

FTfm

## Still a firm believer of market efficiency

### Face to face

The financial crisis has done nothing to shake David Booth's faith, says Pauline Skypala

Did the financial crisis show the failings of the efficient market hypothesis, or demonstrate its validity? Many have written its obituary, but there are still supporters who stand by its basic tenets. David Booth is one of them.

He has made his fortune applying the belief that all publicly available information is priced into stocks and the only way to outperform is to take more risk. In 2008 he gifted some of this, valued at \$300m, to the University of Chicago School of Business (renamed Chicago Booth in recognition of his generosity) in appreciation of its input to Dimensional Fund Advisors, the business he founded in 1981.

Mr Booth was a PhD student at the business school and was taught by Professor Eugene Fama, who came up with the efficient market hypothesis. Recent experience has done nothing to shake Mr Booth's belief in the soundness of the theory. In fact, he says the financial crisis provided "dramatic further evidence and support" of market efficiency, as far as publicly traded stocks and bonds are concerned. (It is not appropriate to extend the idea to other areas, he cautions.)

To deny markets are efficient is to assume there is extra money lying around waiting to be picked up, he says, so "who got all that extra money dur-

ing the market turmoil? I don't know many people who had a great investment experience during this."

Some people accept developed markets are pretty efficient, but suggest emerging markets provide opportunities for stock pickers to outperform because information is less available or reliable.

Mr Booth does not agree. He says Dimensional has specialised in difficult-to-access parts of the stock market that many would have expected to demonstrate inefficiency. The first investment strategy it launched was a US small-cap

'If you look in the mirror and don't see Warren Buffett, you're better off in an index fund'

fund – a new idea at the time.

Going for small cap was in line with the ideas thrown up by Chicago Booth academics, which showed small company stocks have higher expected returns than large company stocks (the same applies to low priced value stocks against

high priced growth stocks).

Dimensional took a passive approach to investing in small caps in the belief this sector of the market was as efficient as large cap. Mr Booth reckons his belief has been vindicated. "Our small-cap portfolios have done much better than the median [fund]."

It was the same story in international small cap, and in emerging markets, he says. This is borne out by Morningstar's list of top performing international stock US mutual funds based on 10-year annualised returns. Dimensional's Emerging Markets Value fund is in fifth place (returning 20 per cent a year), outdone only by specialist Russia, China, or Latin America funds, and its Emerging Markets Small Cap fund is 9th (18.6 per cent).

Such high placing is totally unexpected, says Mr Booth, and shows the imperfections in markets (such as small-cap outperformance) make active management even harder.

This is not to say it is impossible to beat the market by stock picking – there must be people out there who can, he says, although they are very rare and therefore likely to charge a lot. So the question is: "Are markets inefficient and will I get any of the upside?"

Markets may be inefficient,

### Dimensional Fund Advisors

**Established:** 1981

**Assets under management:** \$194bn, as of October 31

**Ownership:** Privately held limited partnership owned mainly by employees and directors

**Employees:** 517 globally

**Funds:** About 250 globally

**Headquarters:** Austin, Texas

**Offices:** Sydney, Santa Monica, Vancouver, London, Amsterdam, Berlin

"but it may not help you because you have to find a manager that will pick the winners for you and charge a low management fee". Why would anyone do that?

Cite Warren Buffett as an example of a man who can and does, and Mr Booth rejoins that Mr Buffett is more like a hedge fund or private equity manager. Besides, his name always comes up: the list of names would be longer if markets were not efficient. Mr Buffett advocates low cost index funds as the best investment for most people, he adds. "If you look in the mirror and you don't see Warren Buffett, you're probably better off in an index fund."

Not that Mr Booth is a totally uncritical fan of index funds. They do a fine job, he says, and have outperformed most managers in each of the past four decades. But the basic

### Curriculum Vitae

**David Booth**

**Born:** 1946

**Education**

**1968:** BA in Economics, University of Kansas

**1969:** MS in Business, University of Kansas

**1971:** MBA, University of Chicago

**Career**

**After 1971:** Analyst at Wells Fargo Bank, working on one of the first index funds

**1981:** Founded Dimensional Fund Advisors, where he is chairman and co-CEO

largecap index fund can be improved upon, by adding a dollop of small cap or value stocks, and by not trading when everyone else does.

Dimensional has adopted such strategies, which distinguishes its funds from traditional index funds. On the trading front, Mr Booth says although the group's processes are highly computerised, transactions are not totally automated. There is a view that "a good trader can add value".

By not trading on the days when stocks go in or out of the index, it is possible to avoid big premiums or losses, he adds.

One form of indexing he does not favour is the fundamental variety, where constituents are

weighted by factors such as book value, earnings or dividends rather than by market capitalisation. It is a version of the value effect, he says, and more like active management than what Dimensional does. More interesting to him is the debate between the efficient market people and the behavioural finance guys. They both make the same observation: that low priced stocks have higher returns than high priced stocks, but differ as to why that occurs.

"We [EMH people] view it as a sensible relation between risk and return. Low priced stocks or smaller companies have a higher cost of capital than high priced companies. Behavioural finance people say

it is market mispricing."

Dimensional has been a test bed for the efficient market theorists' ideas. Its steady inflows suggest the fee-based advisers it deals with remain convinced the ideas work. Inflows slowed to a trickle through the crisis, says Mr Booth, but did not turn to outflows. Before the crisis hit, the group had about \$160bn under management. That fell to \$85bn due to market losses but is now up to \$194bn.

Asked if the small cap and value premia the business is built on could decline in future, Mr Booth says it is impossible to know. "My own opinion is the magnitude of premium is related to volatility and markets are still more

volatile than they have been historically."

The one effect Dimensional does not seek to take advantage of is momentum. Does it give the lie to the efficient market theorists? "If momentum were there in big quantities it would be inconsistent with market efficiency," says Mr Booth. He thinks it is there in small quantities and shows up mainly in small cap stocks. "We take momentum into account when trading, but we don't think it is big enough to induce trading."

The goal is to make people as much money as possible, not to persuade them markets are efficient, he concludes.

Fund data cited in the article is as of October 31, 2010.

As of 12/31/2010

**Average Annual Total Return**

	<b>1 yr</b>	<b>5 yr</b>	<b>10 yr</b>
Emerging Markets Value Portfolio I (DFEVX)	22.06	16.77	21.12
Emerging Markets Small Cap Portfolio I (DEMSX)	30.18	17.51	19.82

Performance data shown represents past performance and is no guarantee of future results. Current performance may be higher or lower than the performance shown. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month-end, visit [www.dimensional.com](http://www.dimensional.com).

International investing involves special risks such as currency fluctuation and political instability. Investing in emerging may accentuate these risks.

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