OUTSIDE THE FLAGS

Jim Parker,
Vice President
DFA Australia Limited

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A Better Way to Invest

They are comments frequently overheard these days on the bus, at the gym, supermarket and at Saturday sport: "The markets are in such a state. I'm worried about my retirement. There has to be a better way to invest."

There's no doubt about it. At times like these, when markets are hugely volatile and unpredictable, the patience of even the most disciplined investor can be tested. The good news is that there is a better way:

- First, there is nothing to be gained from trying to second guess the market. The fact is most people go wrong taking stock-specific bets or seeking to time their entry and exit points. Ultimately, they just end up buying high and selling low. This is never a recipe for success.
- Second, it's worth recalling that not only are risk and return related, but that not all risks are worth taking. This means the best approach is to structure your portfolio around the risks that research shows carry a reliable long-term reward. In tough economic times, uncertainty increases and people gravitate toward safe assets. To attract investors back to risky assets, prices adjust lower. What's often overlooked is that a lower price equates to a higher expected return.
- Third, the best protection against volatility is diversification. It should be evident by now that even "gurus" have no idea which asset class will be the next top performer and which will lag. But if you remain broadly diversified, you don't have to take those sorts of bets.
- Fourth, the biggest determinant of the performance of your portfolio is in how you allocate your capital toward the respective asset classes: Cash, fixed income, domestic and global equities, property and emerging markets—and within equities, large, value and small stocks.

- Fifth, while markets are inherently unpredictable, there are things you can do to lessen the pain. Among them is paying heed to the costs. Paying big fees to fund managers to invest your money based on a hunch is not recommended. Neither are high turnover strategies that leave you with a big tax bill. You can control these things.

- Sixth, indexing is not the only alternative to stock picking and market timing. Why pay managers to outsource decisions to an index provider? There are unnecessary costs involved there as well, as stocks enter and leave the index. A better way is to structure highly diversified portfolios around specific dimensions of risk.

- Seventh, in choosing someone to invest your money, ensure that in their own practices they follow the above advice. They should minimise transaction costs, be mindful of the tax effects of trading, and remain patient, disciplined and focused on long-term returns. The emphasis should be on implementing those strategies as efficiently as possible, not chasing last year's best performers or following fickle fashion.

- Eighth, keep it simple. Much of the financial services industry has a vested interest in making investing sound complicated. That, after all, is how this global crisis started. People got complacent and started taking highly leveraged bets on complex securities that few understood. You need to be absolutely clear about what risks you are taking on.

The eight points above reflect how Dimensional views investing. We recognise that markets are unpredictable. We don't pretend to know what will happen next. But we do understand the sources of long-term returns. And we have built up formidable expertise over nearly three decades in capturing those returns as efficiently as possible, without taking unnecessary risks.

Unlike other fund managers, we don't try to pick stocks or time markets. That's speculation, not investment. Neither do we leave the definition of our strategies to index providers.

What we do is structure highly diversified, low-cost strategies around the known sources of risk and return. We have a disciplined, transparent and patient trading process that is not dependent on hunches or the talents of star individuals riding their luck. We are not interested in chasing trends.

Our clients share this belief, which means our strategies aren't subject to the sort of hot money inflows and outflows that blight other fund managers. That in turn becomes a source of strength, as it helps to keep our costs low.

Yes, market volatility is causing a lot of pain right now. There is no getting away from that. But we have built up deep insights over the years in how to efficiently trade in those parts of the market subject to large swings.

For instance, we developed sophisticated execution tools that enable us to trade in very thinly traded stocks, so we can take advantage of price volatility. With this sort of volatility now evident even in much larger, more liquid stocks, these tools are proving even more invaluable.

Bear in mind, also, that even in volatile markets, momentum effects still need to be taken into account. We do this by delaying trading "fast-moving" stocks. In other words, we don't sell the companies that are moving up the fastest and we don't buy the companies that are falling the hardest.

Another major risk in volatile markets is that there is an increase in unnecessary trading. This is expensive. Momentum filters control this effect, delaying trades and preventing unnecessary turnover.

This is a patient, low-key disciplined approach, one focused on ensuring clients' assets are invested with little or no market impact. Informed by the most rigorous academic research, it's an approach that takes the guesswork out of investment and reflects the broad philosophy described above.

Obviously, there will be periods when markets go down. But crises come and go and markets eventually recover. By minimising volatility and focusing on things you can control, you can ensure you are properly positioned for the inevitable rebound in risk assets when it comes.

It simply is a better way to invest.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

For more articles, visit Dimensional's client site at my.dimensional.com/insight/outside_the_flags

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