



Alpha – The value a manager adds to or subtracts from a fund's return. Beta is the return from the fund's exposure to the market.

# Smart thinking trumps crystal ball

Dimensional has done well in the longer term through a focus on value

TINA BULL



IT is track record through time that can be most telling with fund managers, as they ride out market cycles through smart thinking and investment processes robust enough to withstand the roller-coasters of financial crises.

Texas-based Dimensional Fund Advisors focuses on value and small capitalisation stocks, and deals with them in a way that eschews both index-style and traditionally active trading.

Its Australian Value Trust boasts a 10-year track record of 11.5 per cent annualised to August this year, net of fees, well ahead of the S&P/ASX 200 accumulation index of 7.3 per cent for the same period.

Its Emerging Markets Value portfolio, managed by Dimensional in the US and with a longer track record than its Australian equivalent, has delivered a 10-year return of 11.5 per cent annualised, net of fees, or five percentage points above the MSCI benchmark.

Dimensional set up its Asian base in Sydney in 1994 and in 1999 began offering strategies to Australian clients. With global assets of \$190 billion, it ranks 34th out of 770 money managers worldwide. From Sydney, Graham Lennon leads the international portfolio management team. Here he answers our questions about Dimensional's unique approach:

**Have you seen any big swings in asset allocation recently, perhaps changed perceptions about the times ahead?**

People are more aware of risk than they were three years ago, when it's fair to say all the focus was on return. Obviously, market pricing suggests there is a concern about the wash-up from the financial crisis, in the state of public-sector balance sheets and the sustainability of the recovery.

Listening to our clients, we've noticed a greater weight on transparency and having a clear understanding of what's driving the strategies. There's also a greater focus on cost than before, an awareness of risk control and a demand for flexibility within limits.

That's good for us as we've always put a premium on process and we've always paid close attention to costs. We're also transparent about the securities we target and we closely manage the tension between what the model may tell us and the day-to-day reality of market conditions.

**How would you describe your approach?**

We design investment solutions that aim to deliver above-market returns in a cost-efficient way.

The value-add comes from multiple sources. We constantly research the sources of higher expected returns; we engineer highly diversified strategies aimed at efficiently delivering those returns; and we seek to manage and implement in ways that take account of real-world frictions such as transaction costs, tax and momentum.

We're not a conventional manager that bases its approach on forecasting growth and earnings. But neither are we an index manager that contracts out its security selection to commercial benchmarks. What we do is select securities we identify as offering higher expected returns. We always start from the assumption that markets are extremely competitive and there's not a lot left on the table. Alpha can quickly be wiped out by high cost, which means it is hard to consistently add value the traditional way.

## FIVE TOP TIPS

- Focus on things within your control.
- Take only those risks that come with an expected return, understand what you are investing in and choose an asset allocation that's right for your own goals and risk appetite.
- Diversify your investments as broadly as possible.
- Keep an eye on costs and taxes. They make a big difference.
- Stay disciplined: change your investment only when your needs or circumstances change.

**How do you value companies?**

Our approach is based on the Fama-French research showing low-priced or value stocks tend to offer higher expected returns than high-priced or growth stocks and that small-cap stocks tend to offer higher expected returns than large-cap stocks through the long term. We use a fundamental measure of value, primarily price-to-book or book-to-market. Our view is a company's cost of capital is equivalent to the investor's expected return.

So a company with a low price in relation to fundamentals is a value company. While that value premium may reflect some mispricing, our view is that it mainly reflects compensation for risk.

So in our value strategies, we rank companies on book-to-market and choose as our buy universe those that are the most value-like. But it's not as simple as that in reality. We exclude lots of securities that don't meet the desired characteristics. We filter for momentum and we're conscious of tax effects. We also place a priority on implementation.

Costs are something we can control: not just explicit costs such as broking commissions, but implicit costs such as buy-sell spreads.

Because of the way we put portfolios together, we're able to trade patiently and flexibly. That enables us to earn a liquidity premium rather than to pay a price for liquidity.

**What do you see as the main themes that will surface in the market in the next 12 months?**

A big lesson from the financial crisis — and one we've been stressing for years — is that people tend to come a cropper when they base a strategy around a model about the future. You can manage risk up to a point, but there will always be a degree of uncertainty.

So we control for that through very broad diversification, by only taking those risks that come with an expected return and by paying attention to things we can control, such as costs, taxes and efficiency in implementation.

If we were to make a forecast, it would be to say that the market is starting to come around to our view that managing risk is not about looking into a crystal ball but about building robust processes that are able to withstand extreme and unexpected events.

**Is this climate good for your type of fund?**

Most certainly. There has been a lot of disenchantment with those who promised the world and couldn't deliver.

We're finding people are finally understanding what we do. And that is, we are constantly researching and understanding the sources of excess return. And we know from experience how to build strategies around those.

Best of all, we don't have to make forecasts to achieve that. We know what we know, but we also know what we don't know. And that's how we are able to do what we do.

**What has your performance been like since inception? What is your one-year, three-year and 10-year performance?**

To July 31 our longest-running fund, the Australian Value Trust, gross of fees, has posted one-year, three-year and 10-year performances of, respectively, +8.7 per cent, -3.8 per cent and +12.2 per cent. Our 10-year performance makes our strategy the No 1 performing long-only Australian equity strategy during that period, as measured by Mercer.

**You have about 200 stocks in your Australian Value portfolio. Have you rejigged the portfolio — sold or bought — in recent times?**

We have natural turnover in our portfolios because we don't expect the same stocks to do all the work all the time. What that means is that as value stocks increase in price, we are recycling into new opportunities. Our sector exposures tend to be a result of that process.

**In the whole fund, what proportion would be government debt, semi-government and corporate?**

Our fixed-interest strategies in Australia tend to focus on short term (up to five years) and high quality (AA-rated and above) credits. The composition fluctuates, but tends to

be dominated (about 70 per cent at present) by agency, semi-government and supra-national bonds, alongside sovereign paper.

**How can an investor gain access to your fund?**

We have institutional investors and we provide access through fee-only financial advisers. We don't offer our funds directly to the public as we don't have the capacity to deal with retail investors. By controlling access, we protect all members of the fund from the costs of excessive trading due to clients chasing returns.



Dimensional Fund Advisors' Graham Lennon  
JEREMY PIPER