Market Returns

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The Penny Drops

An article by Jim Parker, Vice President, DFA Australia Limited

Dimensional's philosophy and approach to investment is drawing favourable attention in Australia right now as the media question some of the conventional wisdom about chasing returns.

The head of Dimensional Funds Management's international portfolio management, Graham Lennon, featured in a high-profile interview recently by The Australian newspaper.

The full-page story, contained in the newspaper's weekly 'Wealth' section, focused on Dimensional's philosophy, process, lessons from the global financial crisis and what clients are looking for today.

The interview is titled 'Smart Thinking Trumps Crystal Ball', and here are a fw higlights:

Q: Firstly, have you seen any big swings in asset allocation recently, perhaps a changed perception about the times ahead?

A: "People are more aware of risk than they were three years ago, when it's fair to say all the focus was on return. Obviously, market pricing suggests there is a concern about the wash-up from the financial crisis, in the state of public sector balance sheets and the sustainability of the recovery.

Listening to our clients, we've noticed a greater weight on transparency and having a clear understanding of what's driving the strategies. There's also a greater focus on cost than before, an awareness of risk control and a demand for flexibility within limits.

That's good for us as we've always put a premium on process and we've always paid close attention to costs. We're also transparent about the securities we target and we closely manage the tension between what the model might tell us and the day-to-day reality of market conditions."

Q: How would you describe your approach?

A: "We design investment solutions that aim to deliver above market returns in a cost-efficient way.

The value-add comes from multiple sources. We constantly research the sources of higher expected returns; we engineer highly diversified strategies aimed at efficiently delivering those returns; and we seek to manage and implement in ways that take account of real world frictions like transaction costs, tax and momentum.

We're not a conventional manager that bases its approach on forecasting growth and earnings. But neither are we an index manager that contracts out its security selection to commercial benchmarks. What we do is select securities we identify as offering higher expected returns.

We always start from the assumption that markets are extremely competitive and there's not a lot left on the table. Alpha can quickly be wiped out by high cost, which means it is hard to consistently add value the traditional way."

Q: What do you see as the main themes that will surface in the market in the next 12 months?

A: "A big lesson from the financial crisis – and one we've been stressing for years – is that people tend to come a cropper when they base a strategy around a model about the future. You can manage risk up to a point, but there will always be a degree of uncertainty.

So we control for that through very broad diversification, by only taking those risks that come with an expected return and by paying attention to things we can control like costs, taxes and efficiency in implementation.

If we were to make a forecast, it would be to say that the market is starting to come around to our view – that managing risk is not about looking into a crystal ball, but about building robust processes that are able to withstand extreme and unexpected events."

Q: Is this climate good for your type of fund?

"Most certainly. There has been a lot of disenchantment with those who promised the world and couldn't deliver.

We're finding people are finally understanding what we do. And that is we are constantly researching and understanding the sources of excess return. And we know from experience how to build strategies around those.

Best of all, we don't have to make forecasts to achieve that. We know what we know, but we also know what we don't know. And that's how we are able to do what we do."

ATO Gets Tough on SMSFs

No one should have any doubt of the increasingly punitive attitude of the ATO. Their recent release is worthy of quoting verbatim.

"While the lodgment rates for the SMSF annual return have improved, too many funds continue to have a poor record in this area.

We know that many of these SMSFs remain active and have assets but, despite a number of reminder notices from us, they have still not lodged their annual returns.

Because of this, we have started a pilot exercise involving nearly 250 SMSFs and have issued each fund with a pending default assessment of 45% of the fund's assets, less non-concessional contributions. We will also look at prosecuting trustees who fail to meet their lodgment obligations.

In a recent case, the trustee of a SMSF was prosecuted for failing to comply with court orders to lodge two annual returns. The court convicted the trustee and imposed the maximum fine of $55,000. The courts also sentenced a person to 10 months periodic detention for lodgment breaches."

There has also been a couple cases where the ATO refused to issue new Funds with a regulated fund notice while there were several years trustee personal tax returns outstanding. Though this is not a compliance measure that the tax office has announced it is clearly one that they practice.

The SMSF environment is clearly becoming more carefully scrutinised which is why we insist our trustees maintain a high standard of compliance. So while our trustees at times might think we are a pain in the rear end, it is not worth sacrificing lifestyle in retirement by getting on the wrong side of the ATO.

"Hindenburg Omen" Flames Out

In the US, September was a relatively good month for stocks—total return for the S&P 500 Index was 8.92%, the best September result since 1939. Small cap stocks sparkled as well, with a total return of 12.46% for the Russell 2000 Index, the fifth-best month since inception of the index in January 1979.

Returns in any one month don't usually provoke much excitement, however this buoyant performance occurred in spite of a grim prediction by the so-called "Hindenburg Omen". Attributed to Jim Miekka, a blind physics teacher turned newsletter author, the Omen combines multiple technical indicators tracking moving averages and the number of issues setting new fifty-two-week highs and lows. The Omen allegedly flashed a "sell" signal on Thursday, August 12, and internet chat rooms were buzzing on Friday the 13th about the prospect for a looming disaster in the stock market. Mr. Miekka suggested to a *Wall Street Journal* reporter that the Omen signalled a "market meltdown" in September.

Many investors are easily persuaded that careful analysis of stock market trading patterns offer valuable clues to the direction of stock prices, and a small army of newsletter publishers cater to this belief. Successful timing models (and newsletter publishers) are conspicuous by their absence, and the persistence of this cottage industry brings to mind Samuel Johnson's observation on marriage: "the triumph of hope over experience."

There are a vast array of analysts who produce timing indicators for market newsletters. These statistical wizards have no trouble coming up with technical signals that do very well in predicting major market moves. Unfortunately for fans of timing models, they only work on past data, and none of them continue to work once identified.

But some investors, like alchemists seeking the magic elixir to change lead into gold, cling to the belief that their search for the perfect prediction model will be rewarded.

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