The race to build a better index fund is on. David Booth, who runs wonky DFA, says the answer is to favor small value.

One of the great innovations in finance over the past half-century was the index fund. These passive portfolios track the market at low cost and do an astonishingly good job of beating actively managed portfolios. The grand pooh-bah of all indexes, the S&P 500, has bested two-thirds of actively managed funds over the long term. Competition in the S&P index fund business has sent pricing down to a rock-bottom 10 cents a year per $100 invested.

This market is a little too commodity-like for David Booth, the chief executive of Dimensional Financial Advisors in Santa Monica, Calif. Booth has long believed--"right down to my tippy toes"--that he can beat the standard S&P fund. For the past 25 years he has done just that, with automatic-pilot funds that resemble S&P funds but tilt toward stocks of smaller companies and/or tilt toward value stocks, those being the ones that trade at lower multiples of book value, earnings or dividends. DFA funds command slightly higher fees than the commodity S&P 500 offerings.

This has been a good business for Booth, 59, and the DFA's recently retired cofounder, Rex Sinquefield. DFA's success in edging past standard benchmarks has drawn in $108 billion in assets, yielding close to $300 million a year in revenue to the 250-employee firm. Helping to market Booth's products are the two illustrious academic partners who do the theoretical work behind the construction of DFA's portfolios: Dartmouth's Kenneth French and the University of Chicago's Eugene Fama. In the French-Fama view the standard index fund is flawed by its blind (and rigid) weighting by market capitalization.

The conventional index fund, by its nature, is compelled to load up on stocks newly added to the index, even as other index funds are crowding into the same names. DFA dodges that problem by constructing its own baskets, typically with several hundred stocks.

More important, standard index funds must ignore fundamentals like assets and earnings in favor of tracking the market's passions of the moment. That's because the S&P 500, or a fund designed to track it, is weighted by the market capitalizations of the companies in it. Thus an index fund getting a slug of new money in early 2000 was obliged to put a large amount of the cash into Sun Microsystems, because Sun was a favorite and enjoyed a market capitalization all out of proportion to its sales or earnings. Those late-arriving index investors fared poorly.

How have DFA's customers fared? Pretty well, at least over long time spans. The group's largest fund, DFA U.S. Small Cap Value, has outpaced the Russell 2000 by 6.5 percentage points in annual total return over the past ten years. The next biggest, International Small Cap Value, bettered MSCI EAFE by 4.3 points; the third, U.S. Large Cap Value, was 3.5 points ahead of the S&P 500.

"The world is coming our way," says Booth. "In the history of man there are very few times people have gotten systematically less knowledgeable." You will get some argument from index aficionados (notably, John Bogle, founder of the Vanguard Index 500 fund) about whether the
superior performance of value stocks or small stocks is an eternal verity, not just a cyclical
phenomenon. But there's no denying DFA's appeal these days to the institutions running pension
funds and to the financial advisers steering individuals' portfolios.

The latest innovation at DFA's plush offices overlooking the Pacific Ocean is to tweak its beloved
small-cap value model. Since September 2005 the firm has launched three new funds--Core
Equity I and II for domestic, Core Equity International for foreign--to practice its new theory. In
that short period it has done slightly better than its conventional counterpart index funds.

The justification for using small value stocks as the centerpiece, per Fama's and French's
research: From 1927 (when the first good market data emerged) until now these stocks averaged
an annual return of 14.5%, well ahead of large value companies at 11.4% and trouncing small
growth stocks (9.4%) and large growth (9.5%). But small value stocks come with more risk, as
measured in volatility.

The new Core Equity funds deal with this volatility by admitting a few big companies into the mix.
General Electric and ExxonMobil can be found in the portfolio. Yet you see only a tiny percentage
of big-cap growth stocks trading at obscene multiples. Allowing larger caps into funds solves a
long-standing problem. Many people simultaneously hold a small value index fund and a larger
cap index. Every time a small-cap moves up to a different level, one fund has to sell it, the other
has to buy it--a pointless pair of transactions and a waste of money.

Booth also recommends an investor marry one of his new Core Equity stock portfolios tilted
toward small value shares with shorter term bonds. Consider the performance of a typical
portfolio invested 60% in an S&P 500 index and 40% in long-term bonds. Since 1950 those
holdings would have returned 9.9% annually. But if the 40% long-term bond piece of the portfolio
is shifted so that 35% of it is in short-term bonds and 5% is in small value stocks, the portfolio's
overall return would increase to 10.6%, all with a hair less volatility.

DFA sells its funds to the general public but not willy-nilly. Investors in DFA must buy into an
academically dictated strategy if they want to get in the door. You see, it's a privilege to invest
there. A DFA-approved financial adviser must first vet you to ensure you aren't some hot-money
type who wants to cash out early. The restriction weeds out investors who don't agree with the
DFA philosophy.

Booth is hardly alone in believing that he can surpass traditional indexes. Robert Arnott's
Research Affiliates has come up with its own approach to form indexes that eschew the market
cap orientation. Instead, his RAFI indexes use such measures as dividends, sales, earnings and
book value. Pimco debuted two funds in mid-2005 based on Arnott's work. Fundamental Index
Plus has gained an annual 12.1%, leading the S&P by 0.4 points, and Fundamental Index Plus
Total Return trails the S&P by 0.9. Last December PowerShares started an ETF under Arnott's
banner, called PowerShares FTSE RAFI U.S. 1000, which has returned an annual 9.6%, or two
points above the S&P.

Jeremy Siegel has a similar strategy to beat the indexes. A Wharton professor famous for
predicting the bursting of the tech bubble, Siegel focuses on dividend-paying stocks. In July his
company, WisdomTree Investments, hatched 20 ETFs with a variety of orientations, from the
broad U.S. market to Japan's. In their few short months of existence 14 of the WisdomTree
vehicles are doing better than the S&P, with the leader, International Dividend Top 100, at 12.2%, beating the S&P by five points.

Siegel defiantly says his ETFs will surge past DFA's funds in the fullness of time. He sees a few downsides to the DFA strategy. The first: DFA's reliance on book value rests on an accounting contrivance that means less in the 21st century, when valuable assets, like software, don't show up on the balance sheet. Dividends, he says, are one thing company managers can't fudge, since these require payouts of cash. In addition, dividing companies into "small" and "large" requires drawing arbitrary lines that can exclude valuable stocks.

Booth shoots back that many companies don't issue dividends at all. While 80% of the S&P 500 offer dividends, only 20% of companies overall do. Most companies are small nondividend payers. Shun the no-yielders and you miss much of the small-stock action, he says.

One thing the Booth, Siegel and Arnott iterations share is their funds have relatively low, indexlike costs. Another: You will be hearing more about them.

### A New Dimension at Dimensional

DFA launched its new index funds on steroids a year ago. These Core Equity offerings have beaten their counterparts among standard index funds by a bit.

<table>
<thead>
<tr>
<th>SMALL-CAP FUND</th>
<th>TOTAL RETURN</th>
<th>ASSETS 8/31/06 (SMIL)</th>
<th>ANNUAL EXPENSE $100</th>
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<tbody>
<tr>
<td>DFA US CORE EQUITY I</td>
<td>9.7%</td>
<td>$531</td>
<td>$0.23</td>
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<tr>
<td>DFA US CORE EQUITY II</td>
<td>10.6%</td>
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<td>WILSHIRE 5000 INDEX PORTFOLIO-INV</td>
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<tr>
<th>INTERNATIONAL FUND</th>
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<tr>
<td>DFA INTERNATIONAL CORE EQUITY</td>
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<td>ISHARES MSCI EAFE INDEX</td>
<td><strong>20.0%</strong></td>
<td><strong>30,582</strong></td>
<td><strong>0.35</strong></td>
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*Annualized since 9/15/05 (inception of the three DFA funds) through 9/30/06. Source: Lipper.