To print: Select File and Then Print in your browser pull-down menus.

MUTUAL UNDERSTANDING

Added dimension
DFA small-cap value funds backed by academic research

By John Spence, CBS MarketWatch.com
Last Update: 12:01 AM ET Nov. 1, 2004

BOSTON (CBS.MW) -- Most investors probably haven't heard of Dimensional Fund Advisors due to a significant barrier to entry.

Run by some of the top economic minds, DFA funds are aimed at institutional investors able to pony up a minimum $2 million. Yet individuals can buy into the funds through an advisor who attended mandatory DFA workshops, and some employers offer the funds in retirement programs.

The Santa Monica-based fund family's investing philosophy is complex, but proceeds from the fact that small-cap and value stocks post better average returns over long periods.

Based on the performance of its micro- and small-cap value funds, DFA's passive managers are more than holding their own against Wall Street's top stock-picking fund managers.

A look at DFA's board of directors reveals the firm's impressive academic pedigree.

DFA's fund strategies are based on research by University of Chicago professor Eugene Fama and Dartmouth College's Kenneth French that reveals performance "premiums" in small stocks, and companies with low price-to-book valuation ratios, or so-called "value" stocks.

Fama is known for cultivating the efficient-market theory, the idea that all information about a stock is reflected in its current price. Because stock prices are random and unpredictable, buying the entire market with cheap and diversified index funds is a winning strategy given the difficulty of outperforming the market.

The DFA board also has two resident 1997 Nobel Prize winners in economics: Myron Scholes and Robert Merton, who jointly developed the groundbreaking Black-Scholes options-pricing model.

Small size, big returns

DFA's largest mutual funds are constructed to capture the historical outperformance of small-cap and value stocks that shows up because investors are compensated for investing in these riskier asset classes.

Small-cap stocks are generally more volatile than established large-cap stocks. And value stocks, with their low price-to-book ratios and sometimes ugly balance sheets, are often shunned by Wall Street analysts and investors and thus potentially undervalued.

DFA's first fund, launched in 1981, was designed to invest in a micro-cap index from Chicago's Center for Research in Security Prices or CRSP. The CRSP has a historical database of NYSE-listed stocks that breaks the universe into 10 segments, or "deciles," by size or market capitalization.

The Dimensional U.S. Micro Cap fund (DFSCX: news, chart, profile) invests in the two smallest deciles, or the smallest 4 percent of U.S. stocks. By holding thousands of stocks, the fund tries to capture the "small cap premium," while reducing risk with a broad basket of companies.
Through Sept. 30, its five-year annualized return is 15.3 percent, 16 percentage points more than the S&P 500 index (SPX: news, chart, profile), according to investment research firm Morningstar. Over the same period, the fund also beat the small-cap Russell 2000 index, by almost nine percentage points a year.

The fund has delivered market-beating returns over longer time periods as well. Its 15-year annualized return through Sept. 30 is 13 percent, or 2.6 percentage points above the S&P 500, and 3.3 percentage points above the Russell 2000.

With a 0.56 percent expense ratio, the fund is also cheap - the typical small-cap blend fund carries annual fees of 1.5 percent, according to Morningstar.

More than just index funds

Although the DFA funds are "passive" in that they seek broad exposure to market segments, they are markedly different from traditional index funds. Instead of slavishly following a benchmark, DFA will tolerate relatively higher levels of tracking error compared to Vanguard index funds and exchange-traded funds, for example.

This flexibility leaves DFA free to exploit illiquidity in the small- and micro-cap arena, where many stocks trade infrequently.

"Small-caps are less liquid and the bid-ask spreads are wider," said Russel Kinnel, head of fund research at Morningstar.

By virtue of its size and expertise in trading the market's smallest names, Kinnel said DFA adds performance by getting favorable prices on large or block trades. Oftentimes DFA will act as a liquidity "provider" for momentum funds and investors who are looking to buy or sell a big chunk of shares at once, Kinnel added.

DFA's largest fund with over $5 billion in assets, Dimensional U.S. Small Cap Value (DFSVX: news, chart, profile), invests in the historically best-performing corner of the market as identified by the Fama and French research: small and inexpensive stocks listed on the major exchanges.

Its three-year annualized return is 23.6 percent through Sept. 30, almost 20 percentage points more than the S&P 500, according to Morningstar. Its 10-year return is nearly 16 percent, about 5 percentage points above the S&P 500.

Caveats

Although the two funds are passive, they have relatively high turnover and poor tax efficiency compared to traditional index funds.

Small-cap stocks are more volatile than their more stable large-cap peers, so investors must be willing to stand big performance swings. Also, in the past there have been prolonged periods where the small-cap and value premiums did not show up, even for decades at a time.

For example, small-cap value stocks underperformed during the bubble of the late 1990s when large growth names were in favor. Most investors would have been hard-pressed to stick with a small-cap value fund, but over the long-term they would have been rewarded for their diligence with the fat returns shown above.

That is why most investors can only access the DFA funds through a financial advisor who presumably understands passive investing and can help investors maintain a long-term, disciplined approach.

"The firm wants to try to minimize the presence of fickle investors in its funds," wrote Kinnel in an analysis on Morningstar's Web site. "Unpredictable cash flows could disrupt its ability to trade efficiently, which is a big part of its competitive advantage."

John Spence is a reporter for CBS MarketWatch in Boston.