

Capitalism Will Return in Force

Eugene F. Fama Jr., Vice President, Dimensional Fund Advisors

Translated from the article "Le capitalisme doit revenir en force," L'Echo Belgian Business, March 13, 2009. Efficient markets survive crashes.

An Interview with Eugene Fama Jr., by Jennifer Nille

Has the current financial crisis KO'd capital markets? Eugene Fama Jr. says no. The son of the author of the theory reminds us that in troubled times, believers in efficient markets need the courage of their convictions and to keep investing.

His firm, Dimensional Fund Advisors, sets a strong example. Founded in 1981 by David Booth and Rex Sinquefeld, and counting among its board of directors Nobel laureates such as Robert Merton and Myron Scholes, the firm started out in less-than-perfect conditions. For nine years, it sustained poor relative returns as its primary asset class, small cap stocks, experienced a lengthy downturn while stocks in many other asset classes had stellar performance. The hard times tested, but did not deter, the firm's investors: Dimensional went on to manage a total of \$111 billion of assets around the world [as of early January 2009].

FONDS EUGENE FAMA JR. (DIMENSIONAL FUND ADVISORS)

«Le capitalisme doit revenir en force»

La crise financière actuelle a-t-elle vaincu par K.O. les marchés? A cette question, Eugene Fama Jr. répond par la négative. Le fils de l'auteur de la théorie des marchés efficients rappelle qu'il faut avoir le courage d'investir en actions en cette période trouble. Sa société, Dimensional Fund Advisors, continue à cet égard, un bel exemple. Fondée en 1981 par David Booth et Rex Sinquefeld, et comptant parmi son comité de direction des prix Nobel tels que Robert Merton et Myron Scholes, la firme de gestion a démarré dans les pires conditions. Pendant neuf ans, elle a offert des rendements négatifs, du fait de son pari sur les petites capitalisations qui traversaient alors leur plus mauvaise passe sur 100 ans. Cela n'a pas découragé les investisseurs, qui lui confient à ce jour 111 milliards de dollars sous gestion. La clé repose sur la diversification, et sur une stratégie de «buy and hold» pour éviter des frais de gestion importants. Eugene Fama Jr. revient sur ces principes.

La théorie des marchés efficients, développée par votre père, a été critiquée pour avoir poussé ses disciples à desserrer la vis de la régulation. Elle a été également rudement mise à l'épreuve avec la bulle internet et la crise des subprimes. Est-elle toujours valable? L'efficacité des marchés stipule que toutes les informations valables sont reflétées de manière précise dans les cours. Ceci ne signifie pas qu'ils soient reflétés parfaitement. Les investisseurs ont aussi des croyances. L'efficacité des mar-

chés signifie que les investisseurs tirent profit normalement du marché au détriment d'autres personnes et qu'il est extrêmement difficile de battre le marché. Les krachs que nous avons connus représentent eux en aucun cas une faillite des marchés. Des études ont montré que durant l'éclatement de la bulle internet, sur toutes les sociétés qui ont été rayées de la carte, une ou deux Microsoft en sont sorties vainqueur. Il faut remarquer que les marchés ont toujours fonctionné malgré les krachs. Ceux-ci indiquent seulement que les coûts sur les futurs bénéfices sont extrêmement bas.

Les marchés connaissent actuellement une volatilité sans précédent. Essayez de maintenir une stratégie buy and hold; représente un vrai challenge pour tout investis-



Le fils d'Eugene Fama, auteur de la théorie des marchés efficients.

The key to the firm's success is its philosophy: a belief in markets, diversification, and reduced costs—principles that Fama continues to reinforce. *L'Echo* sat down for a chat with Fama at a recent seminar for University of Chicago Booth School of Business graduates held in Brussels.

The concept of efficient markets developed by your father sometimes gets criticized for loosening the regulatory screws that might have prevented the current economic crisis. The theory was similarly criticized following the internet bubble (of the nineties) and the more recent subprime crisis. Is the Efficient Markets Hypothesis still alive?

None of those events contradicts market efficiency, which simply means all available information is reflected in prices. This doesn't mean prices conform to ex-post

assumptions about what things should be worth. Prices are the current consensus of all the knowledge, beliefs, and predictions of market participants. So market efficiency seems alive and kicking so long as no investor or group of investors seems to abnormally benefit at the expense of all the other investors. And this is pretty much what the evidence shows. On a risk-adjusted basis it's extremely difficult to see how active managers are able to pick and choose stocks that beat markets—especially when everything's performing poorly like right now.

After the fact we always hear that events like the "internet bubble" were irrational; but keep in mind that the market didn't know which of the stocks would succeed or by how much. Research suggests that all that was really required to justify the increase in stock valuations was the incidence of one or two future successes on the order of a Microsoft. Doesn't seem so far-fetched or "irrational" an expectation.

It should be noted that markets have always functioned through strong booms and busts. In a steep decline, all you can conclude is that the consensus about future profits is that they'll be low—not that markets are broken.

The recent markets have had unprecedented volatility. Why? And does this create a daunting challenge for "buy and hold" strategies?

I have a hunch that the period of high volatility over the last several months is due to increased uncertainty over the threat of more regulation. The government sends different signals to the market every day, which so far has only seemed to increase schizophrenia and daily volatility. But we should also remember that by historical standards, the volatility from the early nineties up to around the year 2006 was abnormally low (and returns unusually high). So given that we had it so good for so long, today's higher volatility might seem especially bad.

Is diversification the key to guarding against increased volatility?

Diversification is definitely a key, but not a magic bullet. If you invest in diversified portfolios of risky assets, you still experience risk. The real goal of diversification is to control the type of risk you take. In a market like this, concentrating on a single stock is an invitation to catastrophe. Diversification reduces the effects of losses that are specific to an individual company or industry. Let's put it this way: when you invest in a handful of stocks you're betting that handful of stocks survives. When you invest in every stock in the market and all around the world, you're betting that commerce itself survives. History shows that individual companies come and go but human enterprise plows onward. But there are those times like the recent period when pretty much all security prices fall together and diversification doesn't protect us from loss. But usually you're better off than if you had concentrated in a few financial stocks or something like that.

As a disciple of the Efficient Markets Hypothesis, where do you stand on nationalization and increased market regulations?

Free markets are efficient markets. Liberty and capitalism go hand in hand. Attempts to fix supposed "inefficiencies" through nationalization and regulations have a history of making markets less responsive by hampering and distorting the price mechanism. We should never forget that it was government that took what until then was a run-of-the-mill recession and worsened it, prolonging it into the Great Depression of the thirties. Economic problems become worse when they become political problems. We need to keep this from happening again. A belief that markets work and are efficient—that capitalism is productive and virtuous—is a good place to start.

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