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In Vanguard's Shadow, Small Firm Scores Tweaking Indexes

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When Molly Bernet Balunek expressed interest in putting money into mutual funds run by Dimensional Fund Advisors, she didn't know she was in for a rigorous courtship ritual.

Before getting the go-ahead to invest in Dimensional's products last year, Balunek, a financial adviser from Cleveland, had to submit to an interview, fill out a questionnaire and pay out of her own pocket for a two-day trip to Austin, Texas, where she listened to the company's executives explain how they do business. The process, which Balunek described as "intense," took about five months.

"It is a two-way evaluation process -- Dimensional wanted to understand my business structure and investment philosophy as much as I wanted to understand theirs," said Balunek.

The ritual is part of a sales process that has helped Dimensional attract the third-most money last year after Vanguard Group Inc., known for its low-cost index funds, and JPMorgan Chase & Co. Like Vanguard, Dimensional is capitalizing on a growing belief that stock pickers can't consistently beat markets. Dimensional's approach, though, comes with a twist: unlike traditional index strategies, the funds use data-driven models to beat traditional benchmarks.

Dimensional is among a small group of managers toppling the dominance of firms such as Fidelity Investments and Capital Group, which have built their reputations on picking individual stocks. Among the fastest-growing U.S. mutual fund firms after assets surged almost six-fold in the past decade, Dimensional attracted almost $28 billion in new money in 2014.

Fama, French

Dimensional believes beating the markets is an exercise in futility and most managers cannot justify the fees they charge. What sets Dimensional apart is its investment philosophy, using research pioneered by Nobel laureate Eugene Fama and Kenneth French, of focusing on specific factors or dimensions that have helped certain indexes beat benchmarks such as the Standard & Poor's 500 Index.

Dimensional, which sells its funds only through approved advisers and never directly to the public, spends considerable effort educating investors on how its approach works. Its system of picking advisers breeds a high degree of loyalty. The firm received the highest grades in customer loyalty among mutual fund companies in a July 2014 survey of U.S. financial advisers conducted by Cogent Reports of Cambridge, Massachusetts.

'Brilliant Way'

"They've developed a brilliant way of locking in money and the advisers who use them seem to love it," said Lawrence Glazer, a managing partner at Mayflower Advisors, a Boston-based adviser that oversees $2 billion.

David Butler, who runs Dimensional's financial adviser business, said he could "count on one hand," the advisers who have stopped using the company's funds in his nearly 20 years at the company.

Advisers who use Dimensional, "tend to buy into the firm's unique philosophy and investment approach and direct a higher proportion of their mutual fund dollars to the firm," Linda York, a Cogent vice president, wrote in an e-mail.

Dimensional's assets have more than doubled since 2009 to $381 billion in a mix of mutual funds and institutional accounts. Part of the growth is the result of shifting client sentiment, as investors disillusioned with the ability of stock pickers to insulate them from losses during the 2008 crisis have increasingly turned to cheaper alternatives such as index mutual funds and exchange-traded funds.

Indexers Win

Mutual funds that pick U.S. stocks experienced $98 billion in redemptions in 2014. During the same period, investors added $167 billion to domestic stock index funds and ETFs, according to data from Chicago-based Morningstar Inc.

Vanguard attracted $219 billion in mutual fund and ETF deposits last year. Fidelity had redemptions of $5.3 billion while American Funds, the mutual fund arm of Capital Group, won $345 million.

Mayflower's Glazer said while low-cost indexing is popular at the moment, he said, there is no guarantee it will remain so.

"If the history of asset management is any guide, the companies and styles that were the leaders in one decade, won't be the leaders in the next decade."

Not Delivering

"Conventional active managers promised a lot that they weren't able to deliver," David Booth, 68, chairman and co-founder of Dimensional, said in an interview at his company's headquarters in Austin.

Booth built his firm around the ideas of his University of Chicago mentor Fama, who won the 2013 Nobel Prize in economics for his work on efficient markets. In 2008, crediting the school for his success, Booth donated $300 million to his alma mater, which renamed its business school the University of Chicago Booth School of Business.

Fama and his research partner, Dartmouth College's French, have argued that stock-price movements are unpredictable and that trying to pick securities that will beat the market is pointless.

"Most people are fooling themselves when they think they have the ability to hire a superior manager," said French, in a video posted on Dimensional's website.

The pair's research also shows that certain factors can produce higher returns. Using historical market data, they found that over the long term, small stocks have outperformed large ones, value-oriented equities have beaten growth and more profitable companies have done better than less profitable peers. Dimensional's funds reflect those tilts, with portfolios composed of small-cap companies, value shares and stocks of companies with above-average profits.

Beating Peers

Over the past five, 10 and 15 years, Dimensional's stock funds have outperformed about 70 percent of peers, according to Denver-based Lipper. Bond funds, a smaller piece of the business, trailed about 60 percent. Over the past 15 years, almost 90 percent of the company's stock and bond strategies with a track record that long have topped their benchmarks, Dimensional data show.

Dimensional executives say that they can't quantify or guarantee the amount of outperformance they can generate.

"If we can beat the benchmarks by 50 basis points a year - -and in many strategies by 100 basis points-- I will do handstands," said Booth.

For the last 15 years, Dimensional's funds have benefited from a rally in small-capitalization and value shares. Since the end of 1999, small stocks, as measured by the Russell 2000, have returned more than twice as much as large stocks, represented by the S&P 500 Index. Value stocks gained about four times as much as growth stocks.

Setting Expectations

The opposite pattern prevailed during the technology boom of the late 1990s, as big stocks and growth stocks outperformed, data compiled by Bloomberg show. In 2014, small cap stocks lagged behind large ones by a wide margin. They trailed again in 2015 through Jan. 13.

William Smead, a stock picker who runs the $952 million Smead Value Fund and invests in big companies, said if historical patterns hold, small cap stocks could lag behind large ones for the next six to nine years.

Setting realistic expectations for performance is just one piece of Dimensional's close relationship with advisers, a relationship that began as an accident, according to Booth.

In the 1980s, the firm managed money exclusively for institutional investors. In 1988, an adviser approached Booth about investing in Dimensional funds.

'Invasive' Process

The idea was intriguing and also somewhat disturbing, said Booth, who was concerned that advisers would move in and out of the funds too often, burdening other investors with higher costs. Minimizing trading costs is part of Dimensional's plan for adding value. The solution was to create a system in which the company could pick advisers who bought into Dimensional's approach and played by its rules.

"They don't want advisers who are traders, they don't want hot money and they don't want people who are chasing performance," said Balunek, who described the process of becoming a Dimensional adviser as more "invasive" than she anticipated.

Booth said the extended process -- including having advisers pay their own way to the introductory seminar -- has paid dividends.

"We have made it kind of a pain in the neck to buy the funds, but that has created a mutual affinity."

Bob Rall, an adviser from Merritt Island, Florida, can speak to that affinity. He started out with a firm that tried to pick individual securities and said he got tired of client losses because of bad stock picks.

Drinking Kool-Aid

He found out about Dimensional 12 years ago and attended one of their conferences. Rall now has about 90 percent of the $35 million he oversees invested in Dimensional funds.

"They poured us big glasses of Kool-Aid, we drank it and haven't looked back," he said.

Advisers are also attracted to the credentials of the academics behind Dimensional's investing and trading strategies. In addition to Fama and French, Nobel Prize winner Robert Merton of

Massachusetts Institute of Technology is involved in designing products for the company.

Having advisers that believe in the firm creates another benefit for Dimensional and its customers, according to Michael Rosen, chief investment officer at Angeles Investment Advisors in Santa Monica, California, who oversees $45 billion for endowments and pensions.

'Sticky' Assets

"Educated advisers are more likely to prevent their clients from making radical changes when markets drop," said Rosen. "The fact that those assets are sticky will add value for the investors."

Dimensional's approach to markets, with its tilts towards small and value stocks, at one time made it distinct in the money-management business, said Alex Bryan, an analyst with Morningstar. Many firms are now competing in the same arena including AQR Capital Management, he said, and products such as low-cost ETFs are also vying for investor capital.

"Investors have a lot of options now," said Bryan. "They don't have to go to Dimensional to get exposure to those strategies."

Booth isn't worried by the competition. He has invested in systems that will allow the firm to grow, although he refrains from projecting how big it might get. When the company passed $50 billion in assets in 2004, he said, "It was already bigger than we thought it could possibly be."

Booth, who owns Dimensional along with other past and current employees and directors, doesn't see that changing anytime soon. He said he has turned down repeated requests to sell Dimensional or take it public.

"The next generation of leadership is in place and they will worry about firm ownership," said Booth. "For the time being we are ignoring the fact that we are getting older. This is what we want to be doing."

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