Markets

Quant Pioneer Dimensional Buys Bonds That Ray Dalio Hates

by Liz McCormick
May 26, 2021

► Firm with $650 billion overall has extended duration of debt

► Manager's views are guided by work of Nobel winner Eugene Fama

A quant pioneer with $112 billion in fixed income assets is defying doom-mongers like Ray Dalio as it places a bullish wager on interest-rate risk.

Spurred by groundbreaking insights on systematic investing from its Nobel Prize-winning adviser Eugene Fama, Dimensional Fund Advisors has been extending duration in its core bond portfolios this year.

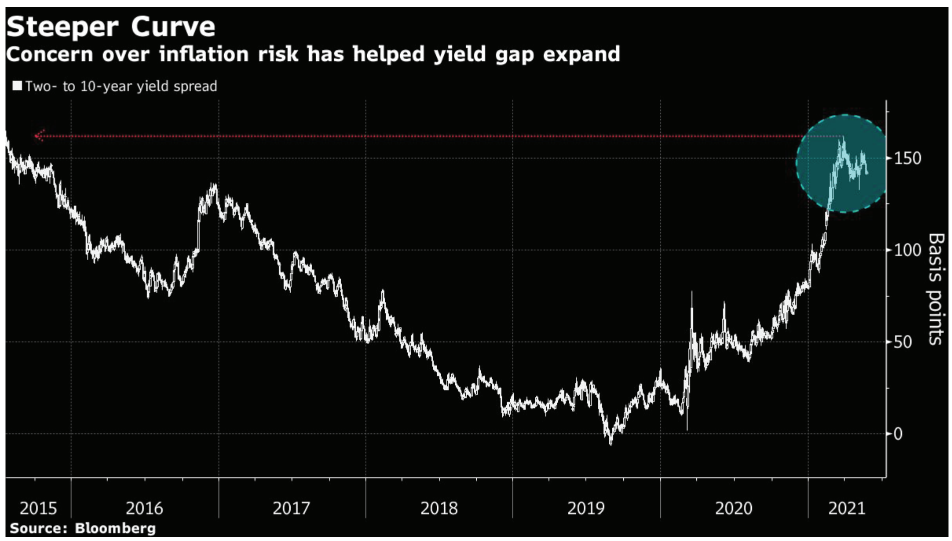
Fama-inspired research spanning decades of market history over thousands of securities shows longer-dated bonds have plenty to offer now that forward rates are on the march. Thank the combination of a steepening U.S. yield curve and the rising compensation for holding long-term Treasuries, or the term premium.

All that is spurring the allocation models that guide David Booth-founded Dimensional to flash buy signals across the asset class.

The Austin, Texas-based manager's conviction adds to the Wall Street divide over the world's biggest bond market as inflation breaks out and debt burdens swell.

"Rising interest rates do not automatically imply a negative return for a bond," said Dave Plecha, the global head of fixed income at Dimensional, which has some $650 billion in assets overall. "We develop portfolios with higher expected returns than the benchmark and over the years we've delivered on that."

Treasuries have taken big hit this year thanks to a sharper-than-expected economic rebound spurred by the rollout of vaccines for Covid 19. While Federal Reserve officials insist inflation will prove transitory, data this month showed U.S. consumer prices climbing in April by the most since 2009. The market-derived outlook for consumer price growth over the next decade, or the breakeven rate, is around 2.4%. In last year's pandemic crash, it hit as low as 0.47%.



That's prompted the likes of Bridgewater Associates founder Dalio to lambaste the safety of Treasuries and tout the hedging potential of Bitcoin as an alternative, with onetime debt king Bill Gross also among naysayers.

But finance legend and Dimensional consultant Fama isn't buying it.

"Companies and governments are issuing tons of debt and they're all getting snapped up," said the professor at the University of Chicago Booth School of Business in an interview. "Investors are still buying a lot of bonds."

While the selloff in U.S. government debt has retreated this quarter, the yield curve, as measured by the gap between two- and 10-year yields, remains near the steepest in over five years. The 10-year term premium -- the compensation for the risk of holding longer-dated U.S. debt over rolling shorter-maturity securities -- turned positive in February for the first time since 2018.

These moves have increased forward rates, or the expected returns derived from current yields and the interest-rate curve. To Dimensional, that's a sure-fire signal that longer-dated bonds today offer richer rewards.

As a result the firm is running higher interest-rate risk, or duration, than the benchmarks in its core strategy allocations.

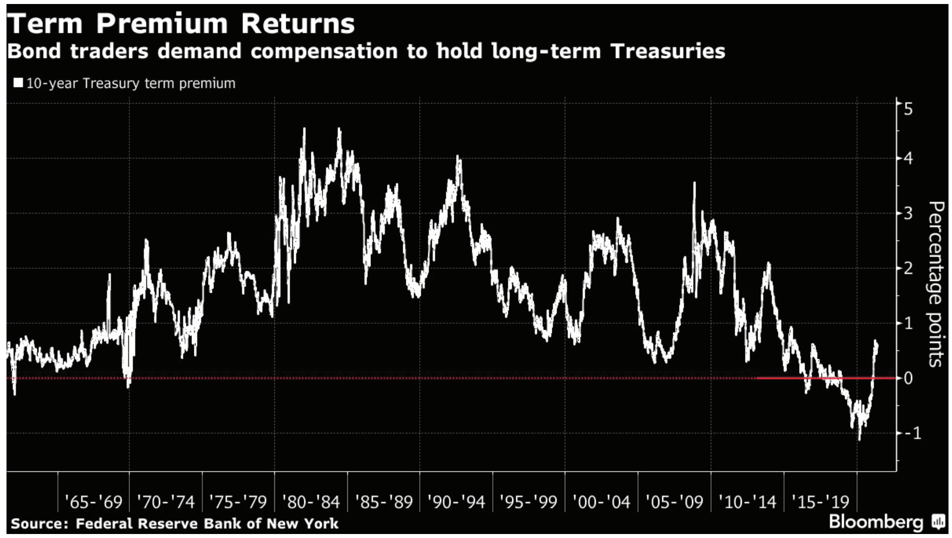
This includes the some $13 billion DFA Investment Grade Portfolio, which has beaten 80% of its peers over the past three years with an annual return of 6.19%, though it's underperformed over the past year, according to Bloomberg data. The $6.6 billion DFA Inflation-Protected Securities Portfolio has surpassed 90% of peers with an annual return of 7.08% over the past three.

Dimensional's approach differs from discretionary investors who like to dissect an issuer's business and model the monetary cycle, and also other fixed-income quants that fixate on factors like quality. It's all part and parcel of the firm's old-school philosophy that efficient markets reward investors for risk.

In stocks, Dimensional has never wavered from its faith in the value strategy, which the firm helped bring to the masses through its network of financial advisors. After the factor underperformed for almost a decade, that faith is finally being rewarded once again.

Pretty Premiums

Looking at past prices as an allocation guide may be beside the point if Wall Street bears are right that Treasuries are in uncharted territory. A surge in inflation could dramatically erode the value of future bond payments, severely undermining potential future returns.



But to Plecha in Santa Monica, California, sticking to tried-and-tested rules over the long haul is preferable to trading on unknowable existential bets.

"Fama's work shows that, on average, when yield curves are upwardly sloped, you can expect larger premiums for moving out the curve," he said. "That tells us to go out and extend duration and collect them."

– With assistance by Justina Lee

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Performance as of June 30, 2021

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AUM is as of March 31, 2021. Eugene Fama is a member of the Board of Directors of the general partner of, and provides consulting services to, Dimensional Fund Advisors LP.

	Average Annual Total Returns %				
Data Series	**1 Year**	**3 Years**	**5 Years**	**10 Years**	**Expense Ratio[1]**
DFA Investment Grade Portfolio	–0.01%	6.30%	3.37%	3.81%	0.22%
Bloomberg Barclays US Aggregate Bond Index	–0.33%	5.34%	3.03%	3.39%	—
DFA Inflation-Protected Securities Portfolio	6.52%	6.76%	4.17%	3.47%	0.11%
Bloomberg Barclays US TIPS Index	6.51%	6.53%	4.17%	3.40%	—

1. Expense ratio as of 2/28/21. The fund's prospectus contains more information on fees and expenses.

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MKT-17542 06/21 1922306