Paul R. Streiber ~ Some Interesting Stuff

Most Mutual Funds May Be for Fish: DFA's Funds Aren't

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POSTED BY PAUL STREIBER IN DIMENSIONAL FUND ADVISORS, EFFICIENT MARKETS, INDEX, INVESTMENTS, METRICS, MUTUAL FUNDS, PASSIVE INVESTING, PORTFOLIOS, PSYCHOLOGY OF INVESTING

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On Sunday and Monday of this week two articles were published that cast doubt on the value of actively managed mutual funds; the first was published in the New York Times while the second was published right here on Seeking Alpha. The New York Times article was written by Yale University's Chief Investment Officer David Swenson. His article stated that mutual funds exist primarily so that their managers can extract exorbitant fees from their clients, and secondly to create wealth for investors. Dr. Swenson summed mutual fund companies up as "companies [that] spend lavishly on marketing campaigns, gather copious amounts of assets—and invest poorly"! He then went so far as to call the entire mutual fund industry "parasites". The full article can be read here.

Russell F. Coleman was in such agreement with Dr. Swenson that after summarizing the opinion piece written by Dr. Swenson he then went on to liken people who invest in mutual funds to fish. He was making the analogy that people who invest in mutual funds behave similarly to fish, who prefer the group mentality and swim in schools. The full article can be read here.

I would agree whole-heartedly with these two men if it were not for one company, Dimensional Fund Advisors (DFA). DFA was started in 1981 by David Booth, the man the University of Chicago's business school is now named after. Booth took the academic work of two U of C professors, Eugene Fama and Kenneth French, and put it into practice. Fama and French were conducting research at the time David

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Booth matriculated through the U of C business school that showed small cap value stocks tended to out-perform the market—by a large margin. This new research joined already available research that showed index funds tend to outperform actively managed funds over periods of time. Booth created the first small cap value index fund on the market.

What Booth did that was really the game changer, in my opinion, was to create an index fund that also actively picks stocks. DFA's small cap value fund follows the bench-mark Russell 2000 value index, with several distinctions. First, if there is any type of financial shenanigans or certain types of litigation at a company, they will not purchase the company's stock. Second, DFA acquires stock through block trades for the best price it can negotiate. DFA, mainly through this fund, has grown to manage assets that are over 100 billion dollars, and holds 20 percent of all small cap value stocks available in the United States. We can imagine, with DFA holding 20 percent of all the small cap value stock in the country, who every investment banker thinks to call when he or she finds out one of their client's would like to sell their small cap value business, and the clout this gives DFA when negotiating those block trades.

To illustrate the value of an index fund that actively picks stocks, I will be writing a multi-part series over the next several weeks that will create a DFA small cap value-like model portfolio and then track its performance over time. The overall strategy will be quite simple: to mimic the DFA small cap value fund so that readers of Seeking Alpha can see the value of this type of actively managed index fund. Through these articles investors who do not meet DFA's minimum capital requirements will also be able to create a similar type of "fund" or portfolio themselves.

I will start by placing the majority (60 percent) of the model's assets in IWN, the ETF that tracks the Russell 2000 Value index. This will save a tremendous amount of money on transaction fees, while creating one problem. The model will now contain stocks that DFA would not pick. The way I will remedy this is to short stocks I perceive would not be purchases by DFA (I will go into details on how to do this in a later article). I will also look for small cap value stocks that have a catalyst for growth and will add individual shares of those stocks to the portfolio.

There will be some things that DFA can do that we just cannot. First and foremost is the block-trading. They will be able to find discounts on stock that we just can't.

From time to time, I will also pick stocks that DFA would never pick because they do not fit into the small cap value universe. These stocks will be stocks that are ready to pop, and should be in every individual investor's portfolio. I am not sure if I will include them in the model, or just as stock of note to include in your portfolio. Please give me feed-back and let me know how you would like to see me handle these out-of-universe stocks.

While I agree with Dr. Swenson and Mr. Coleman that there are many pieces of coal in the actively managed mutual fund industry. Those funds/companies exist primarily to enrich their managers. There are diamonds among the coal that create wealth for their clients first and foremost. Dimensional Fund Advisors is one such company, and to illustrate the value of their small cap value fund I will create a model portfolio and publish articles along the way showing how I did it, and track the results.

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.