

January 3, 2007

Dear clients,

Happy New Year everyone!! By now I have contacted most of you and we have discussed opportunities to improve the quality of your investments through the introduction of several mutual funds offered by Dimensional Fund Advisors. For those of you with whom I have still not personally spoken, I apologize, and pledge to call you and discuss before the end of this quarter.

As I tried to do last letter when writing about the composition of your quarterly reports, sometimes it's a good idea to step back a bit and return to the basics. Understanding the basics as pertains to effectively deploying mutual funds from Dimensional necessitates we have a familiarity with the Efficient Market Theory (EMT). This theory is central to everything Dimensional does in constructing and maintaining mutual funds. Last summer I spent some time writing on the EMT as well but with this letter, and by citing an interesting example, I hope to further your understanding and comfort level with it. Here goes...

Morningstar is probably the most well known and highly respected mutual fund information source in the world. These folks pretty much know all that is important to know about mutual funds and they maintain an astonishingly comprehensive database. A little over five years ago one of its products, **Morningstar FundInvestor**, touted as a publication that seeks to deliver "research and recommendations for the serious investor" launched two model mutual fund portfolios. These portfolios were called "Aggressive Wealth Maker" (AWM) and "Wealth Maker" (WM). The difference in the two being that AWM would seek to maintain an 85% stock level and WM 65%. Both portfolios would have their performances compared against equally weighted benchmarks comprised of Vanguard's Total Stock Market, Total International Stock Market, and Total Bond Market funds.

The thought and expectation presumably was that because Morningstar has such a voluminous amount of data and tremendous insight into the workings of virtually all mutual funds, they should be able to identify superior performers and thereby create a mix of funds that would provide stellar performance. There is no question the idea seems completely logical. The problem is that after five years neither fund has outperformed its corresponding index fund benchmark (AWM trailed its benchmark with a 51% total return vs. 56% and WM lagged its benchmark in total return 41% to 48%).

OK, interesting, but how does this tie into a discussion of the efficient market theory? If having the ability to research investments better than others paid off in performance it should logically be expected that Morningstar (a mutual fund research and information gathering behemoth) should be able to assemble a portfolio of mutual funds that would easily and consistently outshine a mere passive collection of index funds. They couldn't! And neither can I, you, or anyone else for that matter. What about Peter Lynch or Warren Buffet? These two indeed have track records with superior market beating achievement, but who else? Two out of some six and a half billion or so people in this world is very long odds indeed. If markets weren't so efficient I can promise you that we would be able to name many others who could show such consistently superior track records in the performance of their investment picks over time.

More on this critical topic next quarter and specifically I will explain how Dimensional uses the Efficient Market Theory to our collective advantage. To be continued ...

Be well all,

