

Putting Theory into Practice

By Jennifer Vanasco
GSB Chicago
September 1999



Rex Sinquefield and David Booth

When David Booth, '71, and Rex Sinquefield, '72, left successful, established careers to form their own company with an untried idea, people thought they were crazy. Not just because they were walking away from good jobs with established firms, but because their guiding philosophy bordered on radical. The pair planned to start a fund management firm that would rely fully on academic theories of efficient markets, bucking Wall Street conventional wisdom that a stock picker with enough knowledge and research could consistently beat the market.

"We were too young to think we were crazy," laughed Booth, chairman and CEO of Dimensional Fund Advisors Inc. Not quite 10 years out of the GSB, Booth had worked on Wells Fargo's first index fund attempts and was selling investment counseling services at the time he and Sinquefield began formulating a plan. "The idea for a small cap index fund seemed like the right thing to do," Booth said. And if it failed, he said, "I could always go back and get a job as a salesman."

Sinquefield, DFA's cochairman and chief investment officer, also knew it was risky but was ready to move on from his job as executive vice president and head of the trust department of American National Bank & Trust. He had been enthralled with the efficient market principle since his GSB days, and the gamble seemed worthwhile.

Eighteen years later, it's clear that the risk paid off with high returns. DFA currently manages more than \$30 billion in assets across 22 funds, making it one of the largest institutional fund managers in the United States. To honor this success, the GSB has named Booth and Sinquefield the 1999 Distinguished Entrepreneurial Alumni.

"Being a successful entrepreneur is some part skill, some part luck," Booth said. "But one element that's critically important is timing. The ideas [underpinning DFA] presented 10 years earlier would have been too radical; 10 years later, would have been too late. I read an article by Milton Friedman that talked about syzygy, an astronomical term. When [the sun, earth, and moon] line up, which happens rarely, all kinds of weird things are supposed to happen. Being an entrepreneur is looking for syzygy, being sensitive to that moment when things come together, visualizing it, and acting upon it."

After graduation, Siquefield was eager to take the risk of putting the theories he learned into practice, which he made clear when he interviewed with money managers and banks in California, New York, and Chicago. "I said, look, I want to try out these new ideas, I'm not interested in anything else. Every one of them told me I was crazy, nearly every one rejected me. Only American National was interested in experimenting," he said. "There's some debate about this, but I think I set up the first S&P index fund in the galaxy in 1973. Wells Fargo thinks they did it-but in any case, both institutions pioneered index funds."

Booth worked at Wells Fargo Bank in San Francisco and then returned to Chicago in 1975 to join Becker Securities as assistant vice president in funds evaluation. Through the years, he and Siquefield stayed in touch.

"David and I were chatting one day [in 1981] and he was telling me about something he was working on, and I described a product I was thinking about-and the product definitions were almost identical, but we approached it from different ways," Siquefield said. "With David's marketing background, he saw that sponsors were not investing in small stocks, that they had no access to small companies. I was aware of the high rate of returns, and I recognized that most people were not aware of this. It didn't take long for us to put our ideas together."

DFA became the first firm to introduce a small company fund that was fully indexed, a practice that has since become the industry standard. Specializing in brokerage, securities, and investments, the firm manages the portfolios of institutional investors, which hold their stocks for the long term. Another of DFA's innovations is "making money for our clients on the trading side, which is unusual," Siquefield said.

From the beginning, the company has relied heavily on academic research. Siquefield's knowledge of small stocks' high rates of return came from an article by Rolf Banz, Ph.D. '75. Banz, along with Marc R. Reinganum, Ph.D. '79, had studied 54 years of New York Stock Exchange data and concluded that small companies outperformed large ones by 3 percent annually, a conclusion that became known as the "small stock effect."

A paper by Eugene Fama, Robert R. McCormick Distinguished Service Professor of Finance, and former faculty member Ken French that introduced the Fama/French three-factor model was a breakthrough for DFA. "It tied together previous research about why one stock has a higher average return than another," Booth said. "The three-factor model says that the dimensions of return are risk, size, and financial health. We look at all those dimensions, and that's why we're called Dimensional Fund Advisors."

DFA invests in value stocks, which are less healthy than, for instance, blue chips. This strategy works, Booth said, because riskier companies have higher returns due to their need to stay in the market. "It hasn't been proved, but it seems like a sensible risk story. It could also be the result of market mispricing, when the stocks are valued too low because people are

disappointed in small caps," he said. But Booth and Siquefield discount the mispricing argument, Booth said, because they believe in Fama's theory that the market is efficient.

"It was hard to explain to clients in the beginning that I invest in companies with poor earning prospects, but later it makes sense to them that there are higher average returns. Within 30 seconds it's an intuitive story," Booth said.

Siquefield noted, "It's unusual in our business to rely on research as much as we do. [Some people] feel they don't need to rely on academic research. They learned a set of skills in grad school or elsewhere and keep applying them. In our case, both of us had a shared vision of how investing should be done, and that vision comes out of the academic world."

A large part of that vision is maintaining their ties with Chicago. DFA as a company and Booth and Siquefield individually have supported Chicago by leading the campaigns to finance several chaired professorships, including those for Jim Lorie, Merton Miller, and Myron Scholes. They also have provided start-up funding for the GSB's NASDAQ database, given prizes for term papers, and financed doctoral stipends and faculty research.

"What we know now about the markets and about risk and return can't be the final answer," Booth said. "In the next 20 years investment strategy will look quite different. But what we do know is that the U of C will be at the forefront, so we'll keep a close association. If I sound like a loyal alum, I am."

This article contains the opinions of the author(s) and those interviewed by the author(s) but not necessarily Dimensional Fund Advisors Inc. or DFA Securities Inc., and does not represent a recommendation of any particular security, strategy or investment product. The opinions of the author(s) are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. This article is distributed for educational purposes and should not be considered investment advice or an offer of any security for sale. Past performance is not indicative of future results and no representation is made that the stated results will be replicated.

Dimensional Fund Advisors Inc. is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of the Dimensional funds carefully before investing. For this and other information about the Dimensional funds, please read the [prospectus](#) carefully before investing. Prospectuses are available by calling Dimensional Fund Advisors Inc. collect at (310) 395-8005; on the Internet at www.dimensionalfund.com; or, by mail, DFA Securities Inc., c/o Dimensional Fund Advisors Inc., 1299 Ocean Avenue, 11th Floor, Santa Monica, CA 90401.

Mutual funds distributed by DFA Securities Inc.