Dimensional

PERSPECTIVES

Investing with Dimensional in a Mutual Fund versus Exchange-Traded Fund

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Dimensional has launched exchange-traded funds (ETFs), complementing our existing suite of mutual funds, separate accounts, and commingled trusts. Dimensional ETFs are fully transparent active ETFs, which, unlike index ETFs (or index mutual funds), do not passively track an index. Active ETFs and active mutual funds, instead, seek to achieve a specified investment objective using an active investment strategy. This provides flexibility to adjust a portfolio's holdings each day and implement a daily investment process as Dimensional has done for nearly 40 years. The introduction of Dimensional ETFs provides investors greater choice in accessing Dimensional's time-tested, systematic investment approach.

ETFs are often compared and contrasted with mutual funds. Our approach to managing ETFs offers the same components of value-add and cost-effective implementation as our approach to managing mutual funds.

In this article, we highlight key areas of that approach and describe the nuances of applying it to an ETF structure versus a mutual fund. We also touch on some considerations that may be important to investors evaluating which vehicle to choose, such as implications for tax efficiency, the differences in how mutual funds and ETFs are bought and sold, and the types of costs encountered when investing in the two vehicles.

ONE INVESTMENT APPROACH

It's important to distinguish investment strategy from investment vehicle. Dimensional has a consistent investment philosophy and approach that provides the underpinnings of how we manage portfolios, regardless of the investment vehicle.

We have a long track record of designing investment solutions that offer consistent, diversified exposure to the market or market segment in which they invest, while adding value through implementation. We seek to add value at each step of our investment process, which includes research, portfolio design, daily portfolio management, and trading.

Our research team, working in close collaboration with leading academics, continually deepens our understanding of expected returns through robust theoretical and empirical research. We translate these results into portfolios that are designed to systematically and efficiently pursue higher expected returns, while managing risk and controlling costs.

In our daily implementation, portfolio managers consider numerous inputs that inform how we pursue higher expected returns across multiple premiums while giving our traders flexibility when participating in available market liquidity. This flexibility allows them to reduce trading costs. We also aim to enhance the value of our holdings through our integrated approach to corporate actions, securities lending, and investment stewardship practices.

We have four decades of experience, developed through investments in our people, our processes, and the systems that support Dimensional's approach to managing portfolios. We expect to bring all aspects of our investment process to the management of the Dimensional ETFs. **Exhibit 1** lists components of our value-added process that we can employ across both our mutual funds and ETFs.

Exhibit 1
Implementation that Adds Value
Seeking to increase expected returns at every step of the process

Emphasize securities with higher expected returns	
Security Weighting	Overweight smaller market cap
	Overweight lower relative price
	Overweight higher profitability[1]
Security Selection	Small growth low profitability[1] stocks excluded
	Small high asset growth stocks excluded
Incorporate additional information about expected returns into buy and sell decisions	
Momentum	Consider momentum expected return implications for both buy and sell orders
Securities Lending	Delay purchase of small cap securities with a high borrowing fee in the securities lending market
Control Trading Costs	Economies of scale and efficient market access help control explicit costs
	Flexible trading helps control implicit costs
Maintain consistent focus on premiums	
Daily Rebalancing	Evaluate current holdings and cash balances daily
Meaningful Turnover	Rebalancing candidates can help improve expected returns after anticipated costs
Increase the value of holdings in the portfolio	
Corporate Actions	Seek to maximize the value of corporate action elections
Investment Stewardship	Advocate for investors to enhance shareholder value
Securities Lending[2]	Lend securities to generate securities lending revenue

IMPLEMENTED IN MUTUAL FUNDS AND ETFS

While Dimensional has one investment philosophy and we apply the same investment process across our solutions, there are important differences in how an ETF operates that can provide additional tools for implementing daily rebalancing.

ETF portfolio managers can rebalance their underlying portfolios using the same trading tools as mutual fund managers. An additional tool for rebalancing in an ETF is through the in-kind creation and redemption process facilitated through an authorized participant (AP).

For example, when new ETF shares are created, the ETF issues creation units, which are blocks of a specified number of ETF shares, to the AP in exchange for a "basket" of securities and cash. Similarly, the ETF can redeem creation units in exchange for a basket of securities and cash.

ETFs have flexibility to provide to APs "custom baskets," or baskets that do not mirror the exact underlying holdings of the ETF portfolio, that take into consideration the same daily inputs that factor into our buy and sell lists for mutual funds. By using baskets to increase and decrease certain portfolio holdings, we can use the in-kind creation/ redemption process as one more way to rebalance the ETF portfolio, similar to the way we use client cash flows to rebalance our mutual funds.

MANAGING TAX EFFICIENCY

Tax efficiency is an important consideration for many investors. The tax efficiency of any portfolio is strongly related to the investment approach. Dimensional's strategies are designed to be broadly diversified and have lower turnover. That design inherently lends itself to a higher degree of tax efficiency relative to less diversified strategies with higher turnover. We believe that we can deliver tax efficient solutions through a low turnover approach and considering income and potential capital gains in our daily process, whether in a mutual fund or an ETF. To better understand what drives the tax efficiency of Dimensional strategies, it's useful to break down tax efficiency into the management of 1) dividend income and 2) short-term and long-term capital gains.

Income distributions are an important component of tax costs and, for portfolios with low turnover, may be at times a larger component of total distributions than capital gains distributions. By considering dividend income when we buy or sell securities and by excluding real estate investment trusts (REITs) from our equity portfolios, dividend distributions from our mutual funds have historically had a higher portion in qualified dividend income (QDI). QDI is taxed at a lower rate than nonqualified dividend income (NQDI). This has often contributed positively to tax efficiency for Dimensional's mutual funds. Our approach to managing dividend income will be similar across our mutual funds and ETFs.

Selling securities to rebalance the portfolio or meet redemptions has the potential to result in distributable capital gains in both mutual funds and ETFs. Dimensional mutual funds have historically had minimal short-term capital gains. Implementing a consistent investment approach in ETFs, we believe this component likely will have little effect on differences in tax efficiency between Dimensional mutual funds and ETFs.

Dimensional mutual funds have historically had low long-term capital gains distributions given our broadly-diversified, low turnover approach, although ETFs are largely able to limit long-term capital gain distribution to zero or close to zero. In-kind redemptions can reduce or eliminate the need to sell an appreciated security. While in-kind redemptions are available to both mutual funds and ETFs, they have been used with much greater frequency by ETFs. In an ETF, when an AP redeems creation units in exchange for a basket of securities, those securities are redeemed in-kind out of the ETF, which means the ETF can reduce its holdings of these securities without triggering a capital gains distribution. Investors in an ETF may instead eventually pay a gain upon selling shares of the ETF itself. As a result, investors in ETFs have greater control over the timing of capital gains, although the value of this flexibility depends on the particular investor's circumstances.

VEHICLE-DRIVEN CONSIDERATIONS

The decision to invest in a mutual fund versus an ETF depends in part on an investor's preference for one vehicle type over the other. Mutual funds and ETFs have similarities and differences. Both are investment funds that are registered with the SEC under the Investment Company Act of 1940 (40 Act), and the majority of the rules under the 40 Act apply to both of them. Differences between ETFs and mutual funds include how investors buy and sell them, how prices are set, and the types of costs investors should consider.

Holdings Disclosure
A fully transparent active ETF discloses portfolio holdings daily on a public website; whereas mutual funds generally have a 30-day or more lag on portfolio holdings disclosure.

Access and Price
Mutual funds are bought and sold directly with the fund manager at the end of each business day. Investors in mutual funds invest and redeem only at the fund's net asset value (NAV). Unlike mutual funds, ETF shares are traded on a national stock exchange and can be bought and sold throughout the day and at market prices that may be at a premium (above the NAV) or discount (below the NAV).

Cost Structure
In assessing costs of investing in ETFs versus mutual funds, it's useful to consider the types of direct costs investors face and the timing of when they are incurred. For example, both vehicles charge an expense ratio, which accounts for the management fee and other administrative costs. Expense ratios are costs investors incur throughout the holding period.

Investors also face potential costs when transacting in the vehicle, on entry and exit. For example, investors typically pay a brokerage platform transaction fee when buying or selling mutual funds. In contrast, many brokerage platforms now charge low or sometimes no commissions to buy or sell ETFs, including Dimensional ETFs on select platforms. However, as with trading any stock, there are other trading costs to consider, such as bid/ask spreads and market impact.

In addition to the direct, or explicit, costs an investor incurs for each vehicle, investors should consider the cost effectiveness of the underlying portfolio. High transaction costs in the underlying portfolio generally lead to lower returns for investors, all else equal. In both a mutual fund and an ETF, Dimensional considers costs at every step of the process, from broadly diversified and low turnover portfolio design, to flexible portfolio management and trading that take into consideration information in markets daily and use cash flows from client activity and other sources to help rebalance portfolios.

In sum, in either an ETF or mutual fund, Dimensional invests with a consistent investment philosophy and approach to pursuing higher expected returns for investors. Offering both vehicle structures allows investors to choose the vehicle most suitable for their unique circumstances and preferences.

1. Profitability is a measure of current profitability based on information from individual companies' income statements.

2. Securities lending involves risks - including counterparty risk - and possible loss. Revenue is not guaranteed and may fluctuate. Lending activities are conducted by the custodians for the funds.

DEFINITIONS

Asset Growth -

Asset growth is defined as the change in total assets from the prior fiscal year to current fiscal year. Small high asset growth stocks are those securities within the small cap universe that are considered to have high changes in total assets over a fiscal year.

Authorized Participants (AP) -

Typically a bank or broker/dealer, that has a written agreement with an ETF manager that allows the AP to place orders directly with the fund in the primary market.

Bid/Ask Spread -

The difference between the highest price (bid) that a buyer is willing to pay for a security and the lowest price (ask) that a seller is willing to accept.

Capital Gains -

A capital gain refers to an increase in an asset's value. A capital gain is considered to be realized when the asset is sold and may be short-term if the asset was held for one year or less, or longterm if held for more than one year.

Corporate Actions -

A corporate action is an activity that causes a material change to an organization’s structure or business, and impacts its stakeholders. In some cases, shareholders may be permitted to vote on some corporate actions.

Creation/Redemption Basket -

The securities and (or) cash requested by an ETF sponsor to be exchanged for ETF shares in the ETF share creation and redemption process.

Creation Unit -

A block of a specified number of ETF shares that the ETF will issue to (or redeem from) an AP in exchange for the deposit (or delivery) of a basket of securities and cash.]. The number of ETF shares in a creation unit can vary by ETF.

In-Kind Creation and Redemption -

ETF shares are created and redeemed in the primary market through a process between the ETF provider and authorized participants. When securities are exchanged for ETF shares (creation units), this is known as an in-kind transaction. An AP may place an order directly with the ETF provider to purchase creation units of ETF shares in exchange for securities and/or cash that constitute a creation basket defined by the ETF provider. In the case of a redemption, this process works in reverse.

Investment Stewardship -

Investment stewardship refers to the advocation for stronger governance practices at public companies, through activities such as engagement, proxy voting, and public policy advocacy, with the goal of improving shareholder value.

Market Capitalization -

The total market value of a company’s outstanding shares, computed as price times shares outstanding.

Market Impact -

Market impact is the change in the price of an asset caused by the trading of that asset. The extent to which the price moves is generally dependent on the liquidity of the asset.

Momentum -

Momentum investing is the process of buying securities that have had high relative returns over a defined period of time, and selling securities that have had poor relative returns over the same period.

Qualified (Non-Qualified) Dividend Income (QDI) -

A qualified dividend is a dividend that meets specific requirements put in place by the IRS, and consequently is taxed at rates that are lower than the income tax rates on non-qualified, or ordinary, dividends.

Relative Price -

Refers to a company's price, or the market value of its equity, in relation to another measure of economic value, such as book value.

Securities Lending -

Securities lending is the process of loaning a security to an investor or firm in return for a specified rate. In a securities lending transaction, the borrower is required to put up collateral in the form of cash or other securities, while the title and the ownership are transferred to the borrower for the duration of the transaction.

Turnover -

Measures the portion of securities in a portfolio that are bought and sold over a period of time.
