



## Factors in Practice

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For general use.

April 2009

### Clarion Call



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CLIENT READY

When returns are poor (and sometimes even when they're good), investors wonder if things have changed. Is this time different? Does a buy-and-hold strategy still make sense?

Advisors offer reassurance: Nothing has changed. This is just how markets work. Stay the course.

True or not, such counsel can seem reflexive—not just because the severity of the slump, but because things really might be different this time. Financial downturns need not be lesser or greater versions of the same problem, and our clients intuitively get this.

They know that when the operating rules are consistent, all we have to worry about is market risk. The normal ebb and flow of prices is a part of life and thus less harrowing. But changing the rules that govern markets introduces a malicious strain of uncertainty. Will capitalism be allowed to flourish? Is the new government waging war on private enterprise? Will inflation and interest rates rise in response to deficit spending? Will there be another Great Depression?

We can't know. But even if we did know, would we change our approach? The doom predictions don't come with an escape hatch for investors. The fundamental principles of modern finance still offer our best guidance, even if the worst comes to pass.

#### Markets Are Resilient

Whether you believe, as I do (more on this in a future column), that the current mess was caused by the state meddling in free markets or whether you think it was caused by free-market "greed," what matters now is that you re-commit to a belief in the power of markets. Too often investors see markets as a delicate flower that needs perfect conditions (and even a master gardener) to thrive. But markets are better seen as a foundational and permanent element of human interaction—like the water that gives birth to and feeds the flowers. Our job as advisors is to structure the best plumbing, so our capital can find its many and varied uses. And find them it shall.

Markets endure even in the darkest of times. Hurdles are thrown their way, and enterprise circumvents them. Political risk is no different; it's still "priced" risk. Threats to property and liberty increase the chance that investors will not be rewarded for risking capital. This, in turn, increases the cost that companies must pay to obtain capital, which increases expected returns to a point where they spur the reticent to invest.<sup>1</sup>

#### Don't Predict—Prepare

In recent months, capital has seemed to be on strike. Bank failures, forced selling, and changing government policy have sent investors to the sidelines, waiting for better tidings.

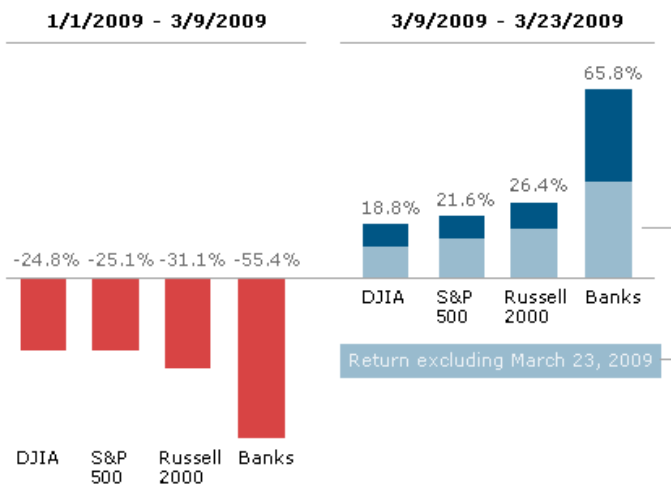
Through the resulting meltdown, cash has been a refuge. Don't expect this to persist. The feds are deficit-spending beyond the pale—funding rampant government expansion by borrowing and printing money. In the event of inflation, the real loss of value in a cash account is no different from a price drop in a stock portfolio—to say nothing of the opportunity cost to investors of missing big rallies.

When all is said and done, clients hire an advisor to invest—not to keep their money in a checking account. Amidst volatility, attempting to time a market reentry is even more risky and counterproductive than usual.

How many investors stockpiling cash realize that the equity market is up 22% so far this month (as of this writing on March 23, as seen in the exhibit below)? Daily price movements are like white noise that not only make timing treacherous but confuse our ability to perceive whether we're in an "up" market or a "down" market—even while we're in it.

#### EXHIBIT 1

#### US Market and Bank Industry Returns



DJIA is the Dow Jones Industrial Average, an index of approx. 30 US large cap companies, provided by Dow Jones Indexes. The S&P 500 Index is an index of approx. 500 US large cap companies, provided by Standard & Poor's Index Services Group. The Russell 2000 Index is an index of approx. 2,000 small cap companies, copyright © Russell Investment Group 1995-2009, all rights reserved. "Banks" are the KBW Bank Index, provided by Keefe, Bruyette & Woods, Inc. Indices are not available for direct investment; their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

We can't declare an extended bull market from one month's return. That would be worse than imprudent—which is exactly the point. If you can't tell which part of the cycle you're already in, how can you predict future cycles, or time a turnaround to the day? The above exhibit shows how much of the 22% (26% for small cap<sup>2</sup>) you would have missed had you been out just a single day: March 20, 2009. The real job of the investor isn't to predict bull and bear markets, but to be invested on days like this.

#### Let It Flow

Capital is the fuel that powers our economy. Money is human energy that must

flow to its efficient uses. An economic axiom holds that total savings equal total investments: even money stuck in the bank doesn't lay fallow. The banks (and other entities downstream) invest it. In this way, big reserves and small droplets alike are drawn inexorably to the sea of wealth creation.

When prices fall and expected return increases, cash in a savings account increasingly risks foregoing the greater expected return of stocks and getting whipsawed by inflation. These unstoppable incentives pull capital back into action. We're in a historically rare environment where accounting valuations exceed prices for multitudes of venerable companies. Hedge funds and debtors are forced to sell at low prices. If you don't have to, why voluntarily join them?

As a general condition, risk taking is compensated. If you think stock returns are low going forward, make a case that stocks are less risky now than they were before all this tumult. I'm listening.

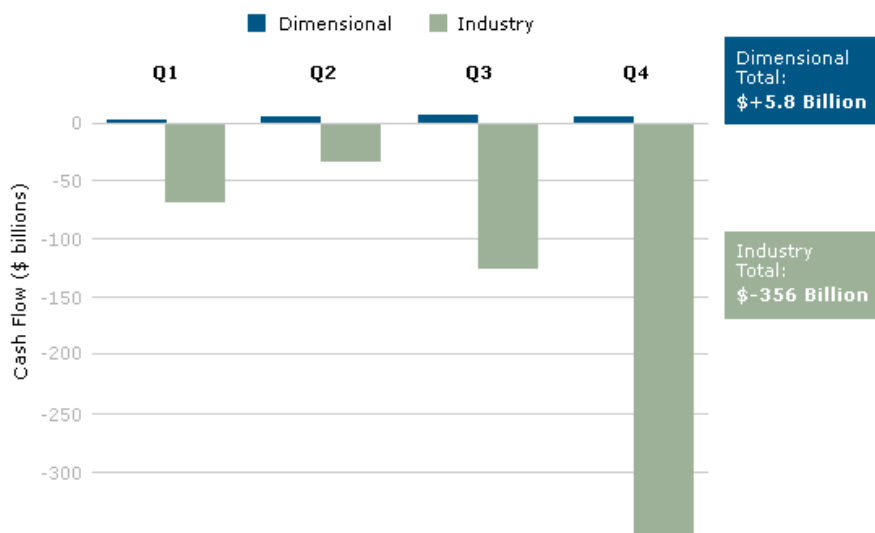
### Take Charge

Like other forces of nature, markets are unfathomable to central planners, the media, or any individual. They adapt to the worst that we throw at them. Consider that China—a country nobody would call a bastion of freedom—generated an annualized stock market return of 47.4% for the five years ending December 2007.<sup>3</sup> The less free the markets become in one country, the greater the incentive for other countries to loosen regulations and increase their competitive advantage. (The moral: global diversification!<sup>4</sup>)

As uncertain as advisors and other plan sponsors feel lately, you have to think it's as bad or worse for end investors and plan beneficiaries. Now is the time for professionals to demonstrate the strength of their convictions. The true test of leadership is during hard times. A belief that capital markets overcome challenges, and an adherence to the principle of modern finance—cost of capital, risk and return, and global diversification—are more crucial now than ever. Our advisors know this: The chart below demonstrates how stable your cashflows have been through the period compared to an industry that seems only to react, flapping in the breeze of uncertainty.

#### EXHIBIT 2

#### Dimensional vs. Industry Cash Flows 2008



In US dollars. Industry data provided by TrimTabs and the Investment Company Institute.

At the risk of hearing a soft strain of the *Patton* theme in the background, I propose that Adam Smith, Thomas Jefferson, and the founders of our economic system were on to something. Liberty, the pursuit of happiness, and enterprise are man's birthright—wired into our DNA. Markets harness and advance these noble impulses better than any other mechanism of human interaction. Political or industry setbacks only induce waiting capital to eventually roar back into action. As an advisor in this philosophy, pride yourself on standing at the front lines of the charge.

Our philosophy makes us all 1776 investors, ready to overcome the forces that brought us to this point, and to assert our capital boldly—with an abiding belief in free markets and our destiny as investors.

Date of first use: April 7, 2009. Prospectuses are available by calling Dimensional Fund Advisors collect at (310) 395-8005; on the internet at [www.dimensionalfund.com](http://www.dimensionalfund.com); or, by mail, DFA Securities LLC, c/o Dimensional Fund Advisors, 1299 Ocean Avenue, Santa Monica, CA 90401.

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<sup>1</sup>Expected return is the percentage increase in value a person may anticipate from an investment based on the level of risk associated with the investment, calculated as the mean value of the probability distribution of possible returns.

<sup>2</sup>Securities of small companies are often less liquid than those of large companies. As a result, small company stocks may fluctuate relatively more in price.

<sup>3</sup>Source: MSCI China Index (net dividends) copyright MSCI 2009, all rights reserved.

<sup>4</sup>Diversification neither assures a profit nor guarantees against loss in a declining market.

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Performance data shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month end, access our website at <https://my.dimensionalfund.com/fundcenter/performance/>. Average annual total returns include reinvestment of dividends and capital gains.

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