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Sweeping changes under way at DFA

Despite its success, firm is tinkering with the way it builds equity portfolios

By Jason Kephart | *August 7, 2013 - 12:49 pm EST*

For the first time in more than 20 years, Dimensional Fund Advisors is changing the way it builds equity portfolios.

Thanks to a breakthrough in asset-pricing research last year, DFA is adding a third layer of screening to its equity portfolios, which already tilt toward small and value stocks. The new layer, or dimension, focuses on a company's persistence of profitability — basically a stock's ability to earn a profit consistently.

The idea that a profitable company is going to perform better than a less profitable company over time isn't a new idea. In fact, it is kind of common sense.

The challenge for DFA, which bases all its investment methodologies on academic research, was finding a reliable way to use data to identify future profitability.

“New research has to be very robust, very reliable and have real information that's not already captured in the other dimensions,” said Eduardo Repetto, Dimensional's co-chief executive and chief investment officer.

The breakthrough came late last year when DFA began looking at companies' earnings-to-assets and earnings-to-book, rather than cash flow or earnings-to-price.

The company found that using a stock's price doesn't lead to any reliable data, because the price of a stock can be very volatile. Using a company's assets or book value, by contrast, provides a more reliable look at how profitable a company is and how likely it is to continue to be profitable.

When DFA looked at the back-tested results of overweighting the most profitable companies in its portfolios, the results weren't inconsequential, Mr. Repetto said.

In fact, the power of the profitability dimension is about par with the premium seen over time by overweighting value. When the two are combined, it leads to even better results.

“When it's combined with size, and in particular with value, you can really form portfolios that add value relative to not using that dimension,” Mr. Repetto said.

The new overlay already has been added to seven equity portfolios with about $2 billion in assets, or less than 1% of DFA's approximately $240 billion in equity portfolios.

The plan is to roll it out across the entire lineup by year's end, Mr. Repetto said.

“Right now, we're working with clients so everyone understands what we're doing,” he said. “We don't want anyone to be surprised.”

The changes may be surprising to financial advisers, given the success of the firm's tried-and-true strategy of tilting toward smaller and undervalued companies.

For example, the $7 billion DFA U.S. Core Equity Fund (DFEOX), which tilts toward small and value stocks, has five-year annualized returns of 9.55%, topping the returns of the $34 billion Vanguard Total Stock Market ETF (VTI), which has five-year annualized returns of 8.86%.

Still, Mr. Repetto is confident that changing the company's Kool-Aid recipe will only lead to better results.

“This is not magic; it's based on our understanding of asset prices,” Mr. Repetto said.

“Whenever we can do something good for our clients, it's in our best interest to do it,” he said.

DFA launched two funds late last year that offer a pure exposure to low book-to-market stocks with a profitability screen so that advisers can add the mix to their own portfolios, but so far, advisers seem to be taking a wait-and-see approach.

The slightly misleadingly named DFA U.S. Large Cap Growth Fund (DUSLX) and the DFA U.S. Small Cap Growth Fund (DSCGX) so far have gained only $151 million and $95 million in assets, respectively.

“I'll keep a close eye on it,” said Michael Angelucci, founder of Angelucci Wealth Management LLC, who has been using DFA funds for about five years. “If there is persistence, why not take advantage of it?”

Lee Munson, principal at Portfolio LLC, recently completed the multistep screening process required for advisers to sell DFA funds and is encouraged by the change.

“They're continuing to innovate all the time,” he said. “It doesn't mean what they were doing in the past was wrong, just that they found new and interesting things.”

The adviser support probably shouldn't come as a surprise for the company that has ranked atop Cogent Research LLC's Adviser Brandscape rankings three out of the past four years.
