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INVESTOR'S GUIDE 2014

David Booth beats the market without picking stocks

By Ian Salisbury @Money January 16, 2014: 10:37 AM ET

"If you want to hold a market portfolio, that's fine...we think you can do better," says David Booth, chairman and co-CEO of Dimensional Fund Advisors.

NEW YORK (Money Magazine)
David Booth built Dimensional Fund Advisors on the idea that investors can't beat the market. The mutual fund company's assets now run to more than $300 billion. So what's the secret of Booth's smashing success? Beating the market.

Long before it was fashionable, Booth, 67, bet his career on "passive" investing -- that is, buying and holding a representative slice of equities instead of trying to choose the next winners. As a grad student he was a research assistant to the economist who would later win a Nobel for showing that even smart investors can't predict stock prices.

In the 1970s, Booth worked on one of the first institutional index funds, which simply held every listed stock on the New York exchange. He co-founded Dimensional in 1981 with a pioneering mutual fund that passively owned stocks of small companies.

So investors in Dimensional are just getting plain-vanilla index funds that track well-known benchmarks like the S&P 500, right? Not exactly. "If you want to hold a market portfolio, that's fine. We think that's pretty good," says Booth, a self-described "aw-shucks" Midwesterner. "But we think you can do better."

Dimensional's portfolios look a lot like index funds. They are broadly diversified, have low management fees, and holdings are rarely changed. No manager is trying to guess the direction of the S&P or evaluate Tim Cook's strategy at Apple (**AAPL**, **Fortune 500**).

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Dimensional does, however, preach that investors can capture a better long-run return by "tilting" their portfolios to favor certain parts of the market (for example, smaller companies). Performance also differs: The company's DFA U.S. Core Equity 1 (**DFEOX**) fund earned an annualized 19.6% over the past five years, compared with 18.4% for an index of the total stock market.

It's tough to buy Dimensional funds: They're sold only through financial advisers who tend to work with the wealthy, and in 401(k)s and some 529 college savings plans. But you're sure to be hearing more ideas like Booth's. And bolder claims too.

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The heyday of what you might call the artisanal fund manager -- a stock picker who carefully selects, say, 50 or 100 companies -- is waning. The success of index funds, now 28% of fund assets and growing, is a big part of that.

Some passive managers, however, are using historical patterns and statistical models to create funds that make broad strategic bets. Besides Dimensional, players now include **BlackRock**, the world's largest asset manager. Taking a more radical position is MIT economist **Andrew Lo**. He's aiming not only to improve on the academic theory that drives both traditional indexers and Dimensional but also to create a new breed of funds he hopes will be as transformative as the original index funds.

What to expect in the stock market in 2014

Proponents of these different approaches can marshal intriguing evidence. There's also reason to be skeptical. Popular tilted strategies have done well in recent years, which can make it harder to see the risks they carry. And marketing, as much as research, is driving the industry's enthusiasm. "Investors have woken up to the fact that it's hard to beat the market, and investment managers need a new story to tell," says Paul Baiocchi, an ETF analyst at the research firm IndexUniverse. "This is the new story."

It's also the investing debate that matters now -- not the choice between passive and active stock picking, but between passive or passive with a twist. According to IndexUniverse, among **exchange-traded funds** (ETFs) that invest in stocks, one in three employ one of these new strategies.

Here's a close look at the arguments behind the "do better" portfolios and lessons you can apply to your own investing, even if you decide to stick with simpler funds.

The Trailblazer: Tweaking the winning formula

Dimensional, which began as a two-man operation based in a Brooklyn apartment, has grown to 800 employees, with its headquarters in an airy, modern-art-filled campus on a hilltop in Austin. Booth's success allowed him to give $300 million to the graduate business program at the University of Chicago. It's now called Booth School of Business.

That gift was not for nothing. The University of Chicago gave Booth not just his MBA but a front-row seat for an investing revolution. Booth and Dimensional co-founder Rex Sinquefield were students of Eugene Fama, who had developed a powerful idea called the "efficient-markets hypothesis."

The basic premise: When new information that could drive a company's stock price up or down comes out -- a new product, say, or an accounting scandal -- information hits the street so quickly that it is instantly factored into prices. There is no reliable way for investors to beat the market.

That's one reason, along with low costs, that index funds consistently beat the average fund manager. As of mid-2013, for example, 72% of U.S. stock funds lagged the S&P Composite 1500, an index of the broad market, over the past five years.

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Fama, who is on Dimensional's board, won the Nobel Memorial Prize in 2013 for the efficient-markets hypothesis. But in the early 1990s he made other findings that were just as important to investors like Booth. Along with economist Ken French, Fama showed that small companies and value stocks -- those trading cheaply compared with the assets on their books -- tend to earn higher returns than the market.

Dimensional's funds are vehicles for capturing such effects. The original fund, DFA U.S. MicroCap (**DFSCX**), is an index-like portfolio of small companies. The newer U.S Core Equity 1, launched in 2005, owns a wider swath of the market but is weighted to smaller and cheaper. It charges annual fees of 0.19%, compared with as little as 0.04% for a plain index, but far less than the average 1.4% for stock funds.

Tilting presents a ticklish problem. If there's evidence that certain stocks outperform, how can markets also be efficient? Why don't investors pile into those great stocks, bidding up prices and thereby eliminating the higher returns?

"They are riskier," explains Booth. Small companies often have untested business models. The value effect is less intuitive; it seems like a cheaper stock should be safer. Yet the discount could mean the market sees something wobbly in the business.

James Montier, of the active fund managers GMO, says you may be disappointed if you get in on tilting now. "They are not priced to work," he says. "They are quite expensive." Booth, of course, doesn't make such calls but cautions that a tweaked approach can leave you out of step with the market at times.

U.S. MicroCap has annualized returns of 12.5% since its 1981 inception, compared with 11.6% for the S&P 500. But the fund lagged for almost a decade before the winds shifted. "People were disillusioned, but they realized that for a long-term strategy, you've got to accept that risk and return are related," says Booth. "We were able to defend it."

It's not that Dimensional never changes its thinking. Booth is excited about new research showing that companies with higher profits, relative to the assets on their books, seem to earn better returns. Dimensional is adding that factor to its tilts. "The really good ideas come along about every decade or so," he says.

The takeaway for you. If you can't get into a Dimensional fund, there are other ways to tilt. On the MONEY 50 recommended list, the Vanguard Small Cap Value ETF (**VBR**) captures both the value and size effects; it's earned an annualized 21.1% over five years, vs. 16.9% for the S&P 500.

There's a lesson, too, even for those who prefer to stick with a broad-market index. Popular S&P 500 index funds tilt away from the small-cap effect because they hold more of the biggest stocks. A better core choice is Vanguard Total Stock Market (**VTI**), which includes small companies.

More fund managers' strategies:

Amy Schioldager, head of beta strategies at BlackRock
Andrew Lo, professor of finance at the Massachusetts Institute of Technology ■

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