

# Interview with Gene Fama Jr.

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Gene Fama is vice president of Dimensional Fund Advisors (DFA), the funds management firm founded on the academic principles of diversification first articulated by his father, Eugene Fama, in the 1960s. He explains to David Chaplin how the DFA philosophy works in the real world.

## **David Chaplin: What is the Dimensional investment philosophy in simple terms?**

Gene Fama Jr.: Markets work. A company's cost of capital is the investor's expected return for investing in that company.

Diversification is crucial—non-diversified portfolios add uncompensated risks.

Risk and return are positively related—the only way to add to expected investment return is by taking more (compensated, or "priced") risk. A portfolio is best structured by taking advantage of the risk factors that best suit an investor's preferences and circumstances.

Portfolios should be tax-efficient.

Dimensional's portfolios are not index funds—the academic process of competing ideas breeds the best definitions of investment classes. Indexes are not sacrosanct or cost-effective and need not be slavishly followed.

With no stock picking or market timing, minimising trade costs adds value. Lower fees help too.

## **Can active managers add value in the long term? If not, why?**

The aggregate of active manager investments is, of course, the market (or pretty close to it). So by definition, the aggregate of active managers delivers market performance minus expenses. The more expensive the active manager, the lower its expected return. But the real problem is that picking stocks and timing markets generates excess variance that in economic theory is considered uncompensated.

**Is a belief in the virtue of capitalism all that investors need? Why shouldn't people try to beat the market?**

You don't have to believe in the virtue of capitalism so much as the efficacy of it. Markets appear to be pretty good at pricing and allocating resources, including investment capital. I don't begrudge anybody the attempt to outguess the market, I just don't think it pays in terms of effort and cost.

**Australia and the US are fundamentally different markets. How does the DFA model deal with these differences?**

I'm not sure this is true. If you mean Australia seems less efficient, my hunch is that it just has less data history and fewer stocks. The dominance of a few companies can cause managers to randomly outperform simply by holding the big names in different proportions than the market portfolio. We can't tell if it's a skill until we see it work over significant investing cycles, which statistically means several decades, not several years. I like to think people, and therefore markets, are the same everywhere, otherwise the differences would be arbitrated away.

**Is the current market turmoil indicative of a fundamental change or just normal volatility? Why?**

We've studied this. Stock volatility is up maybe by a tad, but the increased volatility you see in portfolio performance is not from the overall stockmarket. It's from increased differences across the returns of individual stocks. The differences between stocks are more pronounced than they were 10 years ago by a factor of three. This means active portfolios that hold fewer stocks will have exaggerated performance differences while broadly diversified portfolios will tend to be a bit more stable.

This has occurred in the past so it's not clear anything fundamental has changed. I say it's always safer to assume it's permanent and to diversify.

**How is the threat of war affecting US markets? Is that a factor DFA would take into account when constructing portfolios?**

By the time something like the threat of war is plastered across newspaper headlines it's probably already incorporated in the current prices. Since we believe markets work well, we don't try to anticipate or forecast events. We read the papers, but we don't use them to form long-term policy.

**What is long term investment?**

I'm different on this one. Some people think it means a specific time horizon, like 10 or 20 years. I think it's the life-cycle of all your investments taken together. If you buy a house and it doubles in price by the time you sell it in 10 years, you didn't earn 100 per cent on real estate in the long term unless the next house you buy with the profits doubles in price too. Since even long periods are uncertain, the sum of all your transactions over your entire investing career might be the most effective way to think about the long term.

**DFA has made a point of not paying commissions to advisors? Why, and has this held up its growth?**

That policy has not only helped growth but it's helping change the face of financial advice. The old brokerage model is being replaced by fee-only advice. It only makes sense: everything works best when the person you're working for is the person who pays you. It avoids conflicts of interest. Fee-only advice aligns the interest of the advisor and the client so advisors have no reason not to offer their best advice. The whole industry here seems to be following suit, so it must be a good model.

**What is the appropriate role of the financial advisor?**

To educate clients about portfolio theory and clarify the process, not to deliver product and fill orders. The days when an advisor's chief role is to find good investments are fading away, maybe because it has so little history of working well. But most people are not born long-term investors—they need to be taught how markets work and how to stay disciplined, and that's the advisor's most valuable function.

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