

## Why Indexing Is Good but Dimensional's Approach Is Better for the Long Term

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Articles in the media and academic sphere have provided overwhelming evidence that indexing is better than active stock picking. Investors are voting with their wallets as passive investing has increased its share of the investment market from less than 20% in 2009 to more than 33% of the market (as of late 2015).<sup>1</sup> Lower fees, fewer transaction costs and a disciplined process all lead to better expected long-term outcomes. Principally, we think this trend is great for investors.

But while indexing is an improvement over active stock picking, Forum predominantly uses Dimensional funds because Dimensional's approach is better for the long term.

Dimensional was co-founded by David Booth, who was on the Wells Fargo team that introduced the first index fund in the early 1970s.<sup>2</sup> In fact, that team was told by Wells Fargo that there wasn't much of a future in indexing, so they gave their research to Jack Bogle. Bogle then went on to found Vanguard, and the rest is history. Booth experienced the creation of the index fund, but he realized that there were greater improvements to indexing that could be implemented to significantly increase returns, so he co-founded Dimensional in 1981.

In particular, Booth focused on the research of Professor Ken French and Professor Eugene Fama, who won the Nobel Prize in Economics in 2013. Fama and French had shown that small stocks and value stocks produced higher returns than would be expected by market risk alone. They also showed that this effect was robust across different historical periods and different countries.

Dimensional took this research and incorporated it into its funds. Today, instead of simply holding the index weight, they overweight stocks that are small and value while remaining as diversified as possible.

### Let's look at an example of how this has worked this year.

Here are the year-end returns for the U.S. stock market divided into nine different categories based on the size (small, mid and large) and type of stock (value, core and growth). Small-Value significantly outperformed Large-Growth this year by double digits, as shown to the right.

Now, we can compare the performance of an index fund and a comparable Dimensional mutual fund to see the value of tilting toward small companies and value companies.<sup>3</sup> Note that both the Vanguard Total Stock Market Fund (VTSMX) and the DFA US Core Equity II portfolio (DFQTX) hold the entire U.S. market, but that does not mean they have the same year-end returns because of the differences in how much they hold from each of the nine categories (as shown in the chart below).

Year-to-Date Returns through 12/31/16

	Value	Core	Growth
<b>Large</b>	18.9%	13.8%	1.8%
<b>Mid</b>	25.2%	12.4%	6.5%
<b>Small</b>	28.0%	23.6%	9.6%

Source: Morningstar

## VTSMX and DFQTX Weightings

		Value	Core	Growth
Large	VTSMX	24%	24%	23%
	DFQTX	21%	15%	11%
Mid	VTSMX	6%	7%	7%
	DFQTX	10%	10%	8%
Small	VTSMX	3%	3%	3%
	DFQTX	8%	9%	6%

Source: Morningstar. Weightings as of 11/30/16.

- = DFQTX is underweighted versus VTSMX
- = DFQTX is overweighted versus VTSMX

expected returns for our clients without an equivalent increase in portfolio risk, and therefore, greater expected long-term wealth.

Indexing is an improvement over traditional active management. Dimensional allows us to maintain the advantages of index funds (with low costs, tax efficiency and a disciplined process) while incorporating the best of academic research to provide a better long-term client experience.

VTSMX had a year-end return of 12.53% while DFQTX had a year-end return of 16.58% (as of 12/31/16). This return is 4.05% more than the Vanguard fund.

The advantage of Dimensional funds in 2016 due to the tilts to small and value has been substantial because it is more heavily weighted in the areas that have done well this year — small and value stocks. While it won't happen every year, academic research shows that tilting to small and value works across time and across world markets. This is in part why Forum uses Dimensional for our clients.

While we have examined two major aspects here, Dimensional has other implemented advantages such as profitability, momentum, patient trading and securities lending. Considering those advantages, we are confident that based on the evidence and data, Forum can use Dimensional funds to construct portfolios that drive higher

<sup>1</sup> Julie Verhage, "These Charts Show the Astounding Rise in Passive Management." Bloomberg, December 30, 2015.

<sup>2</sup> Julie Segal, "David Booth Brings Academic Research to Life." *Institutional Investor*, May 10, 2016.

<sup>3</sup> An index fund will provide exposure to all nine squares, but the funds are market-value weighted, meaning they hold all companies in the weight for which they exist in the market. A large company like Apple (AAPL) would have an enormous weighting while a small company like Casella Waste Systems (CWST) would have a tiny percentage in the fund.

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