

## Financial Times article December 2007

### Dimensional's performance speaks volumes

By Steve Johnson

Published: December 10 2007 09:58 | Last updated: December 10 2007 09:58

A cynic might argue that the investment philosophy of Dimensional Fund Advisors is two-dimensional – value and small-cap stocks dominate the house repertoire.

But the Santa Monica, California-based company has been creating waves in its own understated manner on both sides of the Atlantic since its foundation in 1981 – entering the top 20 of US mutual fund providers, as measured by assets under management, and garnering some \$9bn (£4.4bn, €6bn) from European clients since starting a push in the old world in 2002.

And all this without shouting from the rooftops. “We have raised \$2bn from [UK] financial advisers and I don’t know anybody recently who has raised that much without paying a penny in commission or on advertising,” says David Salisbury, the former chief executive of [Schroders](#) who has headed Dimensional’s European operations for the past five years.

This refusal to pay commission means Dimensional will always be off the radar screen of many fund distributors and commission-hungry salesmen, but unusually for a fund manager Dimensional appears to rate quality of inflows over quantity.

“We only work with fee-based advisers,” says Mr Salisbury. “They tend to be more strategically focused in managing clients’ portfolios and have no incentive to generate turnover.”

This approach has probably cost Dimensional sales. Some 80 per cent of its European assets are sourced from institutional investors, twice the proportion in the US, where assets under management have soared to \$150bn, from \$35bn in 2002. But Mr Salisbury has no plans to change.

“We try to discourage investors chasing short-term performance; their activities result in increased transaction costs which are not in the interests of long-term investors,” he asserts, warning that such hot money can exit in a slowdown.

A number of Dimensional’s funds are going through just such a slowdown at present, with small-cap and value stocks having fallen out of favour after strong periods of outperformance. But the company has no plans to change tack.

Dimensional was founded by David Booth and Rex Sinquefeld who both studied under Eugene Fama, the economist who proposed the “efficient market hypothesis” and who sits on Dimensional’s advisory board.

This theory – which holds that all publicly available information is already factored into a stock’s price – suggests that few, if any, active managers can consistently beat an index.

Yet, in Dimensional’s view, this is not inconsistent with the view that some stocks, ie small-cap and value ones, exhibit a higher risk premium than others, and therefore should exhibit stronger returns over time.

According to Dimensional, US small-cap value stocks generated compound annual returns of 17.66 per cent between 1964 and 2006, against 14.09 per cent for large-cap value and 10.27 per cent for large-cap growth.

In the UK, between 1957 and 2006, small-cap value stocks made 21.3 per cent a year, against just 11.07 per cent for large-cap growth, while in continental Europe small value stocks made 17.66 a year between 1981 and 2006, compared with 12.78 per cent for large growth stocks.

While the small-cap premium may be intuitive enough, the existence of a value premium may be harder to rationalise. After all, the future earnings stream of a solid yet unspectacular utility or food manufacturer should be easier to predict than that of a high-growth technology upstart, resulting in lower risk.

But Mr Salisbury, a true believer who sat on Dimensional's board for eight years while gainfully employed at Schroders, merely points to the evidence.

"The value premium, statistically, is as reliable as the equity risk premium," he says. "Historically value stocks [defined by a low price/book ratio] have outperformed growth stocks with a similar consistency to that with which equities have outperformed bonds.

"The premium is prevalent across both developed and emerging markets and we try to capture this."

Dimensional uses these insights to create passive small-cap and value portfolios, as well as more balanced "core" portfolios with a tilt in these two directions.

But, refreshingly, the company takes a pragmatic approach to turnover, avoiding the trap whereby index and exchange traded funds have to constantly trade, often at disadvantageous prices, whenever stocks enter or leave their universe.

"Because we manage highly diversified portfolios, we are able to be highly selective as to which stocks we trade on a given day," says Mr Salisbury, who believes Dimensional has lower transaction costs than any other small-cap manager, and even many large-cap houses.

This approach has resulted in solid outperformance. Dimensional's US-domiciled UK small-cap portfolio has returned 9.87 per cent a year after fees over the past 10 years, against 7.10 per cent for the FTSE Small-Cap index and 6.09 per cent for the FTSE All-Share. The UK component of its International Values Series has made 10.74 per cent a year in the past decade, against 6.16 per cent for the MSCI UK Value Index.

However, since the summer performance has been hit by market rotation. "Both value stocks and small companies have underperformed in the last three or four months as all risk premia have increased," concedes Mr Salisbury. "Every investment approach goes through periods of adversity; the key is to have an approach in which you have long-term confidence so that you are not affected by short-term considerations."

[Copyright](#) The Financial Times Limited 2007