

Indexers, You Too Can Have a Guru

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GETTING GOING

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If you're a performance-hungry stock jockey, you probably have a fistful of investment heroes that you look up to, such as Warren Buffett, Peter Lynch and Bill Miller.

Those of us who index have our own list of heroes. True, it's a somewhat nerdier group (but unlike their heroes, many of ours have won the Nobel Memorial Prize in Economics). Somewhere on that list you would likely find Rex Sinquefeld, 61 years old, who just retired as co-chairman of Dimensional Fund Advisors, a leading provider of index funds, with \$86 billion under management.

To be sure, Mr. Sinquefeld isn't exactly a household name. But his career has paralleled the rise of indexing, and he has played a key role in putting modern financial theory into practice.

Interested in building an index-fund portfolio? It's worth considering Mr. Sinquefeld's innovations -- and whether you want to incorporate them into your own investment strategy.

Mind the Gap

Indexing was born in the early 1970s, and Mr. Sinquefeld was there at the inception. He spent three years studying to become a priest, but eventually opted for finance instead. In 1972, he got a master's degree in business administration from the University of Chicago, arguably the country's top school for economics, and then started work at the American National Bank of Chicago.

There, he was involved in the 1973 launch of one of the first institutional funds designed to track the Standard & Poor's 500-stock index. As part of the bank's pitch to potential clients, Mr. Sinquefeld wanted to point out the value of simply capturing the stock market's performance -- and found the data didn't exist.

"It was astonishing," he recalls. "Today, it's hard to imagine a world in which there's very little data to show how different investments have done. Today, you can have almost any data you want at the push of a button." To generate the data he needed, Mr. Sinquefeld worked with Roger Ibbotson, whom he had met at the University of Chicago. Their research formed the basis for what has become "Stocks, Bonds, Bills, and Inflation," the annual compendium of investment returns now put out by Ibbotson Associates, the Chicago investment-research firm subsequently founded by Mr. Ibbotson.

The initial work by Messrs. Ibbotson and Sinquefeld provided investors with two startling insights. First, they found there was scant difference in the historical returns of long-term and short-term bonds, suggesting that investors were better off favoring the safety of short-term securities.

Second, they discovered there was a huge gap between the long-run performance of stocks and bonds. Indeed, in the years since, there has been heated debate among academics, with many arguing that the stock market's vastly superior performance couldn't be explained by risk alone. Some even suggested that all the publicity might prompt folks to bid up the price of stocks, so that the performance gap thereafter would be narrower. "People said, now we know about it, it'll disappear," Mr. Sinquefeld says. "But it's persisted."

In fact, he thinks historical stock performance can be a reasonably good guide to the future. Mr. Siquefield notes that stocks have climbed at more than 10% a year, with the rise in the stock market's price/earnings multiple contributing roughly one percentage point a year to this long-run return.

"If you want to use historical data and extrapolate it into the future, all you have to do is knock off that one percentage point," he says. Result: We might see average returns of 9% or 9.5%, equal to maybe six percentage points a year above inflation.

Finding Value

In 1981, Mr. Siquefield launched Dimensional Fund Advisors with David Booth, whom he had also met at the University of Chicago. Initially, the Santa Monica, Calif., firm had just one index mutual fund, which was designed to track the performance of small-company stocks. That fund drew on academic research showing that small stocks outperformed larger companies. In the years that followed, DFA launched other small-cap index funds, including funds that track small stocks in Europe, Japan, the Pacific Rim and the United Kingdom. These and other DFA funds are available only to institutional investors and through DFA-approved investment advisers.

In 1993, the firm launched a second series of funds, once again drawing on a key piece of academic research. The research, conducted by finance professors Eugene Fama and Kenneth French, found that bargain-priced "value" shares outperformed fast-expanding, more-glamorous "growth" stocks. In fact, research has found that value stocks have generated superior returns not only in the U.S., but also in many other countries, including emerging markets.

"The only proven avenues for earning above-average returns are small and value," Mr. Siquefield says. As he sees it, this is entirely logical: Small companies and value stocks are riskier, so investors ought to expect higher long-run returns.

The risk explanation certainly makes sense with small companies. Small stocks tend to be wild stock-market performers, reflecting the dicey nature of their underlying business. A small company might have just one or two product lines, so its sales and earnings will typically be more erratic than that of a bigger, better-established company.

By contrast, it isn't so clear that value stocks are riskier than growth stocks. Like small stocks, value companies often are a dodgy proposition. Indeed, a value stock may be cheaply priced compared to earnings and corporate assets because the company's underlying business is in serious trouble -- and there's a real risk that things could get a whole lot worse.

But unlike small stocks, this business risk doesn't always show up in stock-market performance. Value stocks are often less volatile than growth stocks, suggesting that value stocks are less risky.

This is a critical issue. If value stocks aren't riskier, investors shouldn't expect superior returns. So are value stocks riskier -- or aren't they? It's like the debate over the size of the stock-bond performance gap. Only time will tell if value continues to beat growth.

"Thirty years from now, we'll know for sure," Mr. Siquefield says. "If these things persist, then we will know it's risk. If we continue to observe differences in [the performance of] value and growth, then it will be hard to argue that there isn't something enduring."