

Out Of The Style Box

Managers need freedom and flexibility to deliver superior investment results.

► **By Bruce A. Weininger**

If you want to consistently maximize your investment potential, let your experts take off the shackles. It's time to recognize that style boxes are not an asset class.

Many investment consultants or "wealth managers" will tell you that they can help find you managers that specialize in various sub-categories of equities, typically referred to as style boxes. And you will hear how uniquely qualified they are to identify those managers who are likely to beat their (style box) index. We respectfully disagree. But is indexing, the most talked about alternative, the right answer?

Index funds may be a good choice for many investors in that they tend to beat anywhere from two-thirds to three-quarters of active managers, depending on which study you want to believe. It may simply be a matter of the expense drag. When most managers have to overcome the full percentage point or more advantage that an equity index has and the half of a percent or more advantage of bonds, they face an uphill battle.

But even if managers outperform the index, it might not be much of a victory. Studies have shown that if you dollar weight the assets that investors pour into managed funds, accounting for the fact that, as a group, they tend to pour more money into the hot asset classes (think technology in 1999 and maybe REITs in 2006), actual dollar-weighted investor returns are far worse than the mutual fund returns as reported—which are not dollar weighted.

Some have surmised that fewer than 10% of investors beat the indices over longer periods of time—because people tend to want to increase the target allocations to the categories that are doing well—or even add the category du jour, and both moves can defeat the purposes of rebalancing, which is to force investors to sell high and buy low. Instead, it allows them to succumb to fear and greed.

This is not to say that indexing and rebalancing are the right answers for everybody. In fact, for serious individual investors, institutional investors or professional investment advisors, I will argue that there is a better way—but it is likely very different from the way you may be investing currently. And it's almost certainly different from the conventional wisdom coming from the investment consulting firms or your "wealth advisor" at the big brokerage firm.

But to begin to define it, let's start with the conventional wisdom, which I'll refer to as "style boxing." Consultants will tell you that you should subdivide your equities into many different style boxes, generally distinguished by growth, value and core on the "y axis" and large cap, midcap or small

cap on the "x axis"—nine boxes in total. Then, for a fee, they will identify the "very best" manager in each box who has the potential to beat the specific index. (Of course, if the manager doesn't, they will fire and replace him or, in many cases, change the index!) This approach is flawed in both its underlying assumption—that having money in all of the boxes is the best way to beat the market—and its implementation—that the consulting firms are going to be able to identify the managers most likely to beat their assigned indexes.

Starting with the wisdom of allocating assets to all the style boxes, Craig Callahan and C. Thomas Howard published a study in 2005 that looked at the characteristics of stocks held by some of the most successful long-term investors. They concluded that the one common denominator of successful long-term investors is that the companies they own did not conveniently fit in one style box, and that had they been constrained to a single style box as many institutional managers are today, returns would have suffered by 300 basis points annually over long periods of time. In short, while we understand and support the need to manage risk through asset allocation among asset classes (stocks, bonds and cash, for example), style boxes are not an asset class and the most successful managers over long periods of time are willing and able to look across style boxes to find undervalued companies.

Warren Buffett, by almost all accounts the best investor of all time, is a case in point. Over the years, he's bought stakes in companies ranging from Coca-Cola (large-cap growth) to USG (midcap value). Although Berkshire Hathaway's size does not make small-cap investments meaningfully lucrative any longer, he frequently has spoken about the fact that because smaller companies are no longer within his arsenal, this will likely limit future returns.

The key for many of the best investment managers is to be able to go where the value is. If you were a large-cap growth manager



in late 1999, it was hard to find a large-cap growth stock that was trading at less than 35 times earnings. So what did large-cap growth managers do? They continued to buy Microsoft, Home Depot, GE and other terrific companies which went on to further grow their earnings at double-digit rates, while their stock prices fell 50% or more over the next few years—not because they were bad businesses, but because they were overpriced.

At the same time, if you were constrained to the value-oriented style box in the mid-1990s, when in many cases you were able to “upgrade” into some higher-quality companies at only modest premiums to troubled companies, you were destined to underperform the broader market, which seemed willing to reward only growth company investors. If you look at some of the most consistent long-term track records through different market climates (Bill Miller of Legg Mason comes to mind), you will see that those managers will move around based on where they are finding the value, unconstrained by style boxes.

As to the second flaw in the style box approach, you have to look toward its implementation: the ability of consultants to consistently identify managers who are able to outperform their “style box benchmark.” Even if the end game was to find nine managers who beat their style-box benchmarks, this approach has failed in the past and will likely continue to fail. If consultants had been successful in identifying such managers, their lists of recommended managers would presumably be similar to their lists five years ago. But if you were to ask your current consulting (or wealth management) firm if you could see its list of recommended managers from five years ago, you’d be lucky if 20% of the names were the same (many having likely turned over multiple times since then).

Also, aside from the inherent difficulty of sustaining outperformance under ordinary circumstances, the difficulty is magnified when the favored few managers are flooded with assets. While this is less troublesome for large-cap managers, for the smaller six of the nine style boxes, it’s much harder to outperform with \$10 billion than it is with \$1 billion. With \$10 billion (or even half that), it’s hard (impossible?) to not move the market up on your way in and down on your way out, to the detriment of your clients.

Furthermore, the consulting community and wealth managers have failed their clients with half-hearted attempts at rebalancing. Instead of taking profits on the hot asset classes as they told their clients they would do, they instead have fallen into the “give the clients what they want” mentality of car salesmen. If you look at the asset allocation models today and compare them with those of five years ago, they are, almost without exception, heavier in small cap, foreign, real estate and commodities—not coincidentally four of the recent best-performing asset classes.

Likewise, the weightings have gone down for large-cap stocks and anything related to growth (value has outperformed for an unprecedented seven years in a row now). Although probably not to the same degree, it looks a little like technology in 1999 all over again. One must be wary in any market like this of the four most dangerous words: “It’s different this time.”

Finally, the theoretical issues aside, think about what the style box approach does to transaction costs. If you employ nine traditional style box managers, plus a REIT fund and a foreign stock fund, and if each manager owns, on average, 50 securities, you likely own more than 500 stocks. Last year, the average turnover among managers was close to 100%—and that doesn’t take into account the fact that a consultant or wealth manager will likely replace two or three of those managers annually—resulting in another 100% turnover when a new manager is hired. Traditional brokerage commissions aside, you also have bid-ask spreads to contend with on each transaction. At the end of the day with more than 500 stocks, you own a very expensive index fund.

Ennis Knupp, a Chicago-based consulting firm, was one of the first (and still one of the few) consulting firms to note that style boxing was not the best way to go. In 2001, it published a study in *The Journal of Portfolio Management*, concluding that, on average, the style-box approach underperformed the designated index by more than 1.2% annually. Ennis Knupp further went on to point out that both fixed-income and international equity managers have successfully avoided the higher-cost, ineffective style box approach. Why is it that an international manager is somehow able to allocate investments freely among 40 countries and dozens of currencies, but domestic managers need to be constrained to stay within one of nine style boxes, the firm asks?

More recently, Callahan and Howard took issue with the term “style box” altogether. Their premise is that the style boxes really tell you only about the characteristics of the stocks owned, rather than the style by which a manager finds investment opportunities (i.e. momentum, cash flow, and turnarounds might all be “styles” of investing). They cited a 2002 University of Maryland working paper by Russ Wermers that showed managers who “drifted” outperformed managers who remained style-box constrained by 290 basis points annually over 15 years. Callahan and Howard also cited the reversion to the mean among “characteristic” boxes as something that “drifters” can take advantage of. They cite a 15-year study (1984-1999) showing that the worst-performing style box over the prior two years goes on to outperform the best-performing style box by a remarkable 12.9% over the next two years. A style-boxer can’t take advantage of this reversion to the mean—but a drifter easily can, and does.

In short, if you are going to embrace active management for some portion of your domestic equity portfolio, you have a much greater chance of improving performance by using a smaller number of managers who have shown an ability to outperform the market over long and diverse cycles—as long as you give them the freedom to invest in their best ideas, unconstrained by the style-box police. ☺

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