

OUTSIDE THE FLAGS

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MasterChef of Investing

In the popular TV program *MasterChef*, contestants face a series of cooking challenges. From low quality ingredients to inadequate preparation and poor implementation, so many things can, and do, go wrong. It's a bit like investing.

In the world of investment, there customarily are two broad approaches. The first is a traditionally active one: Managers attempt to find mispriced securities or seek to time their entry and exit points from various parts of the market.

This first approach is akin to the *MasterChef* challenge, which requires inventing a new and distinctive dish within a set time frame. The apparent advantage for the chef is flexibility of concept.

But what usually happens is that once the chefs have committed to a chosen recipe, they end up racing against the clock and are locked into particular ingredients to create a single dish. Of course, it may work out, but if they lose attention for a second, the dish is ruined and they have nothing to fall back on.

Likewise, in the investment world, the traditionally active manager locks in on individual ideas. That results in little flexibility and creates time constraints. The manager tries

to trade on information not believed to be reflected in prices. If it doesn't work out, there may not be a Plan B.

If your primary goal is standing out from the crowd, you are going to build cost and complexity into your process. In the cooking analogy, the price of your ingredients (out-of-season avocados, for example) is going to be a secondary consideration to having an impact. And once you're committed to your distinctive dish, you may not be able to turn back.

The second approach to investing is when the investment manager seeks to track as closely as possible to a commercial index. The goal here is not to stand out, so the manager will be most conscious of "tracking error" (deviating from the benchmark).

This approach is more akin to the *MasterChef* challenge in which contestants must cook a standard, popular dish with set ingredients. The focus is not creativity but following an established process as dictated by an outside party.

The ostensible advantage of the second approach is the chefs don't have to create something completely new. The ingredients (or securities, in the case of the investment manager) are known. It is just a matter of assembling them.

But the drawback of this latter approach is the absence of flexibility. The contestants can't substitute one ingredient—or stock—for another. The recipe must be followed. What's more, it must be achieved in a designated timeframe.

A dictated menu also may not suit the clientele. For instance, it may be the world's best lasagna recipe made perfectly to order, but if your diners don't care for Italian food, you have a problem.

But what if we had a system that combined the creativity of the first approach with the simplicity of the second? In this challenge, the focus shifts from being different for its own sake or following someone else's recipe to drawing from a range of ingredients to produce a diverse menu suiting a range of tastes.

In this third approach, our contestants do not face unnecessary constraints either in terms of time or ingredients. Instead, they assemble a broad selection of dishes from multiple ingredients appropriate for the season and at times of their choosing.

The difference under this third way is that the chefs can focus on what they can control and eliminate elements that might restrict their choices. After all, their ultimate goal is to efficiently and consistently provide meals that suit a range of palates.

In the world of investing, we believe this third way is the optimal approach. Picking stocks and timing the market, like making brilliant-off-the-cuff meals in any conditions and in an efficient and consistent manner, is a tough task—even for the masters. Cooking meals off a provided menu, like the index managers, can be inflexible and costly.

The third way is akin to the Dimensional approach.

We don't have to outguess the market to get results. We don't have to lock in on a couple of our best ideas and hope they turn out. But neither do we have to throw up our hands and contract the job to a commercial index provider.

We can research the dimensions of expected returns, design highly diverse portfolios that pursue market premiums, and build flexibility into the system so that we efficiently and consistently serve up investment solutions for a wide range of needs.

Call it the MasterChef of investing.



“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.

The author would like to thank Marlena Lee for her inspiration for this article.

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