RAPPAPORT REICHES
CAPITAL MANAGEMENT, LLC

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# At the Core

Our *Value Added Indexing*℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long-term goals. Dimensional Fund Advisors has been a key partner for us in achieving these goals. Dimensional, founded in 1981, currently manages about $230 billion in a broad range of strategies around the world.[1] They are well known for their deep working relationships with leading academics. By acting as a conduit between financial economists and investors, Dimensional has pioneered many strategies now taken for granted in the industry.

Our firm employs Dimensional's Core equity funds as essential building blocks in our diversified portfolios. In this month's *Journal*, we highlight the benefits of Dimensional's Core approach vs. both traditional portfolio construction and traditional indexing.

## What is Dimensional's investment philosophy?

Dimensional begins with the premise that prices in competitive markets reflect all available information. Given the difficulty of "outsmarting" the markets, their approach looks to deliver the performance of the capital markets, while striving to reduce costs that include operating expenses, market impact, and taxes.

Similar to indexing, this approach contrasts with "active" management. Active managers focus on picking individual securities believed to be mispriced, in an effort to "beat' the market.

Dimensional sees markets as an ally, not an adversary. Rather than trying to find ways markets are mistaken, Dimensional takes advantage of the ways markets are right—the ways in which markets compensate investors for taking on risk.

Numerous research studies have shown that over time, small company and value stocks have had higher returns than large company and growth stocks.[2] Many economists believe small cap and value stocks outperform because the market rationally discounts their prices to reflect underlying risk. The lower prices give investors greater upside as compensation for bearing this risk. Dimensional's fully diversified portfolios provide additional focused exposure to small company and value stocks.

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## What are Dimensional's "Core" portfolios?

Dimensional's Core portfolios are mutual funds that own almost all of the stocks in a given market—either in the U.S., international developed, or international emerging markets. By targeting the total market—ranging from the largest to the very smallest stocks, the Core funds offer seamless integration across the full range of securities. This strategy is part of Dimensional's continuing effort to capture expected return efficiently while reducing costs.

For example, Dimensional's U.S. Core 1 Equity portfolio owns approximately 3,200 stocks, about 91% of the companies listed on the NYSE, AMEX, and NASDAQ exchanges. As a result, the turnover and transaction costs normally associated with maintaining multiple components are strongly reduced.

Consistent with Dimensional's philosophy, Core portfolios hold greater proportions of small company and value stocks than strategies based on market capitalization.

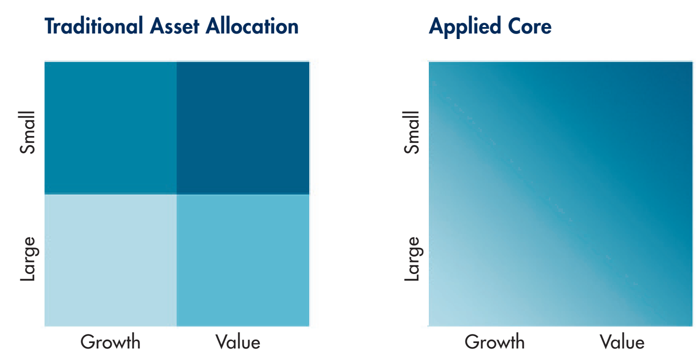
## How does core investing differ from traditional portfolio construction?

Traditional portfolio construction today centers around the "style box" approach. Investors segment a market based on company size (large vs. small) or price (expensive growth stocks vs. cheaper value stocks.) Portfolios are then put together by combining components—mutual funds or managers specializing in each of these areas. The result is a mix of separate funds (such as large cap growth, large cap value, small cap growth, and small cap value) that in aggregate provides broad exposure to a wide mix of stocks.

Dimensional's research shows that portfolios are more cost-effective, and therefore better able to generate return, when they have fewer components. The more separate funds you have, the more walls you erect between segments of the market—walls across which transactions need occur to maintain the portfolio's intended composition. Trading securities, especially less liquid small cap stocks, is expensive. Costs not only include commissions, but market impact and potentially taxes as well.

For example, a small cap fund owns a stock that has risen in price—and now no longer meets the manager's criteria. The stock is sold… only to be bought by a large cap fund elsewhere in the allocation. It is the equivalent of an investor paying to move cash from her left pocket to her right pocket.

**Chart 1—Component vs. Core**



Core investing tears down the walls between funds and allows stocks to migrate naturally and seamlessly from one asset class to another, instead having to be sold and bought. (*See Chart 1 on previous page*). Fewer transactions results in low turnover and less capital gains—particularly important in taxable accounts. Additionally, core investing eliminates the problem of overlap—which occurs when several different funds own the same securities.

## How do Dimensional's Core portfolios differ from traditional index funds?

Traditional index funds track commercial benchmarks designed to represent various segments of the market. For example, funds tracking the S&P 500 Index own shares of the largest 500 (or so) companies trading in the U.S., which represents the large cap sector.

Dimensional's Core strategies differ from traditional index funds in that they do not robotically follow commercial benchmarks. Dimensional's research focuses on obtaining the purest representation possible of each market area, while excluding securities that do not meet their criteria. They also eliminate securities that lack sufficient liquidity for cost-effective trading.

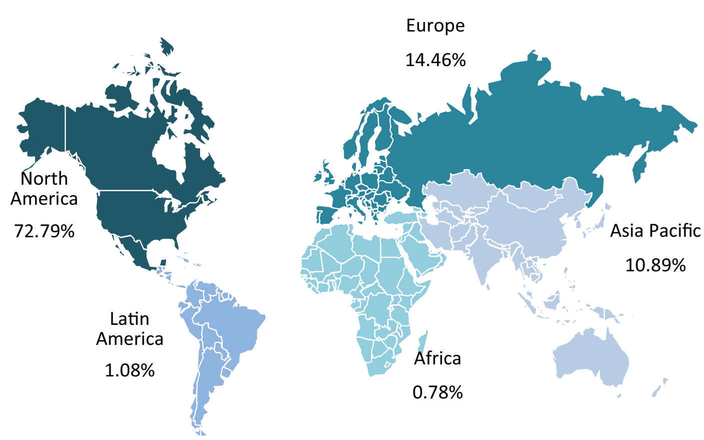
Traditional "total market" index funds hold stocks in proportion to their market capitalization (price times shares outstanding). The result is a dominant proportion of large cap growth companies. Dimensional's Core funds provide additional exposure to small cap stocks and value stocks, relative to traditional index funds.

## How do we utilize Dimensional's Core funds?

In creating global equity portfolios, we combine Dimensional's Core U.S., International Developed Markets and International Emerging Markets funds. The resulting portfolio holds approximately 12,000 stocks in 44 countries. (*See Chart 2*). All client portfolios are tailored to individual circumstances, and often include a diversified bond component as well.

**Chart 2**

| | Weight | Holdings | Countries |
|---|---|---|---|
| U.S. Stocks | 70% | 3,323 | 1 |
| International Developed Stocks | 25% | 5,180 | 23 |
| Emerging Market Stocks | 5% | 3,202 | 20 |
| Total | 100% | 11,705 | 44 |




Exposure to a large number of securities around the world reduces the risk that any one stock or any one market would have a substantial impact on a client's overall wealth.

*Figures as of 12/31/10.*

## Can you summarize the benefits?

The benefits of Dimensional's Core funds relative to traditional portfolio construction are:

- Lower fees
- Lower transactions costs
- Increased rebalancing efficiency
- Higher tax efficiency
- No overlap among stocks
- More precision in targeting returns

Traditional portfolio construction, with its set of arbitrary "products," creates complexity. Relative performance needs to be constantly evaluated. Managers and funds are replaced frequently. Core portfolios move away from a set of products towards a deliberate solution to meet clients' goals.

## Notes

1. As of June 30, 2011.

2. For example, see: Fama, Eugene F., and Kenneth R. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance* 47 (1992): 427-465.

## Disclosures

**Past performance is no guarantee of future results, and every investment strategy has a potential for profit or loss.** Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

**Rappaport Reiches Capital Management** is an investment advisor delivering world-class global investment management and financial planning solutions to individuals and families. As an independent firm, we are beholden only to our clients' best interests.

Our Value Added Indexing℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long term goals. The result is a disciplined investment experience based on sound research and planning, rather than forecasts, emotions or trends.



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