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How the Really Smart Money Invests

Nobel Prize winners entrust their nest eggs to DFA, where investing is a science, not a spectator sport.

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Suppose you made a list of the smartest people alive in finance--those who have done the most to advance our understanding of how the stock market really works. Somewhere near the top you'd surely place Eugene Fama of the University of Chicago, the leading champion of the efficient-market theory and a favorite to win a Nobel Prize one day. You'd obviously want to include Merton Miller of Chicago, who earned a Nobel by analyzing the effect of a corporation's capital structure on its stock price, and Myron Scholes of Stanford, who won his Nobel by explaining the pricing of options. You'd also pencil in Fama's collaborator Kenneth French of MIT, as well as consultant Roger Ibbotson and master data cruncher Rex Sinquefield, who together compiled the most trusted record of stock market returns going back to 1926.

What would you give to know how these titans invest their own money? Well, don't give too much, because all you have to do is look at the funds of one Santa Monica money management firm, Dimensional Fund Advisors. Sinquefield and partner David Booth, both former students of Fama, founded DFA and now run the funds. Fama and French map out many of the investment strategies (and earn royalties for doing so). Miller, Scholes, and Ibbotson are directors. All except Miller, who believes directors should not invest in their own funds, have large chunks of their own money in DFA.

If you want to invest like these giants, however, you may have to check one of your most cherished investment notions at the door. Unlike any other money management firm, DFA insists that each of its funds follow a strategy based on rigorous academic research. And for the past three decades that research has squarely challenged the industry's fundamental assumption--namely, that a stock picker, given enough smarts and enough research, can consistently beat the market. To the Über-intellects at DFA, the genius stock picker is a myth. "I'd compare stock pickers to astrologers," says Fama. "But I don't want to bad-mouth the astrologers."

Such talk may seem harsh in these stock-mad days--when top mutual fund managers are as celebrated as sports stars--but DFA has the numbers to back it up. Sinquefield and Booth will be happy to share the reams of academic research supporting the theory that stocks are, with a few exceptions, an efficient market, in which prices fairly reflect all available information and stock pickers can't really add much value. They can also point to the wildfire spread of indexing among professional and retail investors, an investment strategy they helped pioneer.

Sinquefield and Booth might also bring up the success of their own firm. After being hooted at by Wall Street 20 years ago, the pair today manage $29 billion in 22 funds, making their firm the ninth-largest institutional fund manager in the country. The client list includes the pension funds of PepsiCo, BellSouth, and the state of California, and the endowment of Stanford University. The firm is also the most popular choice of the mutual fund industry's fastest-growing retail distribution channel, fee-only financial planners. (If you want to invest your own money in DFA funds, you'll need to go through one of them.) DFA collects fees averaging about a quarter of a percent on that asset base, for a gross of some $70 million a year. Which pretty much disposes of the notion that ivory-tower ideas never make you rich.

If nothing else, DFA's success is a measure of how deeply the once thorny theories of academic finance have taken hold in mainstream investment practice. And that is due in no small part to the two founders' own tireless proselytizing. Sinquefield and Booth met in 1971 at the University of Chicago Graduate School of Business. Booth, a Ph.D. candidate, was grading papers and advising students in Fama's finance course. Sinquefield, an MBA student, regularly bombarded Booth with doctorate-sized questions. Both were already ardent believers in the efficient-market hypothesis, a theory that Fama first espoused in his Ph.D. thesis in 1964 and elaborated on in subsequent articles and academic confabs. Booth, a blond, Midwestern computer jock, came across Fama's thesis as a master's candidate in computer sciences at the University of Kansas. Dazzled by Fama's intellectual footwork, he gave up his IBMs to move to Chicago and study under Fama.

For Sinquefield, it was a case of one theology replacing another. Raised from age 7 in Saint Vincent's Catholic orphanage in St. Louis, he earned his keep there making beds and waiting on tables. He went on to study for the priesthood but left the seminary after three years. Sinquefield first encountered Fama's theories at the University of Chicago and, like Booth, had an epiphany. "It reminded me of studying Aristotle and Thomas Aquinas," he says. "The theories were so ordered and logical."

To continue: The object of their devotion, Eugene Fama,...

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