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DFA's Disciplined Approach Earns It a Top Mark

The firm puts theory into practice with a focus on investors.

Fund Spy | 06-09-15 | by Alex Bryan

Morningstar recently issued a new Stewardship Grade for DFA. The firm's overall grade—which considers corporate culture, fund board quality, fund manager incentives, fees, and regulatory history—is an A. What follows is Morningstar's analysis of the firm's corporate culture, for which DFA receives an A. This text, as well as analytical text on the other four Stewardship Grade criteria, is available to subscribers of Morningstar's software for advisors and institutions: Morningstar Advisor Workstation(SM), Morningstar Office(SM), and Morningstar Direct(SM).

Dimensional Fund Advisors has forged a strong and distinctive culture that has served investors well. The firm's low-cost structure and disciplined approach to investing, launching new strategies, and qualifying the financial advisors who use its funds help set it apart. It reflects a consistent, industry-leading focus on fundholders, and thus, we are raising its Corporate Culture grade to an A from a B.

Dimensional's investment philosophy is based on the idea that market prices reflect all publicly available information—commonly known as market efficiency. Therefore, it is not in the business of forecasting and individual security selection. But that does not consign it to a broad market-cap-weighted approach. The firm offers strategies that attempt to beat the market by targeting exposures to what it views as the types of risks that the market compensates. These are characteristics that historically have been associated with higher expected returns, such as credit, duration, value, small market capitalization, and profitability.

Each strategy the firm adopts must be economically sound and backed by substantial empirical evidence that it has consistently delivered attractive returns across different markets and time periods. DFA draws heavily on academic research to develop its strategies. For example, it maintains consulting relationships with several finance professors, including two Nobel laureates, to stay on the cutting edge of financial research. To bridge the gap between theory and implementation, DFA maintains an in-house research team, which focuses on vetting and applying academic research, testing new ideas, and improving the implementation of its existing strategies.

Academic research has guided the evolution of DFA's funds throughout its history. DFA started out specializing in small-cap and micro-cap funds, based on research suggesting that small-cap stocks outperform their larger-cap counterparts. The firm launched its first value strategies in 1993, a year after professors Eugene Fama and Kenneth French published their seminal three-factor asset-pricing model, which indicated that value stocks offer an additional return premium. Most recently, the firm has incorporated a profitability tilt into its equity funds, based on new research suggesting that profitability can help predict long-term returns. These changes refined the strategies but did not fundamentally alter them. This research paved the way for DFA to launch its first growth funds, which target stocks with strong profitability.

Transaction-cost management is an essential tenet of DFA's value proposition. It avoids high-turnover strategies and incorporates transaction costs into its portfolio construction framework. Because its funds do not track an index, DFA's managers are not forced to trade when doing so would not be cost-effective. For example, if a security is near the cusp of a fund's targeted style zone but trading it would significantly move prices against the fund, the fund may defer or avoid trading it. The firm's traders are rarely required to trade any specific stock. They can substitute one stock for another that would be cheaper to trade as long as it has the desired characteristics for the strategy.

DFA often leverages this flexibility to provide liquidity—responding to sell orders with purchase orders or selling stocks to satisfy investor demand. This flexibility distinguishes the firm and should help reduce transaction costs. To further reduce costs and retain full control of its orders, DFA has adopted an automated direct-market-access trading model, which it now uses to place nearly all of its stock trades. As of March 2015, DFA employed 23 traders with an average of 14 years of experience.

An investment committee meets twice a month to provide oversight for the strategies and approve implementation changes. The committee includes the firm's senior executives and portfolio managers. DFA also has a separate investment policy committee that meets to recommend new strategies and enhancements to its existing strategies. Professors Fama and French sit on that committee, in a consultancy role, along with many of the firm's senior executives.

While it has a large lineup of funds, DFA only targets a handful of drivers of expected return. There is substantial overlap among its portfolios, which gives investors the option to choose from funds with moderate to more-exaggerated style tilts, but it also creates some redundancy in the lineup. This overlap is a result of the firm's willingness to adapt its strategies to meet client demand. For example, it introduced a series of core equity funds in response to client demand for a broad-market portfolio with systematic small-cap and value tilts. It also offers some socially responsible versions of its funds.

However, client whims don't sway DFA from its methodical approach to launching new strategies. It requires a heavy burden of supporting empirical evidence before it will consider adopting a new strategy. Even when the evidence is solid, the strategy must be consistent with the firm's low-turnover philosophy. For instance, despite the strong empirical evidence that shows the near-term persistence of stock-price momentum, DFA does not attempt to trade on it, though it may use momentum as a reason to delay a trade. Although it has launched 22 funds during the past five years, most of these target the same sources of expected return as its longer-standing funds.

Dimensional usually doesn't chase trendy investment themes. Rather, it takes its cues from the academic community. For example, the firm didn't abandon its stoic value framework during the tech boom in the 1990s. Similarly, it hasn't rushed to offer a low-volatility strategy because it believes investors can achieve the same results more efficiently by allocating a greater portion of their portfolios to fixed income and value equity funds. As a result of its deliberate approach to its fund lineup, DFA rarely liquidates or merges funds. In the United States, DFA has merged or liquidated just three funds, according to Morningstar data. As of March 2015, equity funds represented about 74% of the firm's assets, while fixed-income funds accounted for most of the remainder.

DFA has grown substantively during the past decade, now ranking among the top 10 mutual fund companies with more than 6 times the assets it had 10 years ago. It was able to accomplish that feat without traditional advertising. Rather, it devotes considerable resources to investor education, which is a major area of focus for the marketing team.

Unlike most mutual fund shops, Dimensional does not make its funds available directly to individual investors. Instead, the funds are only available through an intermediary, such as a 401(k) platform, or a financial advisor that DFA has approved. Before qualifying advisors to use its funds, Dimensional educates candidates on its investment approach and attempts to filter out those who are likely to hold the funds for the short term, a practice that could harm the strategies' long-term investors. The firm does not compensate or receive compensation from advisors who use its funds. Investments from financial advisors represent about 55% of Dimensional's assets, while the remaining 45% comes from institutional clients.

The firm's client-education effort appears to be effective. In 2008, when investors were leaving equity funds in droves, DFA bucked the trend and enjoyed net inflows to its equity funds. But even this responsible approach to selling has its limits. Like many fund families', DFA's dollar-weighted investor returns, which approximate how average investors have done in individual funds, are generally subpar to its time-weighted total returns over the past five and 10 years through April 2015.

Because DFA's funds are so process-driven and its approach is team-oriented, it may seem that portfolio-manager retention would be less important than at other firms, where a star manager's departure would have a meaningful, detrimental impact. But manager retention is still important because it is indicative of the firm's ability to attract and retain talent. Dimensional hires many of its portfolio managers straight out of MBA programs. But the team has no shortage of seasoned professionals. As of March 2015, the 45 members of the portfolio management team had an average of 14 years of experience.

During the past five years, Dimensional has retained close to 92% of its managers, which is strong compared with large mutual fund companies. However, this figure is only based on the senior portfolio managers that DFA lists in its regulatory filings with the Securities and Exchange Commission. Dimensional has provided additional information to Morningstar that indicates the retention rate for the broader portfolio management team was above 90% in each year since 2009. This suggests that its managers are well-suited to the firm's distinctive investment approach. The firm's private ownership structure may also contribute to its low turnover. Current and former employees own most of the firm.

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Morningstar produces Stewardship Grades for asset management firms and Stewardship Reports on the US fund industry's 20 largest firms by assets, which together manage more than two-thirds of open-end mutual fund assets.

For those assigned a Stewardship Grade, Morningstar publishes letter grades—A, B, C, D, or F—for each of the five components as well as an overall letter grade. For firms that are assigned a Parent rating, Morningstar gives them a Positive, Neutral, or Negative overall rating. There is a direct relationship between a firm's Stewardship Grade and its Parent rating; firms with a Stewardship Grade of A or B receive a Positive Parent rating, those with a C receive a Neutral Parent rating, and those with a D or F receive a Negative Parent rating. The grades are based on analyses by Morningstar's fund researchers, Morningstar's proprietary data, and information compiled from public regulatory filings.

Morningstar analysts evaluate and assign grades from A (the best grade) to F (the worst grade) to each of these areas, and they combine the component grades to arrive at an overall Stewardship Grade for a family of funds. A local committee of Morningstar fund analysts, which actively studies industry stewardship practices in its market and beyond, reviews the grades to ensure that the methodology is fairly and consistently implemented. All fund firms are graded on an absolute basis.

Past performance is no guarantee of future results. There is no guarantee strategies will be successful. Mutual fund investment risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors.

Eugene Fama and Ken French are members of the Board of Directors for and provide consulting services to Dimensional Fund Advisors LP.

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CANADA

July 1, 2015

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