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Interview with Ken French
Director, Consultant and Head of Investment Policy
Dimensional Fund Advisors

Overview: In October 2007, we were honored to be joined at our annual advisor conference by Ken French, director, consultant and head of investment policy for Dimensional Fund Advisors (Dimensional) and Heidt Professor of Finance at the Tuck School of Business at Dartmouth College. He and Eugene F. Fama are well known for their research into the value effect and the three-factor model, including articles such as “The Cross-Section of Expected Stock Returns” and “Common Risk Factors in the Returns on Stocks and Bonds.” His recent research focuses on tests of asset pricing, the tradeoff between risk and return in domestic and international financial markets, and the relationship between capital structure and firm value. Following is an informative interview held during his visit. We thank Mr. French for sharing his experiences with us.

Q: What are some of the most common arguments you hear against Efficient Markets Hypothesis and how do you respond to those?

A: Let me start with something that may surprise you. The Efficient Markets Hypothesis is not true. It’s a very useful model, but like every other useful model, it is an abstraction from reality. Every price can’t be exactly right all the time. It’s better to ask more operative questions like “Should I *act as if* every price is right?”

The answer to that is yes, for at least three reasons. First, even though I’m willing to stipulate that there are people out there who can actually identify mistakes in prices, I don’t know who they are. Second, even if I were able to reliably identify them, I don’t see why they would leave any of their expertise on the table for me. There is no reason to expect someone with that much expertise to pay me more than a normal rate of return for the use of my money. Finally, even if they wanted to be generous, competition from other investors will drive my expected payoff back to at most a normal rate of return.

Q: Much has been made about the world moving toward a global economy. What kind of impact does that have on the markets, specifically looking at correlations of international markets to domestic markets?

A: What people usually talk about is globalization of the production side of the economy. I think we’ve had pretty globalized financial markets for years, and more and more people have been taking advantage of the diversification that global markets offer. With globalization of the

production side, however, demand and supply may get more correlated across countries, and the benefits of international diversification may get smaller.

Q: What gets covered in your Investments course at the Tuck School of Business?

A: It's basically a course on constructing portfolios — deciding how to invest. We start by looking at what the opportunity set looks like: what investments are available, how the returns on different asset classes are related and how returns vary across asset classes. Then we talk about what investors are trying to accomplish. We discuss risk aversion, taxes, horizon issues, liquidity. When you build your portfolio, what are you trying to maximize? Logically, you might think it makes more sense to start with what people are trying to accomplish, and then look at the opportunity set, but students like to start with dessert and see what the world looks like first.

Finally, we talk about some of the systematic mistakes people make building portfolios. I think it is at best too early for behavioral finance to say much about asset prices, but the folks who study this already have an enormous amount to say about the way investors behave. For example, investors tend to be overconfident and trade too much. It's great to be able to show students some of the systematic biases or decision traps people have when making investment decisions.

In a nutshell: here are the different assets you can invest in, here's what you're trying to accomplish, here are some sensible portfolios; and, by the way, here are some mistakes that people make in trying to build portfolios.

Q: If any, what is some of the overlap between your role as a professor and your role with Dimensional?

A: It's huge. What I do at Dimensional is closely related to what I do at Dartmouth. As you know, at Dimensional we don't spend time trying to pick winning stocks. Instead, we try to add value through engineering. The skills and tools I use while helping in that process are closely related to the skills and tools I use in my academic research.

Q: Describe how some of the investment policy discussions go at Dimensional.

A: A lot of the issues start with the portfolio management and trading groups. We have really talented people who spend most of their time thinking about real live portfolios. That creates issues that bubble up. At the same time, a lot of the new portfolio design comes from clients' requests or concerns.

And some issues are driven by a small working group comprised of David Booth, Gene Fama, Eduardo Repetto and me. The four of us mull things over, dig up whatever data we need and try to sort things out. Then, we go to the investment policy committee — which includes the senior portfolio managers and the head of trading — and get feedback. We may talk to some of the regional directors for additional advice. At some point, we present our results to the investment committee for approval and then they get incorporated into the portfolios.

Editor's Note: The following three questions reference an interview with Mr. French published in the September/October 2005 issue of CFA Magazine.

Q: in the interview you did with CFA Magazine a while back, you suggested that momentum is an embarrassment to the Efficient Markets Hypothesis. Do you believe that momentum in the marketplace will eventually be explained?

A: Explained, perhaps. Rationalized, no. Momentum is often interpreted as a positive feedback process. Usually when people talk about the way the market corrects pricing errors they are describing negative feedback: When prices are too low, the expected return is high and everybody rushes in to buy. In the process, they push prices up and correct the error.

The simplest interpretation of momentum works the other way. Expected returns are high after the realized return is high. Under the positive feedback story, when investors rush in to take advantage of the high expected return, they push the price up even higher. That's positive feedback. If this positive feedback story is right, there is no strong countervailing force that will eliminate momentum.

Of course, there's another story for momentum that does not involve positive feedback. Suppose that when there's good news about a company, the initial price response is not big enough. As the effect of the news spreads across the market, investors gradually push the price up to the right level. If this explanation is right, individual investors can improve their returns by reacting more quickly to the news. The competition to make more money will induce them to react quicker and quicker until any abnormal returns disappear and the momentum effect is eliminated.

But your question was not whether it would go away. It was whether or not it would get explained. It may turn out that it's risk, but it just doesn't smell like risk. Remember, momentum says recent winners have high expected returns and recent losers have low expected returns. Since the set of stocks that win or lose changes a lot from period to period, the set of stocks with high and low expected momentum returns also changes a lot from period to period. This means that any particular stocks expected return moves around a lot, based on its most recent six- to twelve-month return. And if the momentum effect is caused by risk, the stock's risk must change a lot based on its most recent six- to twelve-month return. Do I really think risk is leaping around from stock to stock like that? No.

Q: In the same interview, you mentioned your use of the term "asset class investing." How has use of that term changed with the inception of Dimensional's core equity funds?

A: I don't think the meaning of the term has changed, but rather that we have changed our approach. It's hard to argue that the core funds are asset classes. They just tilt toward asset classes. So, if you think asset class investing means focusing on individual asset classes, the whole theme of the core portfolios is that there is an even better way to invest than asset class investing.

The trouble is, we don't have a good name for the style of investing we are using with the core portfolios. If somebody has a good name, we'd love to hear it.

Q: You mentioned that Dimensional doesn't fit the textbook definition of *passive*. How do you describe Dimensional when asked?

A: We're not passive in the sense of simply buying an index. That's what most people think "passive" means. But, at the same time, we're not trying to pick winning stocks, we're trying to

design and deliver great portfolios. We focus on the things we can do, such as controlling trading costs and style drift, rather than on the things we can't.

About Ken French

Mr. French is the Carl E. and Catherine M. Heidt Professor of Finance at the Tuck School of Business at Dartmouth College. He is also a director, a consultant and head of investment policy at Dimensional. Along with Eugene Fama, he designed Dimensional's value and tax-managed strategies. He is a regular speaker at Dimensional conferences and seminars and is a contributor to the firm's research group. Mr. French is a research associate at the National Bureau of Economic Research, an advisory editor of the *Journal of Financial Economics*, a former associate editor of the *Journal of Finance* and the *Review of Financial Studies*, and president of the American Finance Association.

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