BARRON'S

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SATURDAY, AUGUST 3, 2013

# Where the Smart Money Is Headed

BY BEVERLY GOODMAN

Fund Scope|Scoreboard

The word is getting out.

Eleven years ago, I wrote a rare profile of Dimensional Fund Advisors with the headline "The Best Fund Family You've Never Heard Of…and Why It Doesn't Want Your Money." It's not quite a household name, and the quirky Austin, Texas-based fund company still doesn't sell directly to investors, but advisors are increasingly doing their part to bring DFA's passive strategies to the masses.

In an annual survey just released, Cogent Research asked more than 1,700 financial advisors how likely they are to increase or decrease assets with 24 different mutual fund companies. For the third time in four years, DFA topped the list. Pimco came in second, Vanguard and Franklin Templeton tied for third, and T. Rowe Price and Ivy Funds tied for fourth.

DFA's rise has been steady, perhaps the result of a trend toward indexing, along with its impressive performance and unusual manner of selling. Back in August 2002, DFA had $36 billion under management, with just $13 billion in mutual funds. Today? The firm has $300 billion in assets, $165 billion of which is in their advisor- and broker-sold funds, all of which are no-load.

All money with DFA is managed passively. While that may sound like an oxymoron, DFA's style of "structured investing" is a proven strategy that falls somewhere between indexing and active management, and is based on the notion that markets are efficient. That means you can't beat the market via stock-picking or market-timing, but it doesn't mean you can't beat the market. DFA was founded on the work of famed academics Eugene Fama and Kenneth French, and still operates like more of a think-tank than asset manager, using academic research to structure its portfolios. DFA's funds are constructed to capture the return of an asset class—but they don't just mimic an index. They use selective stock-picking, efficient trading, careful tax management, low costs, and a host of risk controls to beat the benchmarks that index funds merely ape.

"Advisors are increasingly interested in moving towards making rational decisions based on very sound academic research, and that's what we provide," says Eduardo Repetto, DFA's co-CEO and chief investment officer.

"It shows how important it is to bring a distinctive investment philosophy," says Meredith Lloyd Rice, senior director at Cogent. They also score very well in terms of fees and expenses, she adds. "We've had very strong market performance the past couple of years," Rice says, "and now advisors are focusing more on how to lower costs to better deliver returns in a potentially softening market."

The firm's approach isn't easy to understand. That's why it refuses to sell directly to individual investors—DFA wants its philosophy properly explained by the advisors that sell their funds. To ensure they're able to do that, advisors must initially and regularly participate in seminars that explain the academic foundations of the firm, as well as present new research. As a result, advisors should be able to properly understand how to use DFA funds and articulate the process to their clients. "They become evangelists," Rice says.

Despite its reliance on advisors and brokers, DFA doesn't have any fee-sharing agreements with the people who sell its funds. "Absolutely not," Repetto says. "advisors provide a service to the client and the client pays the advisor."

DFA'S FOCUS IS ON ACADEMIC research that isolates the factors that cause stocks to outperform the market, as well as the risk characteristics that can be eliminated from a portfolio. Indexes are simply measures of an asset class; DFA funds are aimed to capture more of the returns of an asset class with much less risk and at far less cost.

For instance: Value stocks have demonstrated outperformance over longer periods. Momentum, however, can cause short-term volatility. DFA might hold off buying a value stock for its value portfolio—even if it's in the broader index—if the short-term momentum factors present too big of a risk. "Momentum factors last for a shorter period than value factors," Repetto says. "When that downward momentum decays, if the stock is still a good value, we'll consider buying."

DFA has data on 400,000 securities worldwide. Even though that figure is immediately slashed to a universe of 40,000, "we like to track the data on everything, so we can create a history, which could be useful if things change," Repetto says. The firm holds about 12,000 securities.

Many securities—DFA is equity-heavy, but has $65 billion in fixed income—are knocked out because they don' t meet the firm's strict criteria. As a rule, it doesn' t invest in initial public offerings, because research shows that to be a losing game. The firm also has rules as to how much liquidity a stock or bond has, how many market makers there are, and minimum accounting standards that exceed those of most exchanges.

In these days of risk aversion and cost management, it's little wonder Dimensional Fund Advisors is edging into the spotlight. ï¿½

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