based on end-of-day net-asset-value pricing.

Potts said DFA instills a belief system among its clients to ensure they are longer-term investors. "They want us to help find the best asset classes to put into a portfolio to help them reach a goal for the least amount of risk," Potts said. He said ETFs typically don't offer the "purity" of asset-class composition that DFA's funds do.

Some DFA funds have historically earned small increments over their indices by forgoing the minimization of tracking error in favor of trading at the best price. As a result, DFA has developed an expertise in trading. I asked Booth whether he has found it more difficult for a large firm like his, which now oversees $350 billion in assets, to maintain a trading advantage in the new world of high-frequency trading that Michael Lewis has described in his new book, *Flash Boys*.

"There hasn't been a drop off in performance as we've gotten bigger," Booth said. He pointed to the increments that DFA has earned over its benchmark indices, which he said were "huge," as large as 200 basis points in the case of its small-cap funds. High-frequency trading hasn't harmed those results, according to Booth.

Potts said 93% of the assets managed by his firm are in DFA funds. As a fiduciary, he continually searches ways to diversify and use asset-class providers that might deliver superior results, he said. "Until that provider comes up, there's no need to make that change," he said. "From Dimensional's standpoint, they're trying to do what's best for their clients. We're trying to do what's best for our clients, and it works together because we have a common goal."

Humility and the drive to innovate

Booth was very humble in his comments. He said, for example, that he didn't know why small-cap or value stocks have provided better returns. "It could be risk; it could be a behavioral bias," he said. "It depends on how one interprets the data."

That humility – which I believe is appropriate – contrasts with some of the feedback this publication received when we voiced our skepticism of DFA's research into profitability. (You can read our position on profitability here and here; you can read some of the feedback from DFA's advisors here.)

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Booth related the history of DFA's incorporation of profitability into its investment process. Like small-cap and value, DFA first learned that profitability might be useful through academic research, in this case by Robert Novy-Marx, a professor at the University of Rochester. As it has done with other academicians – including Fama and French – DFA hired Noxy-Marx to further evaluate the concept. Booth said his firm tested profitability over varying time periods inside and outside the U.S. – so-called out-of-sample tests – to ensure its robustness. Booth said DFA also waited until the profitability research was in the public domain, so that any challenges to it could be countered.

I wanted to know how much incremental return Booth believes profitability could deliver to DFA's clients. That's not a simple question to answer. One could potentially estimate how much profitability could add on its own, but that's not the relevant question for DFA's clients. DFA is adding profitability to the construction process for portfolios that are already weighted toward small-cap, value and momentum stocks. It was in this context that I sought an answer.

"If you talk about incrementally on the margin to an already well-diversified portfolio, maybe you are talking about 25 to 50 basis points a year," he said.

I asked how much confidence he has that his estimate, which is based on indentifying trends in fairly noisy underlying data, will persist in the future.

Booth was justifiably cautious. He said the factors upon which DFA weights its portfolios have historically had premia of 3% to 4%. "How big will they be in the future? We're fairly confident they're nonzero," he said. "That's all you can say."

DFA has a staff of very talented PhDs, who are aided by notable – and in some cases, Nobel-prize winning – academicians. I asked how he manages this team. How does he balance the researchers' motivation to uncover new insights and publish their findings against the evidence that DFA has done an excellent job serving its client's interests by sticking with a very basic, diversified low-cost strategy?

"We're trying to do the right thing, and we're trying not to exaggerate how much information we have," he said. "We know we don't know the total story about risk and return. We don't even know what risk is exactly."

Booth's humility was again evident. But he also conveyed an attitude that I suspect drives DFA's ongoing attempts to innovate: "As enough time goes by, you identify more things that are important, or some of the things you thought were important weren't. … That's what keeps us all coming back. If we thought we were at the end of the story we probably would've retired. This is the thrill."

We'll know in another 20 years whether profitability was able to deliver the 25 or 50 basis points in incremental return that Booth mentioned. In the meantime, however, advisors will be well-served by the discipline and belief system that Potts and Booth described.

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But they must also ask whether DFA's basic premise – over-weighting small-cap and value – will be justified in the future.

I had the opportunity to put this question to John Bogle, Vanguard's founder, who also spoke at the conference.

Investors have known about the small-cap and value premia for a long time, he said, and there have been multi-decade periods when one or the other has underperformed. "Nothing lasts forever," Bogle said.

"It's fine if you want to invest in small-cap and value," he said. "Just don't overpay for it."

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