InvestmentInsights.com

Investment Academy | Investment Styles and Factors

Rules Based Investing

Alan F. Skrainka, CFA
Chief Investment Officer

"Avantis Investors invests in equities through a systematic process whose foundation is a scientific approach with theoretical underpinnings and empirical corroboration... We feel we are able to more precisely identify differences in expected returns compared to a broad-brush factor or smart beta approach."
— Avantis Investors

"At Dimensional, we think of factor investing as a systematic way to design and implement investment strategies to pursue higher expected returns than the market. It's a rules-based approach that takes some of the emotion out of investment and replaces it with rigorous research and efficient implementation."
— Mamdouh Medhat, DFA

Introduction

In an investment world often shaped by emotion, headlines, and human bias, rules-based and factor investing have emerged as powerful antidotes—offering investors a disciplined, evidence-driven path to building wealth. By relying on systematic, transparent rules and targeting specific, research-backed characteristics known as "factors," these approaches seek to remove guesswork from the investment process. Whether aiming to boost returns, manage risk, or simply bring greater consistency to portfolio management, rules-based and factor investing represent a modern evolution in asset management, blending academic rigor with real-world practicality to help investors navigate ever-changing markets with greater confidence and clarity.

Definitions: Rules Based vs. Factor Investing

Rules-Based Investing

Rules-based investing is a systematic approach where all investment decisions are guided by predefined, objective rules rather than emotions or subjective judgment. These rules can be based on a wide range of criteria, such as fundamental metrics (e.g., price-to-earnings ratios), technical indicators (e.g., moving averages), asset allocation targets, or a combination of multiple factors. The goal is to create a structured, repeatable process that minimizes human bias and ensures consistency in decision-making[1].

Key Features:

- Uses set rules for buying, selling, and portfolio management.
- Rules can be fundamental (e.g., only buy stocks with ROE > 15%), technical (e.g., sell when price drops below 200-day moving average), or allocation-based (e.g., rebalance to 60/40 stocks/bonds annually).
- Can be executed manually or automated via algorithms.
- Designed to remove emotional and impulsive decisions from investing, promoting discipline and predictability.

Factor Investing

Factor investing is a specific type of rules-based investing that targets quantifiable firm characteristics—called factors—that have been shown through research to explain differences in asset returns over time[1,2,3,4,5,6,7,8]. Rather than simply following a broad index, factor investing systematically tilts a portfolio toward these characteristics to seek higher returns, reduced risk, or both.

Key Features:

- Focuses on well-researched factors such as value (cheap stocks), size (small caps), momentum (recent winners), quality (profitable, stable companies), and low volatility (less price fluctuation).
- Factors can be “style” (within asset classes, like value or momentum) or “macro” (across asset classes, like interest rates or economic growth).

- The approach is systematic and transparent: portfolios are constructed and managed according to clear, data-driven rules that target specific factors.
- Factor investing can be used to enhance returns, manage risk, and improve diversification by combining factors with low correlations to each other. [2345678]

Comparison Table

Aspect	Rules-Based Investing	Factor Investing
Definition	Systematic investing using predefined rules	Systematic investing targeting specific return drivers
Rule Basis	Any objective rule (fundamental, technical, allocation)	Quantifiable characteristics (factors)
Examples	Rebalancing annually, stop-loss orders, trend-following	Value, size, momentum, quality, low volatility
Goal	Consistency, discipline, reduced emotion	Capture factor premiums, improve risk/return, diversify
Implementation	Manual or automated	Usually automated or algorithmic
Scope	Broad—any systematic strategy	Narrower—focuses on proven return/risk factors

---

Over the long run, broad index funds have beaten the majority of actively managed funds after costs. Index funds perform well because of what we call the “index fund advantage”: They are low cost, broadly diversified, and fully invested at all times. However, there are other funds that employ these same advantages. Also, traditional index investing also has some limitations. By design, it will only ever earn the market's average return (before fees). For investors willing to assume some active risk (deviating from the index), there may be an opportunity to achieve *higher* returns. This is where rules-based investing comes into play – aiming to improve on basic index funds without abandoning their benefits.

Beyond Basic Indexes: What Is Rules-Based (Systematic) Investing?

Rules-based investing (also called systematic or factor investing) is an approach that lies between pure indexing and traditional active management. Like index funds, rules-based strategies rely on predetermined rules and quantitative models, rather than manager intuition, to drive investment decisions. But unlike a plain index, these strategies deliberately tilt the portfolio toward certain characteristics (or "factors") that research has shown can lead to higher expected returns over time.

Dr. Mamdouh Medhat of Dimensional Fund Advisors describes factor investing as "a systematic way to design and implement investment strategies to pursue higher expected returns than the market" – essentially "a rules-based approach that takes some of the emotion out of investment and replaces it with rigorous research and efficient implementation"dimensional.com. In other words, rules-based managers don't randomly pick stocks; they follow evidence-based criteria (the "rules") to decide which stocks to overweight or underweight.

How Rules-Based Strategies Differ from Active and Index Approaches

To understand where rules-based investing fits, it's useful to contrast it with the two extremes:

- **Traditional Active Management:** A fully active fund relies on a manager's stock picking or market timing skill to beat the index. This introduces "manager risk" – the outcome depends on that person's decisions, which may be hit or miss. The fund's performance can stray widely from the market (high tracking error), and fees are usually high to pay for research and trading. Some active managers hold cash or rotate sectors based on forecasts, which can help or hurt. Essentially, the active manager seeks outperformance, but success is far from guaranteed (most underperform their benchmarks over long periods).

- **Pure Indexing (Passive):** At the other end, a passive index fund makes no attempt to beat the market – its goal is to replicate the index as exactly as possibledimensional.com. There's no discretion for the manager to drop unattractive stocks or time the market; the mandate is just "buy everything in the index". This virtually eliminates manager risk and keeps fees minimal, but it also means the fund will never exceed the index's return (by design, any deviation is considered an error to be minimized). Passive investors accept the index return and focus on efficiency and cost.
- **Rules-Based (Systematic) Investing:** Sits in the middle of the spectrum. The aim is to outperform the market or index in a controlled, systematic waydimensional.com. Rather than making ad-hoc predictions, a rules-based strategy follows a *predefined model* grounded in academic research. For example, decades of data show that stocks of smaller companies and those trading at lower price multiples have tended to outperform in the long run. A rules-based fund might therefore overweight small-cap and value stocks in pursuit of those premiums. Crucially, it does this in a diversified, transparent manner – much like an index fund, it still holds a broad basket of stocks, just with different weights than the market. This approach removes the emotional decision-making of traditional active management and sticks to evidence-backed factors.

  Put simply, rules-based investing attempts to capture the best of both worlds. It keeps many of the index fund virtues (diversification, low cost, disciplined process) but introduces active tilts toward characteristics believed to drive higher returns. The trade-off is that the portfolio will no longer track the market exactly – it will have periods of underperformance (known as tracking error). Investors in such strategies accept more short-term divergence from the index in exchange for the *potential* of better long-term returns.

  As Medhat notes, a systematic approach "tries to do is sit between those two extremes… Instead of basing investment decisions on a prediction about the future, systematic investors follow research and evidence"dimensional.com. In essence, the rules (factors) replace the stock picker. Below, we explore how two firms – Avantis Investors and Dimensional Fund Advisors (DFA) – apply rules-based investing, and how their approaches compare to traditional indexing and active management.

Avantis Investors: Indexing 2.0 Through Financial Science

Avantis Investors is a newer asset manager (launched in 2019 as a unit of American Century Investments) explicitly founded to marry the reliability of indexing with the potential for added valuesecure.alpsinc.com. The team at Avantis, led by industry veterans (many of whom came from DFA's ranks), embraces an "academic, financial science-based" philosophysecure.alpsinc.com. In practice, Avantis designs systematic, rules-driven portfolios that are broadly diversified and low-cost, yet *actively* managed on a daily basis to target certain factor premiums.

How Avantis Funds Work: Avantis equity strategies start with a very broad universe (e.g. all U.S. small-cap stocks, or all international markets) and then overweight companies that show traits of higher expected returns – primarily value (low valuations) and high profitability/quality. As Avantis explains, their process "aims to identify securities with higher expected returns based on their current market prices and other company financial information"secure.alpsinc.com. Concretely, that means Avantis favors stocks trading at low price-to-book or price-to-earnings ratios (i.e. "value" stocks) and also screens for high profits relative to size. A stock that is cheap *and* profitable gets a higher weight; a stock that is expensive or unprofitable might be underweighted or excludedavantisinvestors.com. This combination helps avoid the classic "value trap" (a stock that is cheap for good reason, like a deteriorating business) by ensuring some measure of business quality accompanies the low price.

Despite these tilts, Avantis funds remain extremely diversified. For example, the Avantis U.S. Small Cap Value ETF (ticker AVUV) holds over 770 stocksavantisinvestors.com across all sectors – it's not a concentrated bet on just a few companies. The fund's "Why AVUV**?"** description highlights that it "invests in a broad set" of small-cap companies and "pursues the benefits associated with indexing (diversification, low turnover, transparency of exposures), but with the ability to add value by making investment decisions using information in current prices"avantisinvestors.com. This perfectly encapsulates the Avantis ethos: preserve index-like breadth and efficiency, but apply continuous, rules-based active oversight to tilt toward higher expected returns.

Avantis portfolios are managed in a truly systematic way. There is no star stock picker guessing the next big trend; instead, the portfolio managers are implementing a model. They "use current stock prices and fundamentals to enhance expected returns," all while paying close attention to trading costs and taxesres.americancentury.comres.americancentury.com. Unlike a traditional index that might rebalance only once or twice a year, Avantis can trade any day as opportunities arise or risks need managing. For instance, if new information comes out that changes a stock's fundamentals or price, Avantis can adjust its position immediately. This flexibility means the portfolios stay aligned with up-to-date information, rather than adhering to a rigid calendar rebalancing. Avantis claims this "holistic" approach allows them to more precisely target the desired factors compared to a "broad-brush" smart beta index approachres.americancentury.com, while also avoiding unnecessary turnover.

An Example – AVUV vs. a Passive Small Value Index: AVUV (Avantis U.S. Small Cap Value ETF) provides a real-world example of Avantis' rules-based strategy. Its benchmark is the Russell 2000 Value Index (a standard small-cap value index). Both hold hundreds of small companies, but AVUV's active rules have led to important differences. AVUV focuses on the *cheapest* and *most profitable* of the small caps, whereas the Russell index mechanically holds all small stocks that meet its broader value criteria (regardless of profitability). As a result, AVUV's portfolio trades at cheaper valuations than the Russell 2000 Value Index, and with higher average profitability for its holdingsavantisinvestors.com. This deeper "value tilt" paid off in recent years: over the 3-year period through March 31, 2025, AVUV (and a similar DFA fund, discussed next) achieved an annualized return in the mid-single digits, handily beating the near-0% return of the Russell 2000 Value benchmarkmarkets.ft.com. Specifically, Dimensional's U.S. Targeted Value ETF (which has a very similar approach to AVUV) returned about +4.9% per year for the past 3 years, versus essentially 0.0% for the Russell 2000 Value indexmarkets.ft.com. This illustrates how a rules-based fund's active tilts can create a performance gap (in this case, positive) relative to a static index.

Of course, not every period will look that favorable – in the most recent year (2024–early 2025), AVUV slightly trailed its benchmark (returning about –5.4% vs –3.1% for Russell 2000 Value). Such short-term underperformance is the trade-off for long-term outperformance potential. Avantis emphasizes that their strategies are designed to add value over a full market cycle, not necessarily month-to-month. They aim for higher expected returns by tilting to proven factors, but realized results will vary and can lag the market for stretches.

Product Offerings

Avantis offers a range of equity funds applying this philosophy. Many are in ETF form (making them accessible and tax-efficient for individual investors). For U.S. stocks, aside from AVUV (small value), there is a U.S. Equity ETF (AVUS) that covers the entire market cap spectrum while modestly tilting toward smaller, value, and profitable companies. There are also international and emerging market equity funds (e.g. AVDE for international developed, AVEM for emerging markets) that apply similar size/value/profitability screens abroad. Recently, Avantis even launched an All-Equity Markets ETF (AVGE), essentially a one-stop globally diversified equity portfolio that "combines aspects of indexing – low fees, broad diversification, and tax efficiency – with daily active oversight and holistic consideration of company valuations"avantisinvestors.com. This shows Avantis' core principle: bring the advantages of indexing (low cost, diversification, tax efficiency) and enhance them through active, rules-based implementation.

It's worth noting that Avantis labels its approach as "systematic active" managementres.americancentury.com. Technically, funds like AVUV or AVUS are actively managed ETFs (since they don't follow a published index), but in spirit they behave more like index funds with a twist. The fees reflect this hybrid nature – higher than a plain index fund but much lower than typical active funds. For example, AVUV charges 0.25% annuallyavantisinvestors.com, comparable to or even cheaper than many index-based small-cap ETFs, and a fraction of what traditional small-cap value mutual funds charge. This low fee structure is possible because Avantis uses quantitative models and efficient trading rather than armies of research analysts.

In summary, Avantis Investors represents a new breed of manager taking index investing into its next evolution. The firm harnesses decades of academic research on what drives returns (the "financial science") and packages it in diversified, low-cost funds. Investors get the comfort of broad index-like investing – fully invested, no big bets on individual companies – combined with systematic enhancements that seek to outperform the standard indexes.

Dimensional Fund Advisors (DFA): Pioneers of Factor Investing

Dimensional Fund Advisors is often considered the original trailblazer in rules-based, factor investing. Founded in 1981, DFA was built on the research of economists like Eugene Fama and Ken French, who identified dimensions of higher expected returns in the stock market (notably company size, relative price or value, and later profitability)dimensional.comdimensional.com. DFA's core belief is that markets are broadly efficient, but by tilting toward these reliable factors, investors can earn *market-beating* returns without stock picking or market timing. For decades, DFA implemented this via mutual funds (often available only through financial advisors), and more recently through ETFs open to all investors.

DFA's Investment Approach: Much like Avantis, Dimensional's strategies are highly systematic and rules-driven. In fact, Avantis' philosophy is largely inspired by DFA's (several senior Avantis leaders, including its CIO Eduardo Repetto, previously held key roles at DFA). DFA's equity funds aim to capture the returns of the whole market, but with an emphasis on small, value, and high-profitability stocks. They often describe this as targeting the "dimensions of higher expected returns"dimensional.com. For example, a DFA U.S. Core Equity fund holds a very broad swath of U.S. stocks (like an index fund would), but it will overweight a small-cap company relative to a large-cap, and a low price-to-book stock relative to a high price-to-book stock, all else equaldimensional.comdimensional.com. DFA's research, in line with academic findings, indicates that value stocks (low relative price) have higher expected returns than growth stocks, and small caps higher than large caps – albeit with higher volatility and sometimes long dry spells.

What sets DFA apart historically is implementation. The company has been a master of practical trading and portfolio design to capture factor premiums efficiently. DFA does not follow commercial index definitions strictly; instead, they maintain their own flexible buy/sell ranges for what qualifies as "small" or "value". This flexibility allows DFA to, for instance, patiently trade into or out of positions to minimize market impact, or to avoid rushing trades around index reconstitution dates that might incur costs. In the past, DFA also made use of things like block trading and liquidity provision – buying stocks patiently when other investors want to sell, thereby getting price concessions. All of this is done according to *rules and guidelines* rather than a manager's whim, which is why DFA is described as systematic.

Gerard O'Reilly, co-CEO of Dimensional, has noted that while hundreds of "factors" have been proposed in academia, DFA focuses only on a few robust ones – mainly size, value, and profitability (plus momentum used as a secondary consideration to improve trading decisions)dimensional.com. This disciplined focus is rooted in decades of data: "On average, value stocks have outperformed growth stocks by 4.4% annually in the US since 1927"dimensional.com, and smaller companies have outperformed larger ones in many historical periodsdimensional.com. DFA's strategies are built to capture these premiums by tilting the portfolio accordingly. For example, the DFA US Small Cap Value Strategy (now available as an ETF, ticker DFAT) will hold a broad basket of small value stocks and aim for a bit more "valuey" (cheaper) and smaller profile than an index like Russell 2000 Value.

How DFA Differs from an Index: Consider how a DFA core equity fund might differ from a purely indexed fund:

- A broad market index fund (say a total stock market fund) is market-cap weighted, so giant companies like Apple or Microsoft dominate its holdings. DFA's core fund will still hold those giants, but at slightly reduced weights, freeing up allocation to smaller and value stocks instead. This way, the DFA fund is still fully diversified (it owns most of the market), but it is structurally positioned to benefit if small and value stocks outperform the mega-caps.
- Traditional indexes have hard cut-offs (e.g. the moment a stock migrates from small-cap index to mid-cap index, the small-cap fund must sell it). DFA's rules are more gradual – they might start reducing a position as it grows but not dump it all at once at an arbitrary threshold. This flexibility can reduce turnover and trading costs, and also avoid forced trades that everyone else in the market is doing. The result is often lower turnover than index-based factor funds, which helps on costs and taxes.

- DFA has historically refrained from forecasting or market timing – its portfolios stay essentially fully invested in equities, just like an index fund would. The difference is purely in the *composition* of that equity exposure (more weighted toward certain factors). In essence, DFA's portfolios are like index funds with a persistent tilt. They are rules-based in that the tilts are applied consistently according to the model (not at a manager's discretion each day).

  Product Examples: DFA's offerings span U.S., international, and emerging markets, and both equities and fixed income (they apply a similar research-driven approach in bond investing too). For equity investors, some notable funds/ETFs include:

- DFA U.S. Core Equity 2 (DFAC) – a total market U.S. equity fund that emphasizes smaller, cheaper, and more profitable companies within the broad universe. It's a one-stop core holding akin to a total market index, but with that rules-based twist. After converting to an ETF, this fund's expense ratio is only 0.19%etf.com, very competitive with index funds.
- DFA U.S. Small Cap Value (DFAT) – mentioned earlier, targets smaller capitalization and value stocks. It holds hundreds of stocks and, as of recent data, has outperformed its benchmark (Russell 2000 Value) over multi-year periodsmarkets.ft.com. The ETF version charges about 0.34% in feesetf.com.
- DFA International Core Equity (DFAI) and International Value (DFIV) – similar approaches applied to international developed markets, giving exposure to value and size premiums globally.

Historically, DFA's mutual funds were available mainly through approved financial advisors (part of their philosophy was educating advisors and requiring them to stick with the long-term approach so that end investors wouldn't capitulate during underperformance). In recent years, DFA has embraced the ETF structure, converting many mutual funds into ETFs. This has lowered costs (for example, DFAT's fee dropped from 0.43% to 0.34% upon conversion)etf.com and made the funds accessible to any investor with a brokerage account. It also underscores that DFA's strategies, while active in the sense of not tracking an index, are transparent and rule-driven enough to work in an ETF wrapper that discloses holdings daily.

Long-Term Perspective: One of DFA's key teachings (echoed by Avantis as well) is that investors must stay disciplined through cycles. The firm frequently reminds clients that while they **expect a positive "size," "value," and "profitability" premium in the long run, realized premiums can be volatile and sometimes negative in the short or even medium termdimensional.com. The 2010s provided a humbling example: value stocks significantly underperformed growth stocks for about a decade. By one calculation, U.S. growth outpaced value by nearly 7–8% per year during 2010–2019 – a historic stretch of value underperformancevanguard.co.uk. Many questioned whether the "value premium" was dead. Yet DFA's stance (supported by historical data) was that such periods had happened before and eventually reversed. Indeed, starting in late 2020, value stocks staged a strong rebound – DFA often cites that when value outperforms, it can happen in short, powerful bursts, with the average yearly value outperformance (when it does occur) being on the order of +15% in those yearsdimensional.com. This pattern means timing factor strategies is very difficult – one has to endure the droughts to be there for the windfalls.

DFA thus encourages investors to think of their rules-based funds not as trading vehicles but as long-term allocations – just like one might hold an index fund for decades. The *expectation* is that, over 10+ year periods, these diversified, factor-tilted portfolios will deliver a premium over market indexes, but patience and conviction are required. As one DFA commentary put it, "the odds of realizing a positive premium are decidedly in your favor and improve the longer you stay invested"dimensional.com – a gentle reminder that time in the market is critical for the strategy to work.

Comparing Avantis and DFA Approaches

It's no coincidence that Avantis and DFA approaches sound similar – the philosophy is largely aligned. Both firms ground their strategies in the idea that current market prices, combined with company fundamentals, contain useful information about expected returnsres.americancentury.comsecure.alpsinc.com. Both target value, size, and profitability factors as primary drivers. Both believe in broad diversification and systematic implementation to capture these premiums efficiently. And both operate at lower costs than traditional active management, making them compelling alternatives to index funds for investors seeking a *small edge*.

However, there are a few nuanced differences:

- **Heritage and Experience:** DFA has a 40+ year track record and was instrumental in developing many of the techniques and research underpinning factor investing. Avantis is newer (founded by alumni of DFA) and essentially stands on DFA's shoulders, with the benefit of hindsight and newer technology. This means DFA can point to a longer live performance history of its funds through many market cycles. Avantis, while newer, has gotten off to a strong start (gathering tens of billions in assets in just a few years, and showing competitive performance). Some investors may prefer DFA for its longevity and depth of research; others are drawn to Avantis as a fresh, nimble player in this space.

- **Product Structure**: Avantis launched with ETFs from day one, directly targeting individual investors and advisors who wanted factor exposure in a convenient, taxable-friendly format. DFA, on the other hand, started with mutual funds (often with advisor minimums) and only recently converted or introduced ETFs. Today, both offer ETFs, but Avantis' lineup is exclusively ETFs (for equities), whereas DFA still has some legacy mutual funds and a broader array of strategies (including more niche or finely sliced funds for specific needs, and a longer history in fixed income). For the average investor building a portfolio, both families offer the core building blocks in ETF form.

- **Methodology Tweaks**: While neither firm publishes every detail of their "secret sauce," there are minor differences reported in how they implement the factors. For example, Avantis has indicated it uses a bit of momentum timing to avoid buying into stocks that have sharply negative momentum (i.e. waiting for price declines to stabilize before increasing weight) – a tactic to sidestep value traps that DFA has also historically utilized to an extent. Avantis funds might also hold slightly fewer names than DFA funds in comparable strategies, possibly reflecting a bit more concentration in the highest expected return stocks. For instance, AVUV holds ~770 stocks, whereas DFA's US small value fund historically held over 1,000. This suggests Avantis is willing to omit more of the lowest-ranked names (those with less attractive value/profitability traits) to reduce "unnecessary" exposure that doesn't boost expected returns –

thereby potentially reducing tracking error from holding junky stocks that a broad index would includeres.americancentury.com.

- **Tilt Intensity:** It's hard to measure precisely, but observers note that Avantis funds often have slightly stronger factor tilts (value and quality) compared to DFA's core funds. For example, AVUV's average price-to-book or price-to-earnings is a fair bit lower than the Russell 2000 Value's, and likely even a bit more "valuey" than DFA's DFAT. This could be a conscious choice or simply a result of Avantis being smaller and able to trade into deeper value names. DFA by nature of managing larger assets might be a bit more constrained to keep liquidity and diversification broad. In any case, both are far value-tilted relative to the broad market; the difference is of degree, not kind.

- **Cost and Accessibility**: Both firms now price their ETFs attractively. Avantis' equity ETFs generally charge between ~0.15% and 0.36% annually (with broad U.S. and global funds at the lower end, and more specialized like small-cap value around 0.25%). DFA's ETFs, post-conversion, range similarly from ~0.11% for core large-cap (DFUS) to ~0.34% for small value (DFAT)etf.com. So cost is no longer a major differentiator; both are low-cost relative to typical active funds, though still a bit higher than the cheapest pure index ETFs (which can be under 0.05% for large-cap indices). One difference is that Avantis is directly marketed to retail – any investor can go on their website, read materials, and buy the ETFs. DFA historically had an *advisory channel* model and still provides a lot of content through advisors. But with the advent of DFA's ETFs, the playing field is level: an individual investor can now buy DFA or Avantis ETFs with equal ease.

In short, Avantis and DFA share far more similarities than differences. An investor employing either is following a rules-based, factor investing approach rooted in the Fama-French school of thought. It wouldn't be uncommon to even mix funds from both families in a portfolio (some advisors use DFA for certain asset classes and Avantis for others, to diversify provider risk or access slightly different tilts). The key takeaway is that both demonstrate how rules-based investing can be executed in the real world – taking the index concept and adding structured tweaks to pursue better returns.

Performance: Do Rules-Based Funds Deliver?

When evaluating rules-based strategies, performance needs to be assessed over the long term and relative to appropriate benchmarks. Both DFA and Avantis believe that if their models are sound, the long-run results should surpass market-cap weighted index funds.

Historical Evidence: DFA often cites nearly a century of data in support of the size and value premiums. For instance, from 1927 through 2022, U.S. value stocks beat growth stocks by about 4.4% per year on averagedimensional.com. Small caps have similarly shown a long-run edge over large caps (though smaller stocks can be more volatile and less consistent year to year). International markets have exhibited these premiums as well over multi-decade spans. This forms the theoretical justification – if these return patterns persist, a portfolio tilted to small/value/profitable should outperform a market index eventually.

Live Fund Performance: DFA's own funds provide a track record: Many DFA equity funds (particularly those with strong value tilts) did outperform their market benchmarks over horizons like 20 or 30 years. For example, DFA's U.S. Small Cap Value Strategy (the mutual fund predecessor to DFAT) historically earned higher returns than the Russell 2000 Value Index over decades, albeit with bumps along the way. However, results have not been uniformly positive in all periods. The 2010–2019 decade saw many DFA funds lag broad indexes because growth stocks massively outperformed value stocks in that era. Indeed, in the 10 years ending 2022, a global value index underperformed a global market index (7.25% vs 8.49% annualized)dimensional.com. DFA's funds reflected that struggle – their tilts hurt relative performance during that stretch. The important context is what happened next: in 2021–2022, value stocks surged back relative to growth, and DFA funds outperformed markedly. This cyclicality reinforces why DFA urges judging performance over full cycles. As of early 2025, looking back *five years* from the COVID-crash lows of 2020, DFA's U.S. Targeted Value ETF (DFAT) has delivered about 20.4% per annum, outpacing the Russell 2000 Value's ~15.3% per annum over that periodmarkets.ft.com. That translates to roughly a 150% cumulative return for DFAT vs 100% for the index over five years – a substantial added gain for investors who held the strategy during the rebound.

Avantis, with a shorter history, has likewise shown encouraging results so far. Its flagship funds launched in late 2019, unfortunately right before a market crash (the COVID-19 pandemic in early 2020) and a growth-led rally. Early on, Avantis funds lagged frothy growth indexes, but since the value factor's resurgence, they have shined. AVUV (U.S. small value) in particular posted stellar returns in the 2021–2023 period, earning a reputation for delivering on its promise. One Morningstar analysis noted that AVUV's approach "enhances factor exposure while incorporating the information stored in stock prices," and indeed the fund "trades at cheaper valuations than the Russell 2000 Value Index" which helped it outperform in a value-friendly environmentavantisinvestors.com. As of its latest data (3-year annualized, etc.), AVUV was ahead of its benchmark by several percentage points per yearavantisinvestors.comavantisinvestors.com. Similarly, Avantis' international and emerging market funds have generally ranked favorably against comparable index peers since inception.

The Importance of Discipline

Both firms stress that short-term performance should not be overemphasized. By design, a factor-focused fund will diverge from the market – that is the point of doing something different. Sometimes that divergence yields outperformance, other times underperformance. An investor who chases these funds after a good run (or abandons them after a bad run) could easily be disappointed. The key is to stick to the strategy through the ups and downs. As DFA research shows, each premium (value, size, etc.) can be negative in a significant minority of periods – for example, in the U.S. historically, roughly 1 out of 3 years saw the value premium (value vs growth) turn negative, and even on a rolling 10-year basis, there have been stretches where one or another factor laggeddimensional.comdimensional.com. Yet, the *chance of all* targeted factors underperforming simultaneously for a decade was historically very lowdimensional.com. Diversifying across multiple factors and holding for the long term increases the odds of success.

In practical terms, an investor in a rules-based strategy should evaluate performance over at least a full market cycle (say 7-10+ years). It's also wise to compare it to appropriate benchmarks: a small-cap value fund shouldn't be measured against the S&P 500 (which is mostly large growth stocks) in the short run, as their paths will differ greatly. Instead, compare it to a small-value index or blend of indexes that reflects its factor mix. Ultimately, the goal is that over long horizons, the rules-based fund provides a superior risk-adjusted return – either higher returns for similar volatility or similar returns with lower volatility – versus a capitalization-weighted index.

Risks and Challenges of Rules-Based Investing

While rules-based investing offers a compelling middle ground, it does come with its own set of risks and considerations that investors should understand:

- **Factor Cyclicality:** As discussed, the specific factors being targeted (value, size, etc.) go through multi-year cycles of underperformance. It can be psychologically challenging to stick with a strategy that trails the broad market for years. For example, an investor who adopted a heavy value-tilt in 2017 had to endure several years of watching growth stocks soar ahead. Not everyone can tolerate such relative underperformance, even if they intellectually understand the long-term rationale. This cyclicality is not a flaw per se – it is exactly *because* these factors are out of favor at times that they command a premium (investors demand higher future returns to bear them). But the timing of those payoffs is unpredictable. If you bail out at the wrong time (e.g., capitulate on value just before it turns around), you can lock in the underperformance. Patience and conviction are required to reap the benefits of a rules-based approach.
- **Tracking Error and Peer Comparisons:** Tracking error is essentially the volatility of the fund's excess return relative to the market. A rules-based fund will have higher tracking error than an index fund because it is intentionally different from the market. In plain terms, this means your portfolio will sometimes zig when the market zags. If the S&P 500 is up 30% in a year driven by a handful of big growth stocks, a diversified small/value-tilted fund might be up much less (or even down). Investors must be willing to tolerate looking "wrong" in the short term relative to standard benchmarks or peers. This also means one has to carefully choose what to compare the fund to; comparing a multifactor fund to a plain market index will always show some tracking difference. The real question is whether the fund is delivering versus the *expectation* for the factors it holds. The focus should be on long-run outcomes, but human

nature and industry reporting often emphasize short-term peer rankings, which can make factor funds look poor in certain environments (and great in others). Managing this tracking error risk is as much about setting the right expectations as anything.

- **Implementation Risk:** Not all "factor" funds are created equal. There is a risk that a given manager's model doesn't work as expected or that their trading execution erodes the theoretical edge. While firms like DFA and Avantis have robust processes, investors should be aware that rules-based funds are still actively managed under the hood. Portfolio turnover can be higher than a pure index (though still usually moderate), which can incur costs or tax distributions (Avantis and DFA strive to minimize taxable gains and have been largely successful, but it's a consideration). There's also the possibility of model risk – if the relationships that held in the past change (say, the value premium diminishes in the future due to structural market changes), a rules-based strategy could underperform expectations. That said, DFA and Avantis ground their models in very long-term data and economic rationale, not just recent backtests, which provides some comfort that these are enduring factors, not fads.

- **Diversification and Coverage:** By tilting away from the market, you inherently underweight some segments. For example, a value-oriented fund will underweight growth stocks. If those growth stocks dominate for a long period, you miss out. Some investors mitigate this by combining factor funds with core index funds (more on that in the next section). Also, certain rules-based funds may have quirks – for instance, some small-cap funds might avoid very micro-cap or illiquid names to improve trading, which could slightly alter their exposure. It's important to understand the universe and constraints each fund uses. Nonetheless, both Avantis and DFA funds remain broadly diversified within their universes (no single stock has a large impact), so idiosyncratic risk of any one company is low. The bigger risk is at the factor level (betting on whole segments like "small value" doing well or not).

- **Behavioral Risk:** One often overlooked risk is investor behavior. With index funds, it's easier for many to "set it and forget it" because the returns will closely track the market – there's less temptation to second-guess. With a rules-based strategy, the divergences can lead to performance-chasing or abandonment at exactly the wrong times. For example, an investor might see DFA outperforming in a value rally and pile in *after* a lot of the gains have occurred, only to then experience a reversion. Conversely, they might get frustrated during a slump and exit right before the rebound. In this sense, discipline is even more crucial here than with plain indexing. Working with an advisor or having a solid investment policy can help mitigate this risk.

In summary, rules-based factor investing is not a free lunch. It introduces active risk and requires conviction. The potential rewards – higher returns – come at the cost of periodic discomfort. However, for those who understand these risks and manage them, rules-based funds can play a very valuable role.

Fitting Rules-Based Strategies into a Diversified Portfolio

How should an individual investor think about using rules-based, factor-focused funds like those from DFA or Avantis in their portfolio? The answer will depend on one's convictions, goals, and risk tolerance. Here are a few considerations:

- **Core-Satellite Approach:** One common way to integrate factor strategies is via a core-satellite portfolio. For example, an investor might keep the "core" of their equity allocation in a broad index fund (for dependable market exposure), and then allocate a portion to one or more factor-tilted funds as satellites. The core provides stability and will match market performance, while the satellite aims to add alpha over time. An investor could, say, put 70-80% in a total market index or S&P 500 fund, and 20-30% in a combination of a small-cap value fund and a profitability-weighted fund. This way, the portfolio overall won't stray extremely far from the market, but it has an embedded tilt that could boost returns at the margin. The satellite could also be adjusted or rebalanced periodically to maintain the desired exposure.
- **All-in Multifactor Portfolio:** Alternatively, an investor may choose to make the entire equity portfolio a multifactor one. Funds like Avantis All Equity (AVGE) essentially do this for you in one package – they hold global equities with built-in tilts. Dimensional's core funds likewise are meant to be one-stop holdings (e.g. using DFA Global Equity and DFA Global Bond funds to cover stocks and bonds). This approach can simplify things, but the investor must be fully on board with the strategy, because their performance will be judged fully against the market (for better or worse). Over long horizons, if successful, this could mean meaningfully higher ending wealth than a pure index portfolio. But one must be willing to

withstand the tracking error entirely. Many long-term DFA clients have essentially all their equity investments in DFA funds – embracing the philosophy wholesale. Avantis is starting to gather similar adherents.

- **Diversify Across Factors and Geographies:** Just as one diversifies across asset classes, within the rules-based allocation it's wise to diversify across multiple factors and markets. The good news is DFA and Avantis funds are inherently multifactor (value + size + quality). But one can ensure they have exposure to international and emerging markets as well, since factor premiums have shown up in those markets too (and sometimes non-U.S. value can shine when U.S. value doesn't, etc.). A globally diversified factor approach spreads the bets. Also consider fixed income – DFA and Avantis both have systematic bond funds (tilting toward factors like credit and term risk). While bond factors are beyond our scope here, a holistic rules-based portfolio might include those for consistency.

- **Gradual Implementation:** If moving from pure indexing into a rules-based strategy, some investors take a gradual approach. For instance, they may start by shifting a slice of their U.S. equity into a small value fund and see how it behaves, before committing more. Over time, as understanding and comfort grow, one might increase the allocation. There's nothing wrong with taking it slow – factor investing is a long game, and getting the *investor* acclimated is half the battle. However, one should be careful not to "time" the entry based on recent performance (e.g., don't only buy value funds after they've skyrocketed, or avoid them after they've lagged – that defeats the purpose).

- **Rebalancing and Monitoring:** With any active tilt, it's important to rebalance periodically to maintain intended exposures. If, for example, the small/value funds outperform greatly and become a larger share of the portfolio, one might trim them back to target weights (selling high) and vice versa. Rebalancing enforces buying low and selling high across the core and factor components. It's also wise to monitor that the funds continue to adhere to their stated strategy and that the investment thesis for the factors remains intact (as of 2025, the academic consensus still affirms the existence of these premiums over time, albeit with debate about magnitude and variability).

- **Personal Fit:** Finally, consider personal risk tolerance and belief. If you truly believe in the efficacy of rules-based factor investing and can tolerate the volatility, it might make sense as a significant part of your plan. If you're more skeptical or sensitive to underperforming the market for a while, you might keep it as a smaller allocation or even stick to indexing. There's no one-size-fits-all. Some very successful investors use only index funds and do just fine (sleeping well at night is worth a lot!). Others have successfully employed DFA strategies for decades and met their goals with perhaps a bit extra return. One must be honest about their ability to stay the course.

In any case, rules-based funds from reputable firms like DFA and Avantis can be excellent building blocks. They bring academic rigor and professional implementation to your portfolio. Whether used in moderation or as the core, they tilt the odds (ever so slightly) in your favor – provided you can stay in your seat through the journey.

Conclusion: Balancing Passive and Systematic for Long-Term Success

Rules-based investing represents an evolution of the index fund revolution. It recognizes that market indices are a great starting point – giving investors low-cost access to diversified market returns – but also that we have learned something about what drives returns that can potentially be harnessed. Firms like Dimensional Fund Advisors and Avantis Investors have been at the forefront of putting this knowledge into practice. They maintain the best features of indexing (diversification, low cost, tax efficiency, full investment) while systematically tilting toward areas of the market with higher expected returns (such as value, small cap, and quality stocks). The result is neither traditional active stock picking nor blind indexing, but a thoughtful middle path.

For individual investors, the rise of these rules-based factor funds is largely a positive development. It means you are no longer limited to choosing between high-cost active funds or plain-vanilla index funds. You can construct a portfolio that reflects your convictions about factors and still keep expenses low and holdings broad. Real-world results from DFA and Avantis show that the approach can work – but they also show it requires patience. There will be times when a rules-based strategy disappoints relative to the market; that's the admission price for the chance to outperform in the long run.

Ultimately, incorporating rules-based investing comes down to personal strategy. It can serve as a valuable component of a diversified portfolio, potentially boosting returns and enhancing risk-adjusted outcomes. But it should be sized and used in a way that fits your risk tolerance and investment horizon. Even a small allocation to a multifactor fund can tilt your overall portfolio towards those rewarded factors, while a full commitment means you're essentially betting on financial science to deliver.

Whichever route one chooses, having a clear understanding of the concept – as we've outlined, the definition of index investing, the modifications introduced by rules-based strategies, and the evidence and risks behind them – will help in making informed decisions. With clear eyes and a steady hand, rules-based investing can be a powerful tool in pursuing your long-term financial goals, complementing the solid foundation that traditional index funds provide.

Sources:

- Investopedia – Advantages of index funds (low cost, diversification)investopedia.com
- Fidelity – Index fund benefits: low costs (0.015% vs 1%), diversificationfidelity.comfidelity.com
- Vanguard – Index funds track market benchmarks closely (definition of indexing)investor.vanguard.com
- Avantis (American Century) – Q&A on philosophy: combining added value with indexing reliabilitysecure.alpsinc.comsecure.alpsinc.com
- Avantis – "Our Scientific Approach to Investing" (investment perspective)res.americancentury.comres.americancentury.com
- Avantis AVUV Fund Page – Strategy description (focus on low valuations & high profitability, index-like benefits with active decisions)avantisinvestors.com
- Avantis AVUV Performance – 3-year outperformance vs Russell 2000 Value (0% vs ~5%/yr)markets.ft.com
- Dimensional (Medhat article) – Definition of factor investing and systematic approach (rules-based, between active and passive)dimensional.comdimensional.com

- Dimensional – Historical premium of value vs growth (+4.4% annual since 1927)dimensional.com; factor premiums are positive long-term but can be negative at timesdimensional.com
- Dimensional – "Perspective on Premiums" (frequency of negative premiums, importance of long horizon)dimensional.comdimensional.com
- ETF.com – DFA mutual fund to ETF conversions (expense ratios: e.g., DFAT to 0.34%)etf.com
- Avantis website – "Avantis ETFs combine aspects of indexing… with active oversight and consideration of valuations"avantisinvestors.com
- Dimensional fund data (FT) – DFA U.S. Targeted Value performance vs index (5yr and 3yr returns)markets.ft.com and DFA vs Russell 2000 Value examplemarkets.ft.com.

Investing involves risk, including the potential loss of principal. Past performance is not indicative of future results. Investment returns will fluctuate, and investors may receive more or less than their original investment upon redemption.

ETF shares are bought and sold at market price (not NAV) and may trade at a premium or discount. Brokerage commissions and trading costs may apply. Diversification does not guarantee a profit or prevent loss.

Before investing, investors should carefully review the fund's prospectus, which includes information about investment objectives, risks, charges, and expenses. Prospectuses are available from the fund provider's website and should be read carefully before investing.

All information is provided "as is" without warranty of any kind. Although sources are believed to be reliable, accuracy and completeness are not guaranteed. Investment Insights.com does not offer personalized advice or establish a fiduciary relationship. Always consult a licensed financial professional before making investment decisions.

This content is intended for U.S. residents and may not comply with legal requirements of jurisdictions outside the United States.

This content is intended for U.S. residents and may not comply with legal requirements of jurisdictions outside the United States.

For questions about this site or to report concerns, please contact us directly.