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Where Does Dimensional Fund Advisors (DFA) Land in the Active/Passive Debate?

As political debates heat up around the country, I'm reminded that there is no more polarizing investment debate than whether active or passive management delivers better returns. To understand what the brouhaha is all about, let's begin with some definitions.

Passive management is founded on the Efficient Market Hypothesis (EMH). Developed by Nobel Laureate Eugene Fama in 1965, EMH contends that securities will always trade at a fair value price that reflects all available market information. Therefore, if no security can be over- or under-valued at a given point in time, instead of trying to beat the market, passive managers simply own all the stocks or bonds in the same proportions as the index. Therefore, a large-cap passive fund, or an "index fund", would own all 500 stocks in the S&P 500 Index. Because there is no research involve and the manager makes adjustments to the fund only to reflect changes in the index, trading costs are low. And the reduced trading of stocks and bonds can also increase the fund's tax efficiency.

Conversely, active investors believe that markets are inefficient, or that funds managers can uncover unknown information that can lead to better returns versus an index. Accordingly, active managers invest in what they view as the most attractive securities, based on their own investment philosophy and market outlook. By evaluating everything from the state of the global economy to companies' finances and new products, active managers believe they can identify investments that will beat the market, or the index that serves as a particular fund's "benchmark." Therefore, an active large-cap equity fund might own 50 to 200 of what the manager believes to be the most attractive companies in the S&P 500 Index.

Of course, because research is required to identify the most desirable investments, costs are higher for active funds. Proponents of active investing argue that the extra costs are justified because of the potential for an active fund to outperform its benchmark.

So, what approach performs better? Semi-annually, S&P Dow Jones Indices LLC publishes an active/passive scorecard. According to the SPIVA U.S. Year-End 2015 Scorecard, 66.11% of all large-cap managers underperformed the S&P 500 benchmark during the past one-year period. Over the five- and 10-year investment horizons, 84.15% and 82.14% of large-cap managers failed to beat the benchmark. Also, 56.81% of all mid-cap managers failed to beat the S&P Mid-Cap 400® Index over the one-year period and 72.2% of active small-cap funds lagged the S&P Small-Cap 600® Index. Over five- and 10-year horizons, 76.69% and 87.61% of actively managed mid-cap funds and 90.13% and 88.42% of small-cap funds underperformed their respective benchmarks. Of course, some of the underperformance of active funds is a result of higher fees that cut into the funds' returns.

Clearly, recent SPIVA research suggests that active management at the individual stock level is not worth the additional costs for most asset classes. And, over time, these SPIVA studies have shown that only US small-cap and emerging markets funds, where there are more securities to choose from and less access to information, have generally been considered fertile ground for active management. Given SPIVA's report, it should be no surprise that in 2015 actively managed US-based mutual funds saw $207.3 billion in outflows (roughly $169 billion from equity funds) while passive US mutual funds took in $413.8 billion. Investors are coming around to the idea that it in their best interests to invest in asset classes (often via passive funds) rather than make bets on individual active funds or securities.

The Happy Middle Ground
Our approach with DFA funds marries some art with this SPIVA science. Although DFA's philosophy has been characterized as "passive investment management," the firm's academic-based approach defies an absolute characterization as black or white. As you can see in Figure 1 below, the firm's philosophy is gray. If passive investing is also referred to as indexing, DFA has been value-weighted indexing."

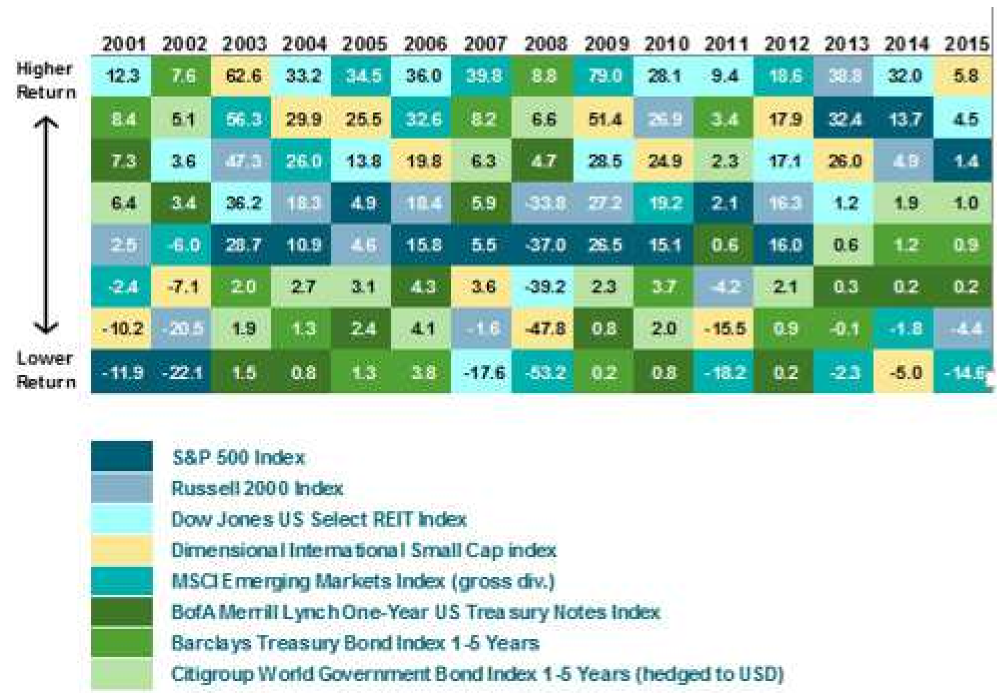
Figure 1: Are DFA's Funds Active or Passive?

DIMENSIONAL	TRADITIONAL ACTIVE MANAGEMENT	INDEX MANAGEMENT
Believes that, in liquid markets, prices reflect all available information	Attempts to identify mispricing in securities on a consistent basis	Allows commercial benchmarks to define strategy
Focuses strategies on the dimensions of higher expected returns	Often relies on forecasting techniques to pick securities and/or time markets	Tethered to a benchmark, reducing flexibility
Seeks to add value through portfolio design and implementation	Generates higher expenses, trading costs, and excess risk	Accepts lower returns and increased trading costs in favor of tracking

Source: Dimensional Fund Advisors

When we debate the merits of active and passive investing, it's important to stress that beating the market should not be an investor's only goal. Each one of us has personal investment goals that can best be achieved by investing in a properly diversified portfolio that is structured to respect the market's efficiency and minimize costs. We diversify across numerous asset classes because, as Figure 2 illustrates, not only is it impossible to choose individual stocks and bonds that will outperform, but it is also impossible to choose outperforming asset classes.

Annual Returns 2001 to 2015



Stay Diversified, Stay the Course!

Source: Dimensional Fund Advisors

In US dollars. Diversification does not eliminate the risk of market loss. Past performance is not a guarantee of future results. Indices are not available for direct investment. Their performance does not reflect expenses associated with the management of an actual portfolio. Source: S&P data provided by Standard & Poor's Index Services Group. Russell data copyright © Russell Investment Group 1997-2016, all rights reserved. Dow Jones data provided by Dow Jones Indexes. Dimensional Index data compiled by Dimensional. MSCI data © 2016, all rights reserved. The BofA Merrill Lynch Indices are used with permission; copyright 2016 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Merrill Lynch, Pierce, Fenner & Smith Incorporated is a wholly owned subsidiary of Bank of America Corporation. Barclays Capital data is provided by Barclays Bank PLC. Citigroup bond indices © 2016 by Citigroup.

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