The DFA Model

Daring to be different.

John Rekenthaler, 01/07/2014

Academically Speaking

In the current issue of Barron's, Beverly Goodman profiles Dimensional Fund Advisors, the nation's eighth-largest mutual fund company. It's a good read.

Dating back to the early 1980s, DFA is the most self-consciously academic of fund companies, having been founded by two former University of Chicago graduate students, David Booth and Rex Sinquefield, who had studied under efficient-markets theorist Eugene Fama. Other fund companies trumpeted star managers; DFA would trumpet star research.

It began operations with a small-company U.S. stock fund, based on data that showed that smaller-company stocks outgained their larger peers over time. It later added a second factor of emphasizing value stocks, as opposed to high-priced growth companies, and recently has discussed adding a third factor of profitability. The company also has greatly expanded its asset classes and now offers international-stock, fixed-income, allocation, and real estate funds, along with a commodities portfolio.

(Indirectly, DFA influenced the development of the Morningstar Style Box, which sorts funds according to the same two criteria of value-growth and size. DFA was not the only company to view U.S. stocks by the value-growth and size perspectives, but it was an influential voice in the process.)

The company coupled its unusual, academically inspired fund lineup with an even more unusual distribution strategy. Whereas the fund industry traditionally featured no-load funds selling directly to investors, or load funds selling through financial advisors, DFA mixed fish with fowl. It launched only no-load funds, to be used only by financial advisors. Not just any financial advisors, either. To use DFA funds, a financial advisor must be screened by the organization and must attend a two-day educational seminar.

I always thought of DFA as an index-fund company, and I think everybody else did, too. After all, its funds not only bought and held entire market segments and were inspired by Gene Fama, who has been called the "father" of index-fund investing (a distinction that must irk Jack Bogle), but they also were supported by advisors who argued the merits of passive, indexing-based strategies rather than active management. In recent years, though, DFA has maintained that, despite appearances, it is in fact an active manager.

The first part of the claim is because DFA believes that its funds will outperform the overall market. With U.S. stocks, for example, it expects a portfolio built with DFA's tilts toward value and smaller companies to beat the S&P 500. In the Barron's article, Booth states, "I recoil when people think that what we do is being passive, because it has nothing to do with being passive. We are trying to beat the market without forecasting in the usual sense."

Hmmm, well. That's a different definition of passive than the one to which I am accustomed. By that definition, many if not most exchange-traded funds are actively run. But never mind the semantics--DFA's ambition is clear. Vanguard is for those who are happy to settle for market performance. DFA aims for more.