

OUTSIDE THE FLAGS

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Simplicity and Sophistication

The Chinese philosopher Confucius once said that life is very simple, but we insist on making it complicated. You could say the same thing about investing.

Complexity in investing often comes with a lack of transparency. The highly engineered and multilayered financial derivatives that contributed to the global financial crisis five years ago are a case in point.

For many investors, these products were problematic because their complexity was such that it was very difficult to understand how they were designed, how they were priced, and whether the proposed payoffs were right for their own needs.

Of course, there is an incentive for many players in the financial services industry and media to make investing seem complicated. For some investment banks, for instance, complexity provided a cover for overpricing.

In contrast, there are far fewer mysteries about the underlying stocks and bonds traded each day on public capital markets, where prices are constantly in flux due to news and the ebb and flow of supply and demand.

The virtue of these highly competitive markets for most investors is that prices quickly incorporate new information and provide rich information on risk and return. From these millions of securities, diverse portfolios can be built around known dimensions of return according to the appetites and needs of each individual.

The competitive nature of public capital markets, the efficiency of pricing, and the difficulty of getting an edge are what underpin the “efficient markets hypothesis” of Prof. Eugene Fama, who was recently awarded the Nobel Prize in economics.

Essentially, the practical takeaway from Fama’s work is that you are better off letting the market work for you rather than beating yourself up adopting complex, expensive, and ultimately futile strategies to “beat” the market.

Writing in the Financial Times on the Nobel, economist and columnist Tim Harford said Fama had helped millions

of people by showing them the futility of picking stocks, finding value-adding managers, or timing the market to their advantage.

“If more investors had taken efficient market theory seriously, they would have been highly suspicious of subprime assets that were somehow rated as very safe yet yielded high returns,” Harford wrote.¹

In the Sydney Morning Herald, journalist and economist Peter Martin said the world owes a great debt to Fama, who “demonstrated rigorously that if the supermarket crowd is big enough or if there are enough cars on the highway, you will get no advantage from changing lanes. Anyone who could have been helped will have already helped themselves.”²

This might be a counterintuitive idea to many people. After all, in other areas of our lives, like business, the secret to success is to study hard, compete aggressively, and constantly look for an edge over our competitors.

One of the other two academics with whom Fama shared the Nobel—Robert Shiller—takes the view that markets can be irrational and subject to human error. He is frequently cited as a philosophical opponent of Fama.

In practical terms, though, both men agree that it is very, very difficult for the average investor to get rich in the markets by trading on publicly available information. Most people trade too much or underestimate the unpredictability of prices.³

For example, many investors bought into supposedly sophisticated trading strategies during the financial crisis that left them on the sidelines in the subsequent rebound, which has driven prices in many markets to multiyear or record highs.

The simpler approach is to adhere to three core principles: Markets reflect the aggregate expectations of investors about risk and return, diversification helps reduce uncertainty, and you can add value by structuring a portfolio focused on known market premiums. For the individual investor, the essential add-ons to this are staying disciplined and keeping a lid on fees and costs.

Yes, these are simple ideas, but to quote another philosopher (Leonardo da Vinci), simplicity is the ultimate sophistication.



“Outside the Flags” began as a weekly web column on Dimensional Fund Advisors’ website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor’s control—including portfolio structure, fees, taxes, and discipline. Jim’s flags metaphor has been taken up and recognized by Australia’s corporate regulator in its own investor education program.

1. Tim Harford, “Why the Efficient Markets Hypothesis Merited a Nobel,” *Financial Times*, Oct. 14, 2013.
2. Peter Martin, “Pitfalls of Looking for Life in the Fast Lane,” *Sydney Morning Herald*, Oct. 16, 2013.
3. Robert Shiller, “Sharing Nobel Honors, and Agreeing to Disagree,” *New York Times*, Oct. 26, 2013.

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