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Mutual Funds Report

Reading the Index To Beat the Index¹

By **HOWARD ISENSTEIN**

INDEX funds mirror the market, and they appeal to investors who realize that most fund managers do not beat the market for extended periods. But by tweaking the mathematical approach taken by index funds, Dimensional Fund Advisors has often been able to beat them.²

The company, based in Santa Monica, Calif., is known in the academic world and among professionals — those who manage assets for pension funds and other big institutions — for its canny trading, sophisticated use of computer modeling and an emphasis on small-cap stocks.

But DFA, as it is often called, is hardly a household word among individual investors, largely because the company requires minimum investments of \$2 million for many of its funds. DFA funds are also available without such requirements through some 401(k) plans, and through select fee-only advisors.

The company was founded in 1981 in the spare bedroom of David G. Booth, now the chief executive and co-chairman. According to John C. Siciliano, the company's director of global institutional services, it manages \$48 billion for pension funds, like those of the Boeing Company and the states of Utah and Missouri, along with 93 mutual funds.

Mr. Booth and Rex A. Siquefield, the other co-founder and co-chairman, together control a majority of the company. Employees, board members and 28 outside investors own the remainder. Among them is Gov. Arnold Schwarzenegger of California. Mr. Siciliano said that Mr. Schwarzenegger was an "outside

investor" with less than 5 percent ownership of the company.³ "Our outside investors are strictly investors and do not have a role in the management or strategy of the company," he said.

A spokesman for Mr. Schwarzenegger declined to comment.

Both Mr. Siquefield and Mr. Booth graduated from the University of Chicago with M.B.A.'s, and their company's investing approach has been heavily influenced by the theories of academics, some of whom are consultants or shareholders of the company or are directors of Dimensional or mutual funds managed by Dimensional. These include Eugene F. Fama, a finance professor at the University of Chicago; Kenneth French, a finance professor at Dartmouth; and Robert C. Merton, a Nobel laureate in economics and a professor at Harvard Business School.

Professor Fama, who owns less than 5 percent of the firm, is its director of research, while Professor French is director of investment strategy. (Professor Fama has served as an economic adviser to Mr. Schwarzenegger, said Paul Wachter, Mr. Schwarzenegger's personal

financial adviser.)

DFA uses approximately two dozen criteria to weed out stocks that neither properly reflect the characteristics of a given class nor are germane to it, Mr. Siciliano said. For example, the firm considers only companies that have been audited



Linda Ford

David G. Booth, chief executive of Dimensional Fund Advisors, said it was important to have a strong belief system when managing assets.

The following information is provided by Dimensional Fund Advisors Inc. ("Dimensional") and did not appear in the original publication:

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2 Performance data in this article represents past performance, and there is no guarantee of future results. Investment results, and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost.

3 As of September 30, 2003, the date of the interview with Mr. Siciliano.

by a major accounting firm, that are profitable and that do not face any material litigation. It excludes initial public offerings and real estate investment trusts (except for inclusion in its real estate fund), and stocks for which a majority of shares are not traded publicly.⁴

In the U.S. small-cap universe, which has about 5,000 stocks, the screens would leave about 3,500, Mr. Siciliano said. The company uses its own stock and market analysis to form portfolios, which resemble the underlying universe of screened stocks but do not necessarily mirror it precisely.

PURE index funds adhere scrupulously to the weighting of the stocks and bonds in an underlying index. But when DFA's fund managers decide that it is time to buy or sell a security, they often wait for a few days or weeks to get better prices.

"We get shown up to 1,000 blocks" of stocks a day, Mr. Siciliano said. "We may do anywhere between 5 and 20" block orders, he added, "and look for a transaction that's below the bid," or lowest price generally offered. Because the firm is a very large trader in the small-cap arena, it often succeeds, Mr. Siciliano said, adding that up to 40 percent of its small-cap trades were done at a discount to the market price.⁵

The ability to screen stocks with sophisticated mathematical techniques and to buy below the bid are among the firm's competitive advantages, and they have been exemplified in the DFA U.S. Micro Cap Portfolio, the firm's first mutual fund. According to a 1995 DFA-financed study by Donald B. Keim, a DFA consultant and a professor at the Wharton School of the

University of Pennsylvania, the U.S. Micro Cap Portfolio has outperformed its closest benchmark, an obscure index known as the CRSP 9-10, by 2.92 percentage points, annualized, since its inception in 1982.⁶

A mathematical focus on small-cap value stocks.

DFA's funds have generally fared well in recent years. Its U.S. Micro Cap Portfolio, for example, gained 16.8 percent in the last quarter and 60.7 percent in 2003, placing it in the top 6 percent of funds in its category for the year, according to Morningstar.⁷ In the five years through 2003, it returned 16.4 percent, annualized. Its U.S. Small Cap Value Portfolio gained 20.7 percent in the quarter and 59.4 percent for 2003, to finish in the top 13 percent of funds in its category for the year. In the five years through 2003, it returned 16.9 percent, annualized.⁸

DFA keeps fees relatively low. They average 0.49 percent of assets, well above the 0.26 percent average at Vanguard but far below the average of 1.44 percent for all mutual funds, according to Morningstar.⁹

Paul Herbert, who covers DFA for Morningstar, said it had "a good reputation in the financial planning and institutional communities," because of its specific style, low costs and good performance.

Jeremy J. Siegel, a finance professor at the Wharton School at the University of Pennsylvania, has a similar view. "It's a very

disciplined group" in terms of maintaining investment objectives and analyzing small-cap stocks, he said.

The firm's emphasis on small-cap stocks has not always produced good returns. From 1996 through 1999, for example, a time when growth stocks were sizzling, U.S. Small Cap Value Portfolio trailed the Standard & Poor's 500, sometimes by large margins; in 1998, the Portfolio lost 7.3 percent, a performance that was 35.9 percentage points worse than the S&P 500 Index.¹⁰ And the 1980's were bad for U.S. small-cap stocks, which were hit particularly hard by the recession early in the decade and lagged behind the market in subsequent years.

For individual investors, the most obvious problem with DFA funds is buying them. "We're really not equipped to be a retail sales organization," Mr. Siciliano said. "We're an investment research shop."

Mr. Herbert of Morningstar says that this is an advantage for fund shareholders because DFA does not "have to deal with finicky flows" into and out of its funds, which can hurt liquidity and returns.

The firm's funds are available to retail investors in two ways — through about 800 fee-only financial planners (www.dfaus.com/find_advisor) or through about 35 major 401(k) plans, including those of Verizon Communications, BellSouth and the Sandia Corporation. Many of those plans offer a handful of DFA funds, often its U.S. Small Cap Portfolio, U.S. Small Cap Value Portfolio, U.S. Micro Cap Portfolio, International Value Portfolio and One-Year Fixed Income Portfolio, Mr. Siciliano said.¹¹

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4 The prospectuses for the funds managed by Dimensional contain more complete information about the funds, including investment objectives, strategies, performance, charges and expenses. Read them carefully before you invest or send money.

5 From July 1985 to June 2003. Past performance is no guarantee of future results and investment results.

6 Performance data represents past performance and is no guarantee of future results and investment results, and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. A portfolio that emphasizes smaller companies may experience greater price volatility. Please see Endnote A and any attachments to this reprint for one-, five- and ten-year standardized performance data. The prospectus for the portfolio presented contains more complete information about the fund, including performance, charges and expenses. Read it carefully before you invest or send money.

The portfolio may differ significantly from the securities held in the CRSP 9-10 Index. The index is not available for direct investment; therefore its performance does not reflect the expenses associated with the management of an actual portfolio. The comparison is presented to show the performance of small stocks during the period.

7 See Footnote 6 and Endnote A.

8 See Footnote 6 and Endnote A.

9 The prospectuses for the portfolios contain more complete information about the fund, including performance, charges and expenses. Read it carefully before you invest or send money.

10 See Footnote 6 and Endnote A.

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ENDNOTES

A. Percentage annualized total returns for the period ending March 31, 2004 are as follows:

	<u>U.S. Micro Cap Portfolio</u>	<u>U.S. Small Cap Value Portfolio</u>	<u>CRSP 9-10 Index*</u>
Year to Date			
Return Before Taxes	6.46	7.38	7.20
Return After Taxes on Distributions	6.46	7.38	N/A
Return After Taxes on Distributions and Sale of Fund Shares	4.20	4.80	N/A
1 Year			
Return Before Taxes	78.20	85.27	94.65
Return After Taxes on Distributions	76.96	82.66	N/A
Return After Taxes on Distributions and Sale of Fund Shares	51.25	56.76	N/A
5 Year			
Return Before Taxes	19.87	20.76	21.31
Return After Taxes on Distributions	17.05	18.01	N/A
Return After Taxes on Distributions and Sale of Fund Shares	15.98	16.88	N/A
10 Year			
Return Before Taxes	15.38	16.22	16.13
Return After Taxes on Distributions	12.68	14.19	N/A
Return After Taxes on Distributions and Sale of Fund Shares	12.09	13.44	N/A

* CRSP 9-10 Index data courtesy of the Center for Research in Security Prices, University of Chicago.

B. For additional copies of prospectuses, please call collect (310) 395-8005 or write to DFA Securities Inc., c/o Dimensional Fund Advisors Inc., 1299 Ocean Avenue, Santa Monica, CA 90401. You may also visit www.dfaus.com to download a copy of a prospectus and to receive performance data current to the most recent month end. Read the prospectus carefully before you invest or send money.