



Beyond ETFs - Integrating Your Passive Funds

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It's been a while since my last article and it has taken questions from *Canadian MoneySaver* readers to get me back to writing. Always good to hear from well-informed and well-read investors—those referred to me by *Canadian MoneySaver* usually are!

Recent questions have been submitted inquiring about Dimensional Fund Advisors (DFA), their funds and how they may be used as a substitute, or replacement, to ETFs or other index products. Others are interested in how portfolios can be built beyond these passively oriented instruments.

In short, I believe DFA funds are a great compliment to ETFs. DFA funds should be considered as investments to be held on a long-term basis. Investors should think of using ETFs for the long term as well; however, ETFs are important for trading when rebalancing is a consideration. Furthermore, having ETFs to further expand beyond asset classes not covered by DFA funds makes sense for added diversification. What follows is a brief review of DFA, some comments on combining them with ETFs and then some reflection to go beyond to active managers.

A Quick Review of DFA

DFA has been operating in Canada since the fall of 2003. They started with 5 funds (U.S. small cap, U.S. value, international small cap, international value and a global 5-year fixed income fund). All of their funds are sold in either A class units (typical fund structure with front-end load and trailer) or F class units for fee-based advisors. As a licensed investment counselor/portfolio manager, we use F class units since we are compensated by our clients through management fees based on "assets under management" rather than a commission structure. I am aware of one other *Canadian MoneySaver* contributor (other than myself) whom I believe to be eligible to act as an advisor for the use of DFA funds. It would not surprise me if there were more.

In the summer of 2004, DFA also released a Canadian equity fund with a mix of both small cap and value tilts. Clearly, DFA has determined that their methodology, explained briefly below, also applies to the Canadian market. This fund's concept was so popular that DFA launched simi-

lar "core" funds for the U.S. equity and international equity asset classes this past summer for the Canadian investor. Thus, they currently have 8 funds offered in Canada (again, each of which are available as A and F class units).

The fundamental philosophy of DFA revolves around the Fama-French 3-factor model. Eugene Fama missed out this year, but I think it's inevitable that he'll win the Nobel Prize in economics sometime soon. Unlike the capital asset pricing model (CAPM) which relies solely on market risk (beta) as a factor to best achieve ideal risk-adjusted returns, the model adds two other factors, or as they call them, "dimensions". The first is based on company size, which is measured by market capitalization. The second is based on company value which is based on the ratio of a company's book value to market value. Given space constraints, I'll leave it at that.

There's just so much material needed to go through to fully appreciate the research conducted at DFA that they actually have advisors to go through a "training process". Although I have never gone through any training of this nature from a mutual fund manufacturer prior to DFA's (nor since), I'm fairly certain that DFA's is unique to the industry. I was quite impressed when I went to the DFA headquarters (Santa Monica, California) in 2003 for the "training" as well as to conduct my due diligence on their operations.

DFA Funds and ETFs

We use DFA to gain the minimum exposure required for certain asset classes as determined by a client's investment policy statement (IPS). So, for example, if a client's IPS says that they must have a minimum amount of international equity at 10%, then we'll invest that 10% in DFA's international equity funds. Furthermore, for example, if our current asset mix says that international equity should be at 25%, then the additional 15% (above the 10% minimal exposure) would likely be invested in ETFs. Bottom line: we don't want to trade DFA funds. We like to think of them as the foundation for our portfolios. However, periodic rebalancing is required for prudent ongoing portfolio

maintenance. For our private client mandates, we don't trade or rebalance our portfolios very often, but when we do, ETFs are great for that. If you are disciplined, and want to keep your asset allocation within certain constraints, bringing your asset mix "back to par" is convenient with ETFs. Just don't get caught in a high frequency trading program by keeping your constraints too tight.

Of course, various asset classes are not covered by DFA funds in Canada (commodities, real estate, etc.), so there's another reason for having ETFs on your list. Beyond that would be the optional use of active management as described in the next section.

Passive Versus Active

It is possible and arguably even desirable to construct a portfolio based entirely on passively managed components (ETFs, DFA funds and index funds). This thinking allows the investor to focus on the key task of asset allocation. However, there are some realities that compel additional issues to be considered beyond asset allocation. Once we get the asset mix decision completed (again, it's the most important), and we determine what added protection is required (alternatives, derivatives, hedging, etc.), then we determine how to implement within each asset class. This subsequent consideration we call "strategy allocation". It is the decision to implement an investment through passive or active means, or a certain combination of both.

I believe in using ETFs and DFA funds when possible and as much as possible. It's actually fun looking at all the new ETFs coming on the market. Some are not so much fun like all the various U.S. equity ETFs coming out, many of which I feel to be redundant and thus unnecessary. But for alternative asset classes (gold, now in Canadian as well as U.S. dollars, alternative energy, etc) as well as the traditional asset classes, it's really becoming an asset allocator's utopia.

Still, I won't prohibit the use of an active manager, if required. In some cases, I'll even use a direct investment in a stock or bond if I think it's warranted, although I admit it's very rare. In short, these are the two main considerations I believe are necessary when having to determine if an investment beyond passive instruments and into an active program is warranted.

Active management as an option based on market efficiency (or lack of): There are clearly opportunities where an active manager should be able to beat his or her benchmark index on a consistent basis. Let's use emerging mar-

kets as an example. It is likely that a manager currently in Mumbai or Shanghai has a better chance to beat any index in their related classification. It is also reasonable to expect that one day there will be thousands of CFAs, MBAs, PhDs researching the Indian and Chinese markets in a similarly robust manner to the U.S., Europe or Japan. At that point in time, enough inefficiencies and information asymmetry should be priced out of the market, so that passive instruments become a viable option. Thus, it is reasonable to assume that there are certain markets where the investable indices are not the best choice for investing.

Active management as an option based on no available passive instrument: So there is a balance point here. Markets once considered "inefficient" may now be considered by some to be highly efficient. This would be confirmed by the recent explosion in ETFs and other passive instruments. However, in some asset classes, usually ones not considered to be highly efficient, there is no ETF suitable as a proxy for that market. Sticking with emerging markets, I'd say that central/eastern Europe is another good example. I don't know of an ETF for that region, but even if there was, I think that there is still a very good chance that an active manager is the right way to go. You may not agree, and so when you consider Latin America, let's say, you'll have to decide if you want to pick an active manager, or go with ILF (in case you don't know, you can go to Google and just type ILF or any other ticker to get some quick info).

As a side note, we do a lot of reading on new thinking in the indexing/passive space. You might want to do some Google searching on Rob Arnott and his views on equally weighted capitalization as well as fundamentally weighted capitalization (also look at the following tickers: RSP, PRF). Almost all ETFs are based on market cap and that means you're buying large and high-priced stocks. These non-market cap weighted index products interest me because their thinking aligns somewhat with DFA's philosophy of buying smaller and value-oriented stocks.

I hope this has given you some food for thought.

Some further introductory reading on DFA can be found from John De Goey's September 2004 *Canadian MoneySaver* article as well as these websites: <http://www.dfacanada.com/>, <http://www.dfaus.com/>

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