Still a firm believer of market efficiency

Face to face

The financial crisis has done nothing to shake David Booth's faith, says Pauline Skyapa

Despite the financial crisis, or show the failings of the market efficiency hypothesis, or demonstrate its validity? Many have written its obituary, but there are still supporters who stand by its basic tenets. David Booth is one of them.

He has made his fortune applying the belief that all publicly available information is priced into stocks and the only way to outperform is to take more risk. In 2008, he gifted some of his valued at $300m, to the University of Chicago Booth School of Business (renamed Chicago in recognition of his generosity) in appreciation of its input to Dimensional Fund Advisors, the business he founded in 1981.

Mr Booth was a PhD student at the business school and was taught by Professor Eugene Fama, who came up with the efficient market hypothesis. Recent experience has done nothing to shake Mr Booth's belief in the soundness of the theory. In fact, he says the recent financial crisis provided "dramatic further evidence and support of market efficiency, as far as publicly traded stocks and bonds are concerned. (It is not appropriate to extend the idea to other areas, he cautions.)"

To deny markets are efficient is to assume there is extra money lying around waiting to be picked up, he says, "so who got all that extra money during the market turmoil? I don't know many people who had a great investment experience during this." Some people accept developed markets are pretty efficient, but suggest emerging markets provide opportunities for stock pickers to outperform because information is less available or reliable.

Mr Booth does not agree. He says Dimensional has specialised in difficult-to-access parts of the stock market that many would have expected, to demonstrate inefficiency. The first investment strategy it launched was a small-cap fund - a new idea at the time.

Going for small cap was in line with the ideas thrown up by Chicago Booth academics. They showed small company stocks have higher expected returns than large company stocks (the same applies to low priced value stocks against high priced growth stocks).

Dimensional took a passive approach to investing in small caps in the belief that this sector of the market was as efficient as large cap. Mr Booth reckons his belief has been vindicated. "Our small-cap portfolios have done much better than the median fund."

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Markets may be inefficient, "but it may not help you because you have to find a manager that will pick the winners for you and charge a low management fee", Why would anyone do that?

Cite Warren Buffett as an example of a man who can pick stocks, and Mr Booth regales that Mr Buffett is more like a hedge fund and private equity manager. Besides, his name always comes up the list of names.

would be longer if markets were not efficient. Mr Buffett advocates low cost index funds as the best investment for most people, he adds. "If you look in the mirror and you don't see Warren Buffett, you're probably better off in an index fund."

Not that Mr Booth is a totally uncritical fan of index funds. They do a fine job, he says, and have outperformed most managers in each of the past four decades. But the basic large cap index fund can be improved upon, by adding a dollop of small cap or value stocks, and by not trading when everyone else does. Dimensional has adopted such strategies, which distinguishes its funds from traditional index funds. On the trading front, Mr Booth says although the group's processes are highly computerised, transactions are not totally automated. There is a view that "a good trader can add value".

By not trading on the days when stocks go in or out of the index, it is possible to avoid big premiums or losses, he adds.

One form of indexing he does not favour is the fundamental variety, where constituents are weighted by factors such as book value, earnings or dividends rather than by market capitalisation. It is a version of the value effect, he says, and more like active management than what Dimensional does.

Curriculum Vitae

David Booth

Born: 1946

Education

1968: BA in Economics, University of Kansas
1969: MS in Business, University of Kansas

Career

1973: MBA, University of Chicago

1974: Analyst at Wards Bank, working on one of the first index funds
1983: Founded Dimensional Fund Advisors, where he is chairman and co-CEO.