

# [Dimensional fund advisors essay sample](https://assignbuster.com/dimensional-fund-advisors-essay-sample/)

Dimensional is a different kind of investment firm headquartered in Austin, Texas with regional offices in Amsterdam, Berlin, London, Santa Monica, Sydney, and Vancouver now (DFA 2012) which was founded in 1981 by David G. Booth and Rex Sinquefield, both graduates of the University Of Chicago Graduate School Of Business. The underlying principle of DFA is that the stock market was “ efficient” which is, on one could beat the market consistently except by luck during some periods. The founders also believed that academic research and the ability of skilled traders could contribute to a fund’s profits even when the investment was inherently passive.

At the first stage, DFA was aiming single investment fund that consisted with small stocks which fit its position in the market as a passive fund. The initial clients were major for tax-exempt institutions such as government, union pension funds and charities and etc. With the time going, DFA pursued individuals while through the intermediaries known as RIAs. Although with the low turnover, low transaction costs and diversification, DFA still could make reasonable profits by charging a moderate advising fee and developed rapidly.

DFA is an outstanding investment firm doing the investment based on precise academic research and strict trading strategy which will both be discussed later. Over the years, DFA have translated financial research into real world investment solutions (DFA 2012) such as Fama-French findings which enabled DFA benefit from “ small” firm and “ value” firm effects until the paper was published. The strict trading strategy of minimized the likelihood of buying “ lemon” stocks enabled DFA to extract a discount on the stock purchase via the block trading which also created benefits for both DFA and its clients.

DFA and Fama-French findings

The original DFA’s fund is basically composed of small size firms based on the academic research that small stocks outperformed the large ones according to Banz during the early 1980s (Rolf W. Banz 1981). Until 1992, Fama and French indicated that book-to-market ratio was another effect in addition to the size effect which was published in the paper “ The Cross-section of Expected Stock Returns”. Before this paper was well known all around the world, DFA had already begun with such strategy that long “ value” stocks while short “ growth” stocks. This effect was also the foundation of Fama-French Three-Factor Model which was published during the 1990s.

With the analysis of worldwide historical data between 1926 and 1962, Fama and French finally convinced the public that the “ value” effect was existed along with the “ size” effect. When a thing is scarce, it is precious. As everyone could predict that small firms generated high return according to the “ size” effect, the efficient market adjusted those stock prices rapidly and resulted into the minimized arbitrage opportunities. It was hard for DFA to make profits during late 1980s under the deep recession in the United State lead to the small companies lost its favor. The same as “ value” effect, in the late 1990s, the stock of those firms with low book-to-market ratio was not as attractive as before Fama and French release their findings. Small and value stocks do not seem to beat the large and growth stocks all the time although it could explain the historical data in some extent.

DFA’s trading strategy

As another DFA’s principle states, the ability of skilled traders will contribute to a fund’s profits even when the investment was inherently passive, the trading strategy brought value to both DFA and its client through the transactions. In order to acquire a firms stock, DFA should make sure that the seller is out of questions at the beginning step. Without any doubt of the seller’s negative private information, DFA started to build up a binding partnership with the sellers with two criteria that fully disclosure of stock holding condition and less steep discount under negotiation with the seller.

Such strategy allowed DFA to avoid decreasing of the stock price after acquiring entirely block of stock from the seller and establish long term partnership. In return, DFA would keep it as secret for its sterling reputation. For those dishonest firms, their name would be locked in a penalty box and out of the consideration for a long time. At the same time, DFA had to pay premium on the stock traded on the second market in order to diversify the index fund. Thus, experienced trader would create value when balancing the amount of stock buying with discount and premium.

New Stream of DFA’s investment

In 1999, a new stream of investment was invited into DFA called tax management which dimensional engineered portfolios tailored to client goals and tax costs (DFA 2012). Such fund is widely used for people who earn high income and in purpose of avoid tax payments during the working period. DFA helps those rich business people to invest with redundant money in the security market in order to reduce the tax rate while does not reduce the net income. By creating such a tax shield, these investments will generate future cash flows under an acceptable tax rate for the high-income group of people even after the retirement. Meanwhile, DFA also creates its own profit with the capital support by this group of people and charge a moderate advisor fee as well as from stock trading.

Pros, Cons & Future

Obviously, DFA owns the most advanced academic research background since 1980s which enabled them to be differentiated from other investment firms during that period of time with “ size” and “ value” effect. Delicate trading strategy allowed them to generate further profit based on the concepts summarized from the academic research. These two cornerstones both follow the beliefs of the founders since 1981 and have created huge success and profits. However, with the globalization of the economy, the information is spread worldwide rapidly.

Once the reason behind DFA’s success is revealed by public, such as Banz and Fama-French research, DFA will face challenges to remain the leading position. Nevertheless, low transaction fees will minimize DFA’s profit margin as well. No doubt that DFA has to keep its academic research as usual to be a different investment firm. New products should be introduced into the firm such as the tax-managed fund in 1999 in order to remain competition with the global market. At the same time, new technology should also be applied throughout the firm to enhance its trading strategy more efficiently.

Reference:
Rolf W. Banz (1981). The Relationship Between Return and Market Value of Common Stocks. Elsevier B. V. abstract. Retrieved from:
http://www. sciencedirect. com/science/article/pii/0304405X81900180

Dimensional (2012). Company overview. Retrieved from:
http://www. dfaus. com/firm/overview. html

Dimensional (2012). Research. Retrieved from:
http://www. dfaus. com/firm/research. html

——————————————–
[ 1 ]. It said that DFA based in Santa Monica, California according to case while Austin, Texas on official website. [ 2 ]. Renamed as University of Chicago Booth School of Business in 2008. [ 3 ]. Fama/French Forum is hosted by DFA since 1981.

[ 4 ]. This ‘ size effect’ has been in existence for at least forty years and is evidence that the capital asset pricing model is misspecified [ 5 ]. With low book-to-market ratio
[ 6 ]. With high book-to-market ratio
[ 7 ]. Four steps to minimize the likelihood of buying a “ lemon” stock. [ 8 ]. Avoiding seller to do the further trading in second market. [ 9 ]. Applied Core Equity (2005), Inflation Protection (2006), Variable Credit (2009)