Every day it seems there is news of the stock market hitting all-time highs. But a look at your quarterly statement reveals a balance that is still below the level you reached in early 2018. Is there something wrong with asset class investing? With DFA? Do you need to retool your investment plan? Are you at risk of failing to achieve your goals? No, no, no, and no. The last few years have been challenging for a diversified asset class approach, but not unprecedented, and there is reason for continued optimism.

Your Portfolio Isn’t the Dow or S&P 500

A typical portfolio for Servo clients consists of a US large cap fund, along with US and international large and small cap value funds. Sometimes these asset classes are combined in total market “Vector” funds. Retired clients or those spending from their portfolios may also have an allocation to a short-term global bond fund. Since 2014, one of these asset classes—US large cap stocks—has been on a tear. The S&P 500 has gained +10.9% per year and the DFA US Large Cap Equity Fund is up +10.2%, both are at all-time highs as of June. US and international, large and small value stocks have had only modest single-digit returns and have yet to regain their highest levels that were seen in early 2018. Short-term bonds have gained only a few percent a year as a tradeoff for their low volatility and have not added to balanced allocation returns. These lagging asset classes have more than offset the outsized gains from our US large cap stock allocation and prevented portfolios from keeping pace with the S&P 500 in recent years.

Over the last year, conditions have become more extreme—US large cap returns are positive while US small value and international stock asset classes have declined! The fact that US large cap indexes—the S&P 500 or the Dow Jones Industrial Average—are at an all-time, high but your portfolio is not, doesn’t indicate a flaw in your plan. It only means that you are more diversified than a simple index fund.

Are We In Uncharted Waters?

There have been many conversations in financial circles over the last few years about whether diversifying globally and/or including small cap and value stocks is still worthwhile. If this were the first time we have endured a 5+ year period of underperformance for international stocks or large and small value asset classes relative to the US market, it would be a serious question.

A look back at history reveals a similar stretch in the late 1990s. When the momentum behind the S&P 500 faded in 2000, the tide turned and we saw 14 years of almost uninterrupted superiority for US and international large and small cap value stocks. The S&P 500 barely beat inflation. During the first ten years of the 2000s (the “Lost Decade”), the S&P 500 actually lost -1.0% per year while other asset classes had modest to significant gains. Should you switch to a US large cap stock dominated portfolio today? Can you afford a 10+ year period of negative returns? The answer to both questions is emphatically, NO!
**What’s Up With DFA?**

Along with the general underperformance of international stocks compared to US stocks, and value and small companies relative to large cap growth stocks, we’ve seen DFA’s asset class mutual funds underperform basic indexes, even ones with similar sounding names. In the days of star managers and active mutual funds, we might think that DFA has “lost their touch” and it would be time to trot out the next hot fund. But you left behind Wall Street brokers and old school investing years ago, so you deserve a more complete explanation of what’s happening.

Our DFA funds aren’t picking stocks or trying to time the market. Each DFA fund is designed to capture a deep and pure subset of the stock market with unique returns known as an “asset class.” The DFA US Large Value Fund, for example, invests in the largest 90% of stocks, the DFA US Small Value Fund only the smallest 10% of stocks; both are restricted to those companies with the cheapest 30% of price-to-book values after accounting for relative profitability (higher profitability stocks are overweighted; less profitable stocks are underweighted or excluded). Certain types of stocks that don’t fit the asset class definition, such as REITs or regulated utilities, are also excluded. DFA then manages the portfolios on a daily basis, using dividends and cash inflows to update and rebalance the portfolios while selling shares that have gone up in size or price and no longer reside in the asset class.

Index funds don’t dig as deeply into the small cap segment of the market; they don’t focus as heavily on the lowest-priced value stocks, and their portfolios are only updated once or twice per year (managing an index fund is good work if you can find it!). This “hands-off” approach is why their expense ratios are slightly less. But the cost that comes with less focused small cap exposure and a more watered down orientation to value also reduces the expected returns of the funds, more than small differences in expenses.

When small cap and value stocks are underperforming, it’s logical to expect DFA funds to underperform other strategies such as Vanguard Funds or iShares ETFs—even if the names of the funds are similar. But a comparison of DFA and Vanguard/iShares strategies over a full market cycle reveals that DFA’s style-pure approach should eventually win out. It is important to stick with asset class funds during unpredictable but inevitable periods when they are underperforming. It’s the only way you’ll achieve the full asset class return that your investment plan is based on.

<table>
<thead>
<tr>
<th>Asset Class/Index Fund</th>
<th>Value “Wins”</th>
<th>Value “Loses”</th>
</tr>
</thead>
<tbody>
<tr>
<td>DFA US Large Value</td>
<td>8.3%</td>
<td>7.9%</td>
</tr>
<tr>
<td>VanguardValue Index</td>
<td>5.1%</td>
<td>9.6%</td>
</tr>
<tr>
<td>DFA US Small Value</td>
<td>12.2%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Vanguard Small Value Index</td>
<td>10.5%</td>
<td>7.4%</td>
</tr>
</tbody>
</table>

If past returns aren’t convincing, then portfolio characteristics might help. Morningstar reports as of May 31 that the DFA US Large Value Fund holds stocks that are 28% smaller and 25% more value-oriented on a price-to-book basis than the Vanguard Value Index. The DFA US Small Value Fund holds stocks that are 55% smaller and 40% cheaper than the Vanguard Small Value Index. These more targeted portfolio allocations have hurt DFA’s relative returns over the last few years; however if small cap and value stocks return to favor, as they are expected to, DFA’s funds should benefit significantly.

**Dealing With Difficult Markets**

We often think of difficult times to invest in terms of bear markets like 2000-2002 or 2008. But holding a diversified portfolio and watching it underperform the S&P 500 for five years or more can be equally frustrating. Unfortunately, in investing, what works isn’t always working. It’s an unavoidable fact that the short-term returns associated with successful investment strategies are random. There are, however, a few things you can do to ease the pain.

First, embrace uncertainty—it doesn’t make sense to worry about things you can’t control. Next, consider looking at your portfolio (far) less; your Servo Quarterly Report is sufficient to check on your ongoing progress, and an annual review can address most issues, questions, and needed changes. There’s nothing to be gained from watching your funds daily or weekly, but it can cause an urge to make an ill-advised change. Finally, recognize that you made a good and well-researched decision when you started on this path, so you should trust the process. Successful investing requires faith and patience. If you do your part, in time you’ll most likely find that your outcome converges to the plans you had when you originally began this journey.