

QUARTERLY INSTITUTIONAL REVIEW

THE IMPORTANCE OF THE EQUITY RISK PREMIUM

Since stocks are much riskier than bonds, the equity risk premium has to be high enough to induce risk-averse investors to invest in stocks. Some investors have to hold equities, and the equity risk premium is the premium that they can expect to earn. However, by its nature this equity risk premium is not guaranteed, for it is only an expectation or average. It is the fact that realizations are so volatile that leads to the premium in the first place. This high volatility also makes the equity risk premium very difficult to estimate or predict.

The equity risk premium is also important since it is at the very core of so much financial theory. The equity risk premium can be used in three quite different theoretical contexts. First, from the investor's point of view, it is the expected excess return of equities over bonds. Second, from the corporation's point of view, it figures into the cost of equity capital and consequently into the firm's weighted average cost of capital. Third, from the valuation point of view, it figures into the discount rate that is used in calculations of present value. The equity risk premium is the same from all three perspectives, except for some potential market imperfection adjustments, such as taxes and transactions costs.

—William N. Goetzmann and
Roger G. Ibbotson

The Equity Risk Premium (New York, NY: Oxford University Press, 2006): 7-8.

FIRST QUARTER 2007

Research Update

p. 2

There is evidence that the value premium is predictable. The value spread, the difference in the book-to-market ratios of value stocks and growth stocks, is one of the variables that contain information about the future size of the value premium. We look at whether that relationship is strong enough to implement a successful real-life investment strategy based on it. In a second article, we explain the differences among the different versions of the MSCI international indices.

Performance Overview

p. 10

Despite some rough patches, global equity markets ended the first quarter in positive territory. US markets had modest gains across the board, with REITs and small cap growth stocks leading the way. International returns for US investors looked better than US returns and were aided by the relative weakness of the US dollar. The size effect was particularly strong in international developed markets in the first quarter. For Dimensional, the International Small Cap Value strategy was the strongest performer.

US Equity

p. 11

International Equity

p. 12

Fixed Income

p. 14

Real Estate

p. 14

What's New at Dimensional

p. 15

Appendix

p. 16

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RESEARCH UPDATE

DOES THE VALUE SPREAD PREDICT THE VALUE PREMIUM?

On average, value stocks have higher returns than growth stocks (Fama and French 1992, 1993, 1998; Lakonishok, Shleifer and Vishny, 1994). The difference between the return on a value portfolio and the return on a growth portfolio is known as the value premium.

The value premium is predictable. Asness, Friedman, Krail, and Liew (2000) and Cohen, Polk, and Vuolteenaho (2003) find a strong positive relation between the value spread—the difference between the book-equity-to-market-equity (BE/ME) ratios of a value portfolio and a growth portfolio—and the value premium using US data for 1982-1999 and 1938-1997, respectively. When the value spread is high, the value premium tends to be high, and when the spread is low, the premium tends to be low. In this paper, we use a larger historical span to explore the forecast ability of the value spread in and out of sample.

Data and Methodology

We start by constructing our measures of the value premium and spread. As in Fama and French (1993), in June of each year t from 1926 to 2003 we sort NYSE, AMEX, and NASDAQ stocks into two size groups, big (B) and small (S), based on the NYSE median size (price times shares). Independently, we sort stocks into three BE/ME groups based on the breakpoints for the bottom 30% (L), middle 40%, and top 30% (H) of the BE/ME values for NYSE stocks. Each firm's book-to-market ratio in June of year t is its book equity for the fiscal year ending in calendar year $t-1$ divided by its market equity at the end of December of $t-1$. From the intersection of the size and BE/ME sorts we construct two high BE/ME (value) portfolios (B/H and S/H) and two low BE/ME (growth) portfolios (B/L and S/L). Firms in the portfolios are value weighted. Thus, a portfolio's BE/ME for year t is the average of the firms' book-to-market ratios for t , value weighted by their market equity at the end of June of year t . We define the value spread for year t , VS_t , as the difference between the average of the BE/ME of the two value portfolios and the average of the BE/ME

of the two growth portfolios for that year t . Our measure of the value premium for year $t+1$ is HML (high minus low), the difference between the average of the continuously compounded returns on the two value portfolios and the average of the continuously compounded returns on the two growth portfolio from July of year t to June of $t+1$.

Data Analysis

Table 1 shows summary statistics for the value premium and the value spread. From 1927 to 2004, the value premium was 6.1% per year, with an annual standard deviation of 19.9%. Breaking the full sample period into three subperiods yields similar results in two of the three subperiods. The only exception is the 1927-1940 subperiod. The size of the value premium is much lower between 1927 and 1940 than in the other two subperiods, and the standard deviation of the value premium is more than two times larger in the 1927-1940 subperiod than in the two post-1940 subperiods. The higher volatility of HML for 1927-1940 is caused by the Great Depression years. The standard deviation of the value premium for 1941-1972 is almost the same as that for 1973-2004.

TABLE 1
SUMMARY STATISTICS FOR THE VALUE PREMIUM
AND THE VALUE SPREAD

| | 1927- 2004 | 1927- 1940 | 1941- 1972 | 1973- 2004 |
|---------------------------|---------------|---------------|---------------|---------------|
| HML | | | | |
| ANNUAL MEAN | 6.05% | 3.56% | 6.75% | 6.44% |
| ANNUAL STANDARD DEVIATION | 19.90% | 35.05% | 15.39% | 15.10% |
| VALUE SPREAD | | | | |
| ANNUAL MEAN | 2.35 | 5.31 | 2.14 | 1.27 |
| ANNUAL STANDARD DEVIATION | 2.45 | 4.11 | 1.54 | 0.42 |

The change in the volatility of the value premium around 1940 suggests that an ordinary least squares (OLS) regression analysis will yield inefficient estimates of the relation between the value premium and the value spread for periods overlapping the shift in volatility. Hence, we present separate OLS regressions for the pre- and post-1940 periods.

Table 2 summarizes the regressions of the future value premium, HML_{t+1} , on the current value spread, VS_t . Except for the 1927-1940 period, the regressions produce strong

See Appendix: Standardized Performance Data and Disclosures for how to obtain complete information on performance, investment objectives, risks, advisory fees, and expenses of Dimensional's funds.

evidence of the predictability of the value premium. The slopes for the three post-1940 subperiods are more than 1.9 standard errors above 0. Moreover, the value spread captures about 17% of the variance of the value premium for 1941-2004. In short, the value spread is a reliable predictor of the value premium in the post-1940 period.

TABLE 2
PREDICTIVE REGRESSIONS OF THE VALUE PREMIUM ON THE VALUE SPREAD
 $HML_{t+1} = a + b VS_t + e_t$

| | a | b | R ² |
|-----------|-------------------|-----------------|----------------|
| 1927-1940 | -11.19 (-0.73) | 2.78 (1.20) | 0.03 |
| 1941-2004 | -2.59 (-0.87) | 5.39 (3.74) | 0.17 |
| 1941-1972 | -5.57 (-1.42) | 5.75 (3.85) | 0.31 |
| 1973-2004 | -8.59 (-1.04) | 11.88 (1.92) | 0.08 |

The t-statistics are in parentheses. The R² has been adjusted for the degrees of freedom.

To test whether the forecast power of the value spread is sensitive to our choice of value and growth portfolios, we use NYSE quintile BE/ME breakpoints (the top and bottom 20%, rather than the top and bottom 30%) to construct more extreme high- and low-BE/ME portfolios. The results for these portfolios, which are not reported, confirm the positive and statistically reliable relation between the value spread and the value premium for the 1941-2004 period.

We also redo our analysis with a more timely measure of firms' BE/ME ratios. Rather than using ME at the end of December of year $t-1$, we use ME at the end of June of year t as the denominator in each firm's BE/ME ratio for year t . These results are reported in Table 3.

“THE VALUE SPREAD RETAINS ITS PREDICTIVE ABILITY IN THE POST-1940 PERIOD FOR DIFFERENT DEFINITIONS OF VALUE AND GROWTH PORTFOLIOS, WHICH GIVES AN AFFIRMATIVE ANSWER TO THE QUESTION: DOES THE VALUE SPREAD FORECAST THE VALUE PREMIUM IN SAMPLE?”

TABLE 3
PREDICTIVE REGRESSIONS OF THE VALUE PREMIUM ON THE VALUE SPREAD, USING ME(JUNE T) IN FIRMS' BE/ME RATIOS
 $HML_{t+1} = a + b VS_t + e_t$

| | a | b | R ² |
|-----------|-------------------|-----------------|----------------|
| 1927-1940 | -31.63 (-3.70) | 6.31 (5.89) | 0.72 |
| 1941-2004 | -5.23 (1.57) | 6.80 (3.84) | 0.18 |
| 1941-1972 | -9.27 (-2.43) | 7.47 (4.62) | 0.40 |
| 1973-2004 | -17.06 (-1.48) | 18.95 (2.02) | 0.09 |

The t-statistics are in parentheses. The R² has been adjusted for the degrees of freedom.

The main difference between Tables 2 and 3 is the strong statistical reliability of the slope coefficient for 1927-1940. The slope for this subperiod is more than 5.5 standard errors above 0. The dramatic swing in the pre-1940 results, due to a few influential observations, implies that the relation between the value premium and the value spread is not dependable during the first fourteen years of the sample. In contrast, the predictive

ability of the value spread is consistently strong in the years after 1940. For all three post-1940 subperiods, the regression slopes and adjusted R² values reported in Table 3 are very close to those in Table 2.

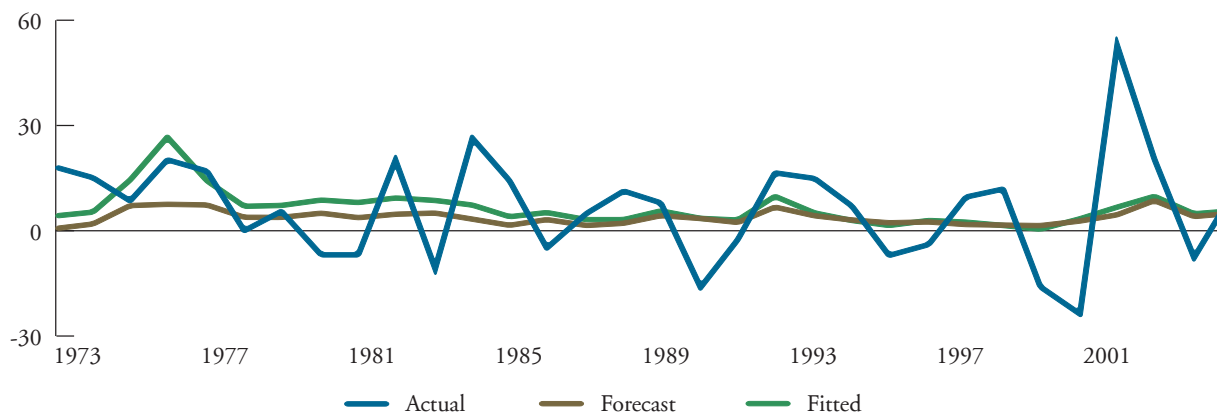
The value spread retains its predictive ability in the post-1940 period for different definitions of value and growth portfolios, which gives an affirmative answer to the question: Does the value spread forecast the value premium in sample? The remaining question is: Does the prediction work well out of sample? In other words, can we predict the value premium for the next twelve months using only data available at the end of June of this year?

To answer that question, we use out-of-sample forecasts. We forecast the value premiums for 1973-2004. Each forecast is from an OLS regression of the value premium,

HML_{t+1} , on the value spread, VS_t , for the preceding thirty-two-year period. For example, to predict the value premium for 1973, we

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FIGURE 1
ACTUAL, FORECAST, AND FITTED HML RETURNS: 1973-2004



use the regression intercept and slope estimated with the thirty-two *HML* returns for 1941-1972. We start the estimation period in 1941 because of the evidence that the relation between the value premium and the value spread is unreliable toward the beginning of the sample. We start the forecasts in 1973 (the midpoint of the 1941-2004 period) because this allows us to use thirty-two years for the estimations and thirty-two years for the predictions. Figure 1 plots the out-of-sample forecasts against the actual *HML* returns for 1973-2004. For comparison purposes, we also show the fitted values from the in-sample regression for 1973-2004.

The value spread performs worse out of sample than in sample. The mean absolute error (MAE) of the out-of-sample forecasts is 11.79%, whereas the MAE of the fitted values is 11.11%. Moreover, the adjusted R^2 of the in-sample regression is 0.08, while its equivalent for the out-of-sample forecasts is 0.02. The out-of-sample underperformance of the value spread, along with its inability to warn investors of shifts in the sign of

the premium, implies that a real-life investment strategy, based on the forecasting power of the value spread, is likely to fail.

Conclusion

There is in-sample evidence that the value spread, the difference between the average BE/ME of two value portfolios (*B/H* and *S/H*) and the average BE/ME of two growth portfolios (*B/L* and *S/L*), is positively related to the value premium, the difference between the average next-year returns on the value and growth portfolios. However, investors should be cautious about using this relation to predict the value premium. Our forecast model works poorly out of sample.

—Savina Rizova

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MSCI INDEX COMPARISONS

The MSCI family of international, multi-country indices has several variants for each index. Deciding which version of an index is the appropriate one is an important but often overlooked task. It is an important task because, for most investors, indices fulfill a dual role. They are representations of an asset class or specific investment universe and they serve as benchmarks against which to evaluate the performance of (active) managers. Choosing the wrong index could lead to an undesired asset allocation or to the evaluation of managers using the wrong yardstick. It is an overlooked task because investors assume that, so long as the underlying components of the several versions of an index remain the same, the different versions of an index will produce very similar returns. This note highlights the main differences among the different versions of the MSCI indices and offers some suggestions on which version to use as a benchmark.

Index Methodologies

MSCI calculates indices using two different methodologies: a price-only index methodology and a total return index methodology.¹ A price-only index measures the market performance of the individual securities in the index, but does not incorporate any returns due to distributions and reinvestment of dividends. In other words, a price-only index captures the market-weighted capital market appreciation of the components of the index. Because dividends can be an important component of the total return to a security, a price-only index is likely to understate the returns available to a portfolio manager (the Appendix shows the impact that dividends have on index returns).

A total return index, on the other hand, measures the overall performance of the individual securities that make up an index. It includes price performance as well as income derived from dividend payments reinvested in the index. Total return indices are further subdivided according to the reinvestment methodology into gross and net dividends. A gross dividends index calculates the maximum possible return if all dividends received were reinvested by an individual resident in the country of the company that distributes the dividends after taxes on those dividends have been applied at the rate applicable to individual domestic investors. This series does not include any tax credits that investors may receive. These tax credits arise because in some countries shareholders do not have to pay taxes

twice on the same income—first, at the company level; and second, at the individual level. If a company pays taxes on its income and distributes dividends from its after-tax income and if individual shareholders pay taxes on the dividends received, then the income received in the form of dividends will be taxed twice. To avoid doing so, the fiscal authority in some countries issues a tax credit or reimbursement. The impact of excluding any tax credits from a gross dividends index on the returns of that index will likely be to understate those returns relative to the returns that are available to domestic investors. But, if any of the countries in the index impose higher dividend taxes on foreign investors or grant smaller tax credits to these investors relative to domestic investors, then the situation changes considerably. In this case, a gross dividends index will likely overstate, not understate, the returns that are available to investors, because investors can only reside in one country. This means that the index returns that come from the home country will likely be understated, but the index returns that come from all the other countries that make up the index will likely be overstated. And, for investors who are residents of a country that is not a part of the index (e.g., US investors in the MSCI EAFE indices), a gross dividends index will overstate the returns that are available to them.

A net dividends index calculates the minimum possible return if all dividends are reinvested after withholding taxes at the maximum possible rate for institutional investors are applied. In the case of an international index, MSCI applies the highest maximum rate applicable to non-resident institutional investors and assumes that these investors do not benefit from double-taxation treaties nor do they receive any tax credits. Again, the impact of excluding any tax credits from a net dividends index on the returns of that index will likely be to understate those returns relative to the returns that are available to investors. In addition, if a country has an international tax treaty with any country in the index that exempts institutional investors in full or in part from double taxation of dividend income (first in the source country and second in the home country of those institutional investors), then a net dividends index is likely to understate the returns that are available to the institutional investors of that country.

Currency Denomination

MSCI provides index returns in local currency and in major international currencies such as the US dollar, the yen, the pound sterling, the euro, the Swiss franc, and the Canadian and Australian dollars. Multi-country indices with returns denominated in local currency allow us to determine the effects of exchange rate fluctuations on returns, but their practical use does not extend much beyond that. They are

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just constructs that represent the theoretical returns of an index in the absence of any exchange rate fluctuations. Or put another way, they represent the returns of an index that is continuously and perfectly hedged so that it is not exposed to any currency fluctuations. On the other hand, an index expressed in US dollars, or in any other major currency, incorporates the effects of currency fluctuations on returns. The greater the volatility of the currency in which the index returns are expressed relative to the currencies of the countries in the index, the greater the difference between the returns of an index expressed in local currency and the returns of an index expressed in a major foreign currency.

Index Selection

As stated above, some investors see indices as mainly representations of an asset class, while others see indices mainly as performance benchmarks. For some investors, determining which version of an index is the appropriate one to use might largely be a function of whether they see themselves in the first camp more than in the second, or vice versa. But, perhaps, a better approach—and one that does not require taking a stand on what role indices should fulfill—is to select the version of an index that most closely approximates the maximum returns that are *available* to investors, given the structure of markets and the legal settings under which markets and market participants operate. A price-only index most closely reflects the *market* performance of the securities in the index, but does not include the impact that dividends and dividend taxes have on total returns. Using a price-only index as a performance benchmark—or as a representation of an asset class—eliminates from the benchmark (asset class) returns a nontrivial amount of the returns that are available to and captured by the portfolio manager. This gives those managers an unfair advantage relative to the benchmark and understates the returns to the asset class; in some cases, by a considerable amount.

If a price-only index is not an appropriate choice regardless of which role investors see in indices, which total return index—gross dividends or net dividends—should be chosen? While neither a gross dividends index nor a net dividends index is a perfect choice, a net dividends index appears to be the more appropriate choice. Its dividend reinvestment rules are closer to the dividend reinvestment rules that investors face in real life than the reinvestment rules of a gross dividends index, which makes the returns of a net dividends index most closely approximate the returns that are available to institutional investors.

—L. Jacobo Rodríguez

Appendix

Table A1 shows the annual average return of the price-only and total return series for the main MSCI indices, while Table A2 shows the annual average return differences between the price-only indices and any of the two versions of the total return indices. As we can see in Table A2, those differences are quite substantial: they range from 1.6% to 4.3%. On the other hand, the annual average return differences between the net dividends indices and the gross dividends indices are much smaller, and range from 0.3% to 0.7%.

TABLE A1
DOLLAR-DENOMINATED RETURNS FOR MSCI INDICES
AS OF DECEMBER 31, 2006

| | ONE YEAR | THREE YEARS ANNUALIZED | FIVE YEARS ANNUALIZED | TEN YEARS ANNUALIZED |
|---|-------------|------------------------------|-----------------------------|----------------------------|
| MSCI EAFE (PRICE-ONLY) | 23.47% | 17.20% | 12.43% | 5.75% |
| MSCI EAFE (NET DIVIDENDS) | 26.34% | 19.93% | 14.98% | 7.71% |
| MSCI EAFE (GROSS DIVIDENDS) | 26.86% | 20.41% | 15.43% | 8.06% |
| MSCI EAFE VALUE (PRICE-ONLY) | 26.76% | 19.29% | 14.62% | 7.83% |
| MSCI EAFE VALUE (NET DIVIDENDS) | 30.38% | 22.64% | 17.65% | 10.18% |
| MSCI EAFE VALUE (GROSS DIVIDENDS) | 31.05% | 23.25% | 18.19% | 10.62% |
| MSCI EAFE GROWTH (PRICE-ONLY) | 20.19% | 15.07% | 10.19% | 3.51% |
| MSCI EAFE GROWTH (NET DIVIDENDS) | 22.33% | 17.18% | 12.27% | 5.07% |
| MSCI EAFE GROWTH (GROSS DIVIDENDS) | 22.69% | 17.54% | 12.63% | 5.35% |
| MSCI EAFE SMALL CAP (PRICE-ONLY) | 17.35% | 23.05% | 21.59% | 6.81% |
| MSCI EAFE SMALL CAP (NET DIVIDENDS) | 19.31% | 25.34% | 23.98% | n/a |
| MSCI EAFE SMALL CAP (GROSS DIVIDENDS) | 19.67% | 25.77% | 24.46% | n/a |
| MSCI EMERGING MARKETS (PRICE-ONLY) | 29.18% | 27.26% | 23.52% | 6.72% |
| MSCI EMERGING MARKETS (NET DIVIDENDS) | 32.17% | 30.52% | 26.59% | n/a |
| MSCI EMERGING MARKETS (GROSS DIVIDENDS) | 32.57% | 30.98% | 26.98% | 9.40% |

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TABLE A2
RETURN DIFFERENCES AMONG THE DIFFERENT VARIANTS
OF THE MSCI INDICES
AS OF DECEMBER 31, 2006

| | ONE YEAR | THREE YEARS ANNUALIZED | FIVE YEARS ANNUALIZED | TEN YEARS ANNUALIZED |
|---|----------|---------------------------|--------------------------|-------------------------|
| MSCI EAFE (GROSS DIV.) MINUS MSCI EAFE (PRICE-ONLY) | 3.39% | 3.21% | 3.00% | 2.31% |
| MSCI EAFE (NET DIV.) MINUS MSCI EAFE (PRICE-ONLY) | 2.87% | 2.73% | 2.55% | 1.96% |
| MSCI EAFE (GROSS DIV.) MINUS MSCI EAFE (NET DIV.) | 0.52% | 0.48% | 0.45% | 0.35% |
| MSCI EAFE VALUE (GROSS DIV.) MINUS MSCI EAFE VALUE (PRICE-ONLY) | 4.29% | 3.96% | 3.57% | 2.79% |
| MSCI EAFE VALUE (NET DIV.) MINUS MSCI EAFE VALUE (PRICE-ONLY) | 3.62% | 3.35% | 3.03% | 2.35% |
| MSCI EAFE VALUE (GROSS DIV.) MINUS MSCI EAFE VALUE (NET DIV.) | 0.67% | 0.61% | 0.54% | 0.44% |
| MSCI EAFE GROWTH (GROSS DIV.) MINUS MSCI EAFE GROWTH (PRICE-ONLY) | 2.50% | 2.47% | 2.44% | 1.84% |
| MSCI EAFE GROWTH (NET DIV.) MINUS MSCI EAFE GROWTH (PRICE-ONLY) | 2.14% | 2.11% | 2.08% | 1.56% |
| MSCI EAFE GROWTH (GROSS DIV.) MINUS MSCI EAFE GROWTH (NET DIV.) | 0.36% | 0.36% | 0.36% | 0.28% |
| MSCI EAFE SMALL CAP (GROSS DIV.) MINUS MSCI EAFE SMALL CAP (PRICE-ONLY) | 2.32% | 2.72% | 2.87% | n/a |
| MSCI EAFE SMALL CAP (NET DIV.) MINUS MSCI EAFE SMALL CAP (PRICE-ONLY) | 1.96% | 2.29% | 2.39% | n/a |
| MSCI EAFE SMALL CAP (GROSS DIV.) MINUS MSCI EAFE SMALL CAP (NET DIV.) | 0.36% | 0.43% | 0.48% | n/a |
| MSCI EMERGING MARKETS (GROSS DIV.) MINUS MSCI EMERGING MARKETS (PRICE-ONLY) | 3.39% | 3.72% | 3.46% | 2.68% |
| MSCI EMERGING MARKETS (NET DIV.) MINUS MSCI EMERGING MARKETS (PRICE-ONLY) | 2.99% | 3.26% | 3.07% | n/a |
| MSCI EMERGING MARKETS (GROSS DIV.) MINUS MSCI EMERGING MARKETS (NET DIV.) | 0.40% | 0.46% | 0.39% | n/a |

1. For more information on the MSCI index methodologies, see "MSCI Index Calculation Methodology," available at http://www.msci.com/methodology/meth_docs/MSCI_Jan07_IndexCalcMethodology.pdf.

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PERFORMANCE OVERVIEW

First Quarter 2007

- Despite some rough patches along the way, global equity markets ended the first quarter in positive territory. In the US, small cap stocks, especially small cap growth stocks, led the way. International returns for US investors looked better than US returns and were aided by the relative weakness of the US dollar. The size effect was particularly strong in international developed markets in the first quarter. Emerging markets were also relatively strong performers in the quarter, notwithstanding the weak performance of China and Russia.
- Small stocks outperformed large stocks in the United States and in the developed non-US markets. Along the style dimension, results in the United States were mixed: small growth stocks outperformed small value stocks, while large value stocks slightly outperformed large growth stocks.
- Fixed income securities across all maturities had positive returns in the first quarter. Long-term securities had higher returns than short-term securities.
- Strong returns in January allowed US real estate to end the first quarter as the best-performing US asset class, notwithstanding its negative return in February and March.

Three Years As of March 31, 2007

- For the three years ending in March, small company and value strategies generally outperformed their large and growth counterparts. Stocks in emerging and developed non-US regions particularly benefited from the size and value effects and were the top-performing asset classes.
- The US dollar depreciated against most major currencies except the yen. The dollar's depreciation, which ranged from 4.3% against the Swiss franc to 13.8% against the Canadian dollar in the three years ending in March, helped the dollar-denominated returns of international strategies.
- Over the three years ending in March, fixed income markets delivered annual returns that ranged from 2.1% to 2.9%.
- Real estate was by far the best-performing domestic asset class during the three-year period that ended in March.

DIMENSIONAL FUND QUARTERLY RETURNS
AS OF MARCH 31, 2007



DIMENSIONAL FUND THREE-YEAR ANNUALIZED RETURNS
AS OF MARCH 31, 2007



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US EQUITY

In the first quarter, US equity markets delivered modest positive returns across the board, despite some rough patches along the way. Quarterly returns for the broad US market, as measured by the Russell 3000 Index, were 1.3%. Asset class returns ranged from 2.5% for small cap growth stocks to 1.2% for large cap growth stocks. Using the Russell indices as proxies, small cap (Russell 2000) outperformed large cap (Russell 1000) by 0.7% in the quarter. Over the three-year period that ended in March, small cap stocks outperformed large cap stocks by 1.3% annualized.

Across the style dimension, results were mixed. Small value stocks underperformed small growth stocks by 1.0% in the first quarter, while large value stocks outperformed large growth stocks by 5 basis points in the quarter. Over the three-year period through March 31, the difference between value and growth strategies remained wide for both large and small stocks. The Russell 1000 Value Index outperformed the Russell 1000 Growth Index by 7.4% annualized over that period, while the Russell 2000 Value Index outperformed the Russell 2000 Growth Index by 5.1% annualized.

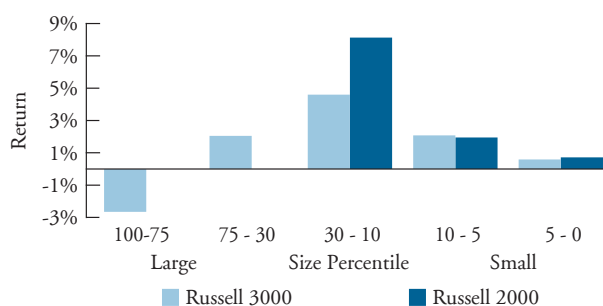
A look at the determinants of equity performance—size and price—provides some insight into the sources of returns. Historically, small stocks have experienced higher returns than large stocks, but that was not exactly the case in the first quarter. For both the Russell 3000 Index and the Russell 2000 Index, the best relative performance came from mid cap stocks, those in the 10-30 percentile market capitalization range. For the Russell 3000 Index, the largest contribution (group return multiplied by group weight) came from stocks in the 30-75 percentile range, which made up 46% of the Index in the quarter. For the Russell 2000 Index, the largest contribution came from stocks in the 5-10 percentile range, which made up 50% of the Index.

US EQUITY RETURNS

| AS OF MARCH 31, 2007 | RETURN (%) | | |
|---------------------------------|---------------|----------|------------------------|
| | FIRST QUARTER | ONE YEAR | THREE YEARS ANNUALIZED |
| DIMENSIONAL FUND RETURNS | | | |
| US Core Equity 1 | 1.78 | 10.52 | – |
| US Core Equity 2 | 1.92 | 10.91 | – |
| US Vector Equity | 2.23 | 9.58 | – |
| US Micro Cap | 1.66 | 3.24 | 11.55 |
| US Small Cap | 2.04 | 4.49 | 12.01 |
| US Small Cap Value | 3.07 | 8.89 | 16.40 |
| US Targeted Value | 2.34 | 10.05 | 15.92 |
| US Large Cap | 0.62 | 11.73 | 9.95 |
| US Large Cap Value | 2.01 | 15.44 | 15.44 |
| INDEX | | | |
| Russell 3000 | 1.28 | 11.28 | 10.84 |
| Russell 2000 | 1.95 | 5.91 | 12.00 |
| Russell 2000 Value | 1.46 | 10.38 | 14.47 |
| Russell 2000 Growth | 2.48 | 1.56 | 9.41 |
| Russell 1000 | 1.21 | 11.84 | 10.72 |
| Russell 1000 Value | 1.24 | 16.83 | 14.41 |
| Russell 1000 Growth | 1.19 | 7.06 | 7.01 |
| S&P 500 | 0.64 | 11.83 | 10.06 |

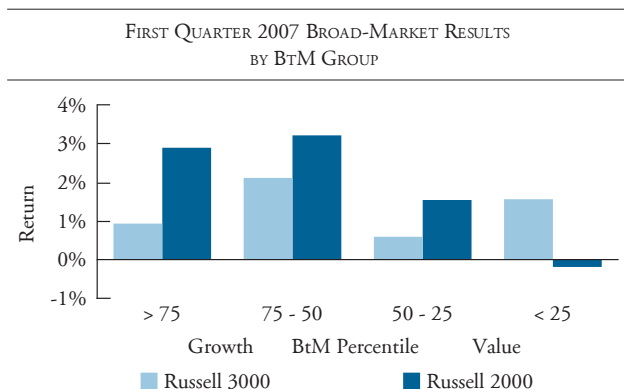
Frank Russell Company is the source and owner of Russell data. The S&P data are provided by Standard & Poor's Index Services Group.

FIRST QUARTER 2007 BROAD-MARKET RESULTS BY SIZE GROUP



Frank Russell Company is the source and owner of Russell data.

Historically, value stocks, as measured by the ratio of book-to-market equity (BtM), have outperformed growth stocks, but that was not the case in the first quarter. For the Russell 3000 Index, the best relative performance as well as the largest contribution to performance, as measured by group return multiplied by group weight, came from growth-oriented stocks in the 50-75 BtM percentile range. For the Russell 2000 Index, the best relative performance as well as the largest contribution to performance also came from growth-oriented stocks in the 50-75 BtM percentile range.



Frank Russell Company is the source and owner of Russell data.

The first quarter of 2007 saw most of Dimensional's US equity strategies outperform their benchmarks. The exclusion of REITs from Dimensional's equity strategies had a mixed impact on the relative performance of domestic strategies, generally contributing to the relative performance of small cap strategies and detracting from the relative performance of large cap strategies.

Dimensional's **US Micro Cap** strategy underperformed the Russell 2000 Index by 29 basis points for the quarter. Over the three-year period that ended in March, the **Micro Cap** strategy trailed the Index by 45 basis points on an annualized basis.

Dimensional's **US Small Cap** strategy outperformed the Russell 2000 Index by 9 basis points in the first quarter. Over the three-year period, the **Small Cap** strategy was 1 basis point ahead of the Index on an annualized basis.

The Dimensional **US Small Cap Value** strategy outperformed the Russell 2000 Value Index by 1.6% in the quarter. Differences in portfolio composition within the book-to-market percentile ranges, especially in the 0-25 BtM percentile range, had the largest positive impact on the strategy's relative performance. Over the three-year period, the strategy was ahead of the Index by 1.9% on an annualized basis.

Dimensional's **US Targeted Value** strategy outperformed the Russell 2000 Value Index by 88 basis points in the first quarter. Over the three-year period that ended in March, the **Targeted Value** strategy outperformed its benchmark by 1.5% on an annualized basis.

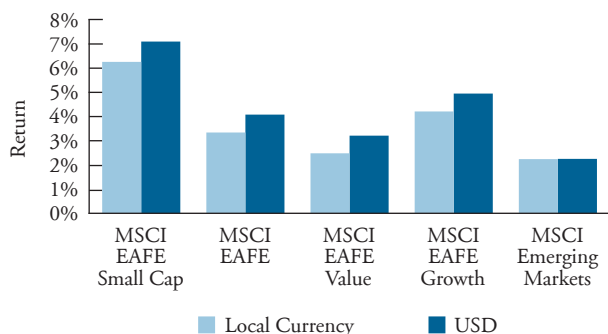
Dimensional's **US Large Cap** strategy underperformed the Russell 1000 Index by 59 basis points in the first quarter. The strategy also underperformed the S&P 500 Index by 2 basis points in the first quarter. Over the three-year period that ended in March, the **Large Cap** strategy trailed the Russell 1000 by 0.8% on an annualized basis and the S&P 500 by 11 basis points annualized.

The Dimensional **US Large Cap Value** strategy outperformed the Russell 1000 Value Index by 77 basis points in the first quarter. The strategy's smaller allocation to the largest stocks, those in the 75-100 market capitalization range, as well as differences in composition within that range had the largest positive impact on relative performance. Over the three-year time period, the deeper value orientation of the strategy allowed it to outperform the Index by 1.0% on an annualized basis.

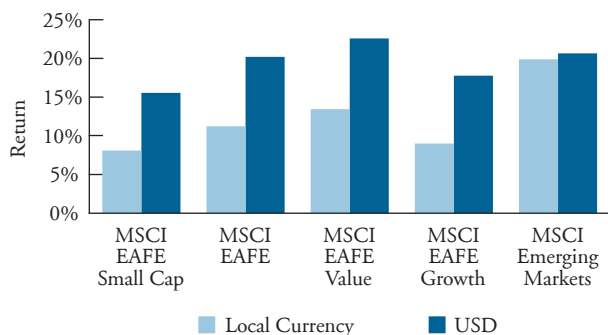
INTERNATIONAL EQUITY

Developed market equities, especially small cap stocks, were very strong performers in the first quarter, and were aided by the relative weakness of the US dollar. In the first quarter, the US dollar depreciated against all major currencies, which increased the dollar-denominated returns of developed market equities. The US dollar's depreciation ranged from 0.3% against the Swiss franc to 2.5% against the Australian dollar. The US dollar's performance relative to the main emerging market currencies was mixed, and ended up having a negligible impact on the dollar-denominated returns on emerging market equities. Most of Dimensional's international strategies outperformed their benchmarks in the first quarter.

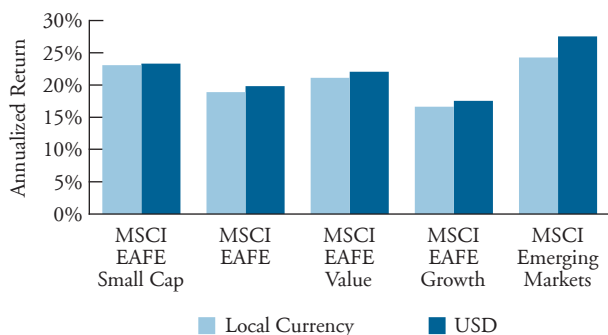
FIRST QUARTER CURRENCY EFFECTS ON INTERNATIONAL EQUITY RETURNS
AS OF MARCH 31, 2007



ONE-YEAR CURRENCY EFFECTS ON INTERNATIONAL EQUITY RETURNS
AS OF MARCH 31, 2007



THREE-YEAR CURRENCY EFFECTS ON INTERNATIONAL EQUITY RETURNS
AS OF MARCH 31, 2007



MSCI indices are total returns net of foreign withholding taxes on dividends.
MSCI data copyright MSCI 2007, all rights reserved.

The Dimensional **International Small Company** strategy outperformed the MSCI EAFE Small Cap Index by 1.1% in the quarter. The strategy was 0.7% per year ahead of the Index for the three-year period ending in March. The **International Small Value** strategy outperformed the benchmark by 2.0% in the first quarter. It remained 3.5% ahead of the Index on an annualized basis for the three-year period.

INTERNATIONAL EQUITY RETURNS

| AS OF MARCH 31, 2007 | RETURN (%) | | |
|------------------------------|---------------|----------|------------------------|
| | FIRST QUARTER | ONE YEAR | THREE YEARS ANNUALIZED |
| DIMENSIONAL FUND RETURNS | | | |
| International Core Equity | 5.60 | 21.02 | - |
| International Small Co. | 8.15 | 21.52 | 23.99 |
| International Small Value | 9.06 | 24.27 | 26.85 |
| International Large Co. | 4.38 | 19.55 | 18.98 |
| International Value | 5.03 | 25.41 | 24.95 |
| Emerging Markets Core Equity | 5.00 | 23.54 | - |
| Emerging Markets Small Cap | 7.35 | 30.63 | 29.85 |
| Emerging Markets Large Cap | 4.40 | 21.85 | 28.58 |
| Emerging Markets Value | 7.42 | 30.32 | 34.65 |
| INDEX | | | |
| MSCI EAFE Small Cap | 7.10 | 15.55 | 23.32 |
| MSCI EAFE | 4.08 | 20.20 | 19.83 |
| MSCI EAFE Value | 3.21 | 22.58 | 22.05 |
| MSCI EAFE Growth | 4.95 | 17.77 | 17.55 |
| MSCI Emerging Markets | 2.25 | 20.65 | 27.54 |

MSCI indices are total returns net of foreign withholding taxes on dividends.
MSCI data copyright MSCI 2007, all rights reserved.

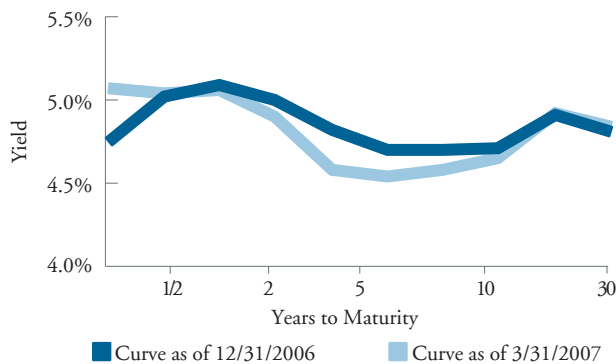
Dimensional's **International Large Company** strategy edged the MSCI EAFE Index by 30 basis points in the first quarter, while the **International Value** strategy edged its benchmark, the MSCI EAFE Value Index, by 1.8% for the quarter. Over the three-year period, the **International Large Company** strategy was 0.9% behind the EAFE Index on an annualized basis, while the **International Value** strategy was 2.9% ahead of its benchmark.

Dimensional's **Emerging Markets** strategies (**Large, Value, and Small Company**) had excellent absolute and relative results in the first quarter. The strategies' lack of exposure to China and Russia helped performance relative to the Index, as those two countries performed poorly in the first quarter. The **Small Cap** and **Value** strategies outperformed the MSCI Emerging Markets Index by 5.1% and 5.2%, respectively, in the quarter, while the **Large Company** strategy outperformed the benchmark by 2.2% in the first quarter. Over the three-year period that ended in March, the **Emerging Markets Value** strategy was 7.1% ahead of the benchmark on an annualized basis, while the **Emerging Markets Large Company** and the **Emerging Markets Small** strategies were 1.0% and 2.3%, respectively, ahead of the benchmark on an annualized basis.

FIXED INCOME

The Federal Open Market Committee left its target for the federal funds rate unchanged in its two first-quarter meetings. Core inflation, which excludes volatile food and energy prices, and inflation expectations are likely to continue to moderate over time, as the effects of previous monetary policy actions work their way through the economy, but they remain above the 2% level that is considered to be the upper bound of the Federal Reserve's comfort zone. Consistent with the Fed's mandate for maintaining price stability, Federal Reserve officials have indicated that additional monetary tightening may yet be needed to keep inflation and inflation expectations in check, although future monetary policy actions will depend on new information about inflation, inflation expectations, and real economic growth. Relative to the end of 2006, interest rates rose sharply at the very short end of the yield curve, fell in the one-year-to-maturity to ten-years-to-maturity range, and rose slightly at the very long end of the yield curve. As a result, the yield curve was more sharply inverted at the end of the first quarter of 2007 than at the end of the fourth quarter of 2006. The difference in yields between ten-year bonds and one-month US Treasury bills was -42 basis points, compared to -4 basis points at the end of 2006.

US TREASURY YIELD CURVE



Source: US Department of the Treasury.

Dimensional's fixed income strategies had mixed returns relative to their benchmarks in the first quarter. Dimensional's **One-Year Fixed Income** strategy outperformed the One-Year Treasury Note Index by 5 basis points for the quarter, and remains 15 basis points (annualized) ahead of the Index over the three-year period that ended in March. Dimensional's **Intermediate Government** strategy also edged its benchmark, the Lehman Intermediate Government Index, by 10 basis points in the first quarter. Our longer-maturity strategies, **Five-Year Government** and **Five-Year Global**, had poorer results relative to their benchmarks in the first quarter. The **Five-Year Government** strategy underperformed its

benchmark, the Lehman Intermediate Government Index, by 30 basis points for the quarter, while the **Five-Year Global** strategy underperformed its benchmark, the Lehman Aggregate Index, by 17 basis points for the quarter.

FIXED INCOME RETURNS

| AS OF MARCH 31, 2007 | RETURN (%) | | |
|---|---------------|----------|------------------------|
| | FIRST QUARTER | ONE YEAR | THREE YEARS ANNUALIZED |
| DIMENSIONAL FUND RETURNS | | | |
| One-Year Fixed Income | 1.34 | 5.14 | 2.92 |
| Two-Year Global | 1.28 | 5.02 | 2.47 |
| Intermediate Government | 1.63 | 6.30 | 2.45 |
| Five-Year Government | 1.23 | 5.02 | 2.07 |
| Five-Year Global | 1.33 | 5.27 | 2.29 |
| INDEX | | | |
| Merrill Lynch Three-Month T-Bills | 1.25 | 5.08 | 3.42 |
| Merrill Lynch One-Year US Treasury Note Index | 1.29 | 4.86 | 2.77 |
| Merrill Lynch 1-3 G/C | 1.44 | 5.25 | 2.50 |
| Lehman Intermediate Government | 1.53 | 5.75 | 2.39 |
| Lehman Aggregate 1-30 | 1.50 | 6.59 | 3.31 |

Merrill Lynch data provided by Merrill Lynch.
Lehman data provided by Lehman Brothers, Inc.

REAL ESTATE

The strong returns in January allowed US real estate to end the first quarter as the best-performing US asset class, notwithstanding its negative return in February and March. The Dimensional **Real Estate Securities** strategy underperformed the Dow Jones Wilshire REIT Index by 13 basis points in the first quarter. Over the three-year period that ended in March, the Dimensional portfolio trailed the benchmark by 0.9% per year net of fees and expenses.

REAL ESTATE RETURNS

| AS OF MARCH 31, 2007 | RETURN (%) | | |
|---------------------------------|---------------|----------|------------------------|
| | FIRST QUARTER | ONE YEAR | THREE YEARS ANNUALIZED |
| DIMENSIONAL FUND RETURNS | | | |
| Real Estate Securities | 3.49 | 21.31 | 23.15 |
| INDEX | | | |
| Dow Jones Wilshire REIT Index | 3.62 | 21.84 | 24.09 |

Dow Jones Wilshire data provided by Dow Jones Indexes.

WHAT'S NEW AT DIMENSIONAL

- **New Product Launched**

Dimensional Fund Advisors launched an **International Real Estate Securities** strategy in March. This strategy will offer exposure to real estate securities outside the United States and will be a complement to Dimensional's existing **US Real Estate Securities** strategy.

The strategy invests in non-US real estate investment trusts (REITs) and other companies that Dimensional considers to be REIT-like entities. Securities eligible for purchase in the International Real Estate Securities strategy will generally not be purchased in Dimensional's existing non-US equity strategies.

For more information about this new strategy or any other Dimensional products, please contact your regional director.

- **Eduardo Repetto Named Chief Investment Officer at Dimensional**

Dimensional Fund Advisors named Eduardo Repetto chief investment officer effective March 30. He assumed this role from David Booth, the company's founder, chairman, and chief executive officer. Repetto joined Dimensional in 2000 and has been most recently serving as Dimensional's head of research. In this capacity, he has responsibility for the design, development, and delivery of analytics and data that guide the firm's scientific approach to investing. He holds a Ph.D. in aeronautics from the California Institute of Technology and a master of science degree in engineering from Brown University.

- **New Addition to Institutional Team**

Tom Mitchell Jr. has joined the Institutional group at Dimensional as a regional director after twelve years at the Marco Consulting Group. At Marco, Tom started as a data analyst and moved through the ranks as fixed income characteristics analyst, investment manager search analyst, and director of manager search to become a consultant in 1998. Before joining Marco Consulting, Tom worked as a municipal finance and asset management analyst for Bear Stearns. He will be based out of the Austin office.

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See *Appendix: Standardized Performance Data and Disclosures* for how to obtain complete information on performance, investment objectives, risks, advisory fees, and expenses of Dimensional's funds.

APPENDIX

Standardized Performance Data

| AS OF MARCH 31, 2007 AVERAGE ANNUAL TOTAL RETURNS (%) | ONE YEAR | FIVE YEARS | TEN YEARS | SINCE INCEPTION | INCEPTION |
|--|-------------|---------------|--------------|--------------------|------------|
| US Core Equity 1 Portfolio | 10.52 | – | – | 12.81 | 9/15/2005 |
| US Core Equity 2 Portfolio | 10.91 | – | – | 13.90 | 9/15/2005 |
| US Vector Equity Portfolio | 9.58 | – | – | 17.77 | 12/30/2005 |
| US Micro Cap Portfolio | 3.24 | 13.99 | 14.01 | 13.90 | 12/23/1981 |
| US Small Cap Portfolio | 4.50 | 11.69 | 12.39 | 12.30 | 3/19/1992 |
| US Small Cap Value Portfolio | 8.89 | 17.07 | 16.22 | 16.08 | 3/2/1993 |
| US Targeted Value Portfolio | 10.05 | 15.59 | – | 18.76 | 2/23/2000 |
| US Large Cap Value Portfolio | 15.44 | 11.39 | 12.06 | 12.85 | 2/19/1993 |
| US Large Company Portfolio | 11.73 | 6.15 | 8.06 | 11.43 | 12/28/1990 |
| Enhanced US Large Company Portfolio | 11.26 | 6.16 | 8.04 | 9.10 | 7/2/1996 |
| Real Estate Securities Portfolio | 21.31 | 22.33 | 15.47 | 14.35 | 1/5/1993 |
| International Core Equity Portfolio | 21.02 | – | – | 25.91 | 9/15/2005 |
| International Small Company Portfolio | 21.53 | 26.45 | 11.76 | 10.46 | 9/30/1996 |
| Continental Small Company Portfolio | 34.74 | 31.51 | 16.88 | 13.12 | 4/15/1988 |
| Japanese Small Company Portfolio | -9.48 | 19.42 | 3.55 | 5.78 | 1/31/1986 |
| Asia Pacific Small Company Portfolio | 35.70 | 26.83 | 8.64 | 11.00 | 1/5/1993 |
| United Kingdom Small Company Portfolio | 38.07 | 24.18 | 12.87 | 14.28 | 3/4/1986 |
| International Small Cap Value Portfolio | 24.27 | 30.42 | 14.08 | 11.29 | 12/29/1994 |
| International Value Portfolio | 25.41 | 22.26 | 12.37 | 10.86 | 2/15/1994 |
| Large Cap International Portfolio | 19.55 | 15.28 | 8.58 | 8.29 | 7/17/1991 |
| International Real Estate Securities Portfolio | – | – | – | 4.80 | 3/1/2007 |
| Emerging Markets Core Equity Portfolio | 23.54 | – | – | 30.26 | 4/5/2005 |
| Emerging Markets Small Cap Portfolio | 30.63 | 29.18 | – | 18.65 | 3/5/1998 |
| Emerging Markets Value Portfolio | 30.32 | 32.78 | – | 19.18 | 4/1/1998 |
| Emerging Markets Portfolio | 21.85 | 24.79 | 9.71 | 9.49 | 4/25/1994 |
| One-Year Fixed Income Portfolio | 5.14 | 2.91 | 4.24 | 6.11 | 7/25/1983 |
| Two-Year Global Fixed Income Portfolio | 5.02 | 3.09 | 4.38 | 4.60 | 2/9/1996 |
| Five-Year Government Portfolio | 5.02 | 4.77 | 5.26 | 6.36 | 6/1/1987 |
| Five-Year Global Fixed Income Portfolio | 5.27 | 4.70 | 5.47 | 6.62 | 11/6/1990 |
| Intermediate Government Fixed Income Portfolio | 6.31 | 5.81 | 6.61 | 7.33 | 10/19/1990 |
| Inflation-Protected Securities Portfolio | – | – | – | 2.02 | 9/18/2006 |
| Short-Term Municipal Bond Portfolio | 3.37 | – | – | 2.06 | 8/20/2002 |
| California Short-Term Municipal Bond Portfolio | – | – | – | – | 4/2/2007 |

Performance data shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month end, access our website at www.dimensionalfund.com. Average annual total returns include reinvestment of dividends and capital gains.

Dimensional Fund Advisors is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of the Dimensional funds carefully before investing. For this and other information about the Dimensional funds, please read the prospectus carefully before investing. Prospectuses are available by calling Dimensional Fund Advisors collect at (310) 395-8005; on the Internet at www.dimensionalfund.com; or, by mail, DFA Securities Inc., c/o Dimensional Fund Advisors, 1299 Ocean Avenue, Santa Monica, CA 90401. Dimensional funds are distributed by DFA Securities Inc.

Prior to April 1, 2002, the following reimbursement fees may have been charged to purchasers of the respective portfolios: International Small Company Portfolio 0.675%; Continental Small Company Portfolio 1.00%; Japanese Small Company Portfolio 0.50%; Pacific Rim Small Company Portfolio 1.00%; International Small Cap Value Portfolio 0.675%; Emerging Markets Small Cap Portfolio 1.00%; Emerging Markets Value Portfolio 0.50%; Emerging Markets Portfolio 0.50%. Prior to April 1998, the reimbursement fees were as follows: International Small Company Portfolio 0.70%; International Small Cap Value Portfolio 0.70%. Prior to July 1995, the reimbursement fees were as follows: International Small Cap Value Portfolio 1.00%; Continental Small Company Portfolio 1.50%; Japanese Small Company Portfolio 1.00%; Asia Pacific Small Company Portfolio 1.50%; UK Small Company Portfolio 1.50%; Emerging Markets Portfolio 1.50%. Returns for these portfolios are presented net of these reimbursement fees.

All reimbursement fees are based on the net asset value of the shares purchased. The standardized returns presented reflect deduction, where applicable, of the reimbursement fees for the portfolios. Non-standardized performance data reported by Dimensional Fund Advisors does not reflect deduction of the reimbursement fee. If reflected, the fee would reduce the performance quoted.

Investments in foreign issuers are subject to certain considerations that are not associated with investments in US public companies. Investments of the foreign equity portfolios and the global fixed income portfolios are denominated in foreign currencies. Changes in the relative values of these foreign currencies and the US dollar, therefore, may affect the value of investments in these portfolios. However, the global fixed income portfolios may utilize forward currency contracts to minimize these changes. Further, foreign issuers are not generally subject to uniform accounting, auditing, and financial reporting standards comparable to those of US public corporations and there may be less publicly available information about such companies than comparable US companies. Also, legal, political, or diplomatic actions of foreign governments, including expropriation, confiscatory taxation, and limitations on the removal of securities, property, or other assets of the portfolios could adversely affect the value of the assets of these portfolios.