Los Angeles Times

FRIDAY DECEMBER 30, 2005 SECTION C

Dimensional's 'Passive' Course Pays Off

Rex Sinquefield retires 33 years after setting out key tenets of the investment strategy.

By Tom Petruno
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Rex Sinquefield gave up plans to become a Catholic priest in favor of a career in finance.

The church, he jokes, is better off. And so is the investment world, according to Sinquefield's many fans.

The 61-year-old Sinquefield will end an era today as he steps down as co-chairman of Santa Monica-based Dimensional Fund Advisors, an $86-billion-asset money management firm.

Dimensional, under Sinquefield and co-founder David Booth, was one of the pioneers of "passive" stock market investing — a discipline that sees no merit in trying to pick individual winners among equities, or in trying to time market swings.

Instead, passive investors believe in the so-called efficient market theory, which maintains that almost no one can be smarter than the market as a whole in the long run. So they buy and hold broad portfolios of shares, betting that their returns over time will trump the gains of most "active" managers who try to find the stocks with the brightest prospects.

Valley Forge, Pa.-based Vanguard Group is the better known passive money manager and is 10 times Dimensional's size. But in the field of finance, Sinquefield's work 33 years ago establishing key tenets of passive investing — and his development of long-term market performance statistics that have become the bedrock of investing decisions — place him in Wall Street's pantheon, his admirers say.

"Virtually every investment portfolio has been influenced in some way by what he has done," said Michael Rosen, head of Angeles Investment Advisors, a Los Angeles investment consultant.

"His contribution has been huge," said Robert Arnott, a money manager and editor of the Financial Analysts Journal.

Today, trillions of dollars worldwide are invested in passive portfolios. The most famous such fund for small investors is the $108-billion Vanguard 500 Index fund, which replicates the returns of the blue-chip Standard & Poor's 500 stock index.

Dimensional, under Sinquefield and Booth, has boomed by focusing on passive, low-cost investing in three niches: smaller stocks, value-oriented shares and foreign issues. All three have been among the hottest market sectors in this decade.

The firm's largest fund, the $7-billion U.S. Small Cap Value portfolio, has helped make Dimensional's case that the typical active manager can't beat a passive portfolio: The fund produced an average total return of 18.3% a year in the five years ended Sept. 30. That trounced the 14.6% gain of the average small-cap value fund, according to Morningstar Inc.

Sinquefield, who grew up in St. Louis, entered a seminary after high school, expecting to become a priest. But his interests soon shifted to business, he says. He left the seminary for St. Louis University, then went on to the University of Chicago in 1970 to study for a master's degree in business administration.

The University of Chicago had long been a bastion of free-market theory — the idea that the economy, and financial markets, work beautifully for all when left unfettered.

It was just 10 minutes into his first class with the late professor Merton Miller, who would win a Nobel Prize in economics in 1990, when the lightning bolt struck, Sinquefield recalls.

"He was explaining the notion of efficient markets," Sinquefield said. "It was like an epiphany to me. I thought, 'This makes sense.' "

He had dabbled in stock investing on his own, but had come to believe that any success he would have picking individual shares amounted to being "somewhere between stupid and lucky," he said.

Eugene Fama, a University of Chicago professor who is considered the father of the efficient market theory, became a mentor to Sinquefield in the early 1970s. But while academic research on the concept of passive investing was blossoming, there was no fund in which investors could test the theory with real money.

That was Sinquefield's master stroke: Working in the trust department at American National Bank in Chicago in 1973, he convinced his bosses to launch a fund that would match the performance of the S&P 500 index.

The fund made its debut three years before Vanguard's S&P 500 portfolio was born.

To market the American National fund to investors, however, Sinquefield knew that he needed data on how the index had performed historically. But he couldn't find all the information he required. Standard & Poor's, for example, didn't keep statistics on how much companies in its index paid in dividends each year, which was key to figuring total gains.

Long before personal computers, when many financial statistics existed only on musty paper, the head of S&P's research department "said it couldn't be done," Sinquefield said.

So he put together his own historical data back to 1926, using stock dividend information in American National's trust department records.

Working with Roger Ibbotson, another University of Chicago alumnus, Sinquefield's efforts became the basis for a statistical reference simply titled "Stocks, Bonds, Bills and Inflation." It was, and remains, one of the bibles of the money management business because it shows average returns since 1926 for large-company and small-company stocks, Treasury and corporate bonds, and Treasury bills.

As interest in passive investing grew in the late 1970s and early-1980s, Sinquefield linked up with Booth, another Chicago alumnus who also fervently believed in the efficient market theory. Booth launched Dimensional in New York in 1981 specifically to develop funds to invest passively in small-company stocks, a novel idea at the time.

Booth and Sinquefield moved their company to Santa Monica in 1985 — in part, Sinquefield says, because back then they found the area's housing affordable and the commute easy.

With his retirement from Dimensional, Sinquefield's commute should get easier again: He and his wife, Jeanne, who has headed the firm's stock trading unit, are moving permanently to their 1,000-acre farm on the Osage River in Missouri.

After three decades in the investment business, Sinquefield said he felt it was time to try something new. He has founded a think tank, the Show-Me Institute, which he says will focus on public policy issues in Missouri.

He will keep his board seat and ownership stake in privately held Dimensional. Booth, 59, will become the firm's sole chairman.

Although many investors worldwide still shun passive investing, preferring to bet with active money managers in the hope of beating average market returns, Sinquefield and Booth believe they're in a growth business in the long run.

'Passive' in a Different Sense

Most "passive" investment funds seek to track specific market indexes, like the Standard & Poor's 500. Dimensional Fund Advisors approaches passive investing differently.

"We say we're passive but not index," said Rex Sinquefield, the firm's co-founder. "We don't worry about perfect tracking of an index."

Instead, the firm's managers essentially create their own indexes, fashioning portfolios from hundreds or thousands of stocks in their market niches — for example, small Japanese shares.

That gives Dimensional more flexibility in how and when to buy or sell stocks. And with smaller shares in particular, deft trading can be crucial in getting the best prices, which can boost investors'returns.

"Even though we come from the efficient market school, we still think there are things you can do to make more money" in a fund, said David Booth, Sinquefield's partner at Dimensional.

Another way to boost returns, Booth said, is to avoid excessive trading. To that end, Dimensional limits access to its 56 funds: It sells them only through professional financial advisors, rather than directly to investors.

The idea, Booth said, is to keep out "hot" money, people who are short-term traders rather than long-term investors.

But given the surge in cash into Dimensional's main market niches of small stocks, value shares and foreign issues in the last few years, a big test may lie ahead: whether the firm's newer investors will stick with it if those sectors suddenly slump.

— Tom Petruno