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Are Style Benchmarks Useful Templates For Index Funds?

By: Gary Gastineau



Most ways of breaking down the common stock universe from a total market index into sub-categories are easy to understand. Of course, there is not universal agreement on where size cut-off points or ranges belong or even what industry or sector every company should be assigned to, but most classifications are not too highly controversial.

There is—and should be—significant controversy over how to divide the stock universe into growth and value components. Allocating stocks between growth and value indexes can be as simple as ranking them by the ratio of market price to book value (as S&P/BARRA does), or it can be based on several variables (Russell, Dow Jones, Morgan Stanley Capital International (MSCI), Morningstar and S&P/Citigroup). Common elements in the classification ratios include price, earnings, book value, dividends and growth rates. Each of these elements can be part of more than one factor in a multi-factor growth/value stock allocation system, creating some (probably) benign redundancy.

As Craig Lazzara (2004) points out, style index publishers tend to use growth and value either as categories or as quantities. If S&P/BARRA, a categorizer, assigns a stock to the growth or value category, the company is either growth or value—and is never divided between the two. The index providers that treat growth and value as quantities will often assign a stock partly to growth and partly to value. This split allocation recognizes that some stocks do not fit neatly into either growth or value. Only Dow Jones and Morningstar recognize that even the growth/value split does not work for all companies, and resist the urge to assign all the companies in their market benchmarks to growth or value or both. Thus, Dow Jones and Morningstar are the only major index families that do not always have a collectively exhaustive growth/value split. Morningstar does share Dow Jones' understanding that core is a residual to be left out of the growth/value split when you are developing style indexes, but does not share in Dow's belief that core is not a category that an investor should or would choose to invest in—to the exclusion of stocks with growth or value characteristics.

The greatest problem with style benchmarks based on defined stock characteristics is that growth investing and value investing are also processes used by active stock pickers who describe themselves as either growth managers or value managers. Just as there is little consensus among index providers as to how they arrive at their growth and value splits, there is no consistency among style managers as to how they evaluate the growth and value characteristics of a stock. For example, one of the most successful "value" managers in recent years has been William Miller, manager of the Legg Mason Value Trust. In words from his firm's sales literature, Miller "[f]ollows a value discipline of investing by purchasing primarily large capitalization stocks at large discounts to the manager's assessment of their intrinsic value."¹

This is unequivocally the credo of a large-cap value manager. Clearly, market price is part of his value-based selection equation, but "intrinsic value" is not identical to book value. In fact, the perception of intrinsic value might be based on expectations for future growth or on the belief that a company is building future value—not quite the same thing.² As of the end of 2003, the second largest position in the Legg Mason Value Trust was Amazon.com—a company that has reported aggregate net losses over its corporate life but that, in the view of some analysts, has an extraordinary business and interesting prospects. Amazon.com is not in the S&P/BARRA indexes because of S&P's earnings test,³ but it is allocated exclusively to the "growth" style by all the other index publishers listed above—even by those willing to divide a single stock between growth and value.⁴

William F. Sharpe initiated the division of large-cap stocks into separate growth and value asset classes, noting in justification that "there is significant positive correlation among: book/price, earnings/price, low earnings growth, dividend yield and low return on equity. Moreover, the industry compositions of the value and

growth groups differ (e.g., companies with high research budgets tend to have low book values relative to their stock prices).⁵ Sharpe used statistical value and growth differences to decompose the characteristics of mutual funds to show the impact of a fund's style characteristics on its performance. I do not find anything resembling a proposal for growth and value style index funds in Sharpe's paper.

With or without Sharpe's endorsement, growth and value index funds are clearly here to stay. With Vanguard's recent change in its growth and value benchmarks to the MSCI index family and new funds based on Morningstar indexes and the Powershares approach to style, ETF style fund investors will have their choice of six approaches to the growth/value split.

A number of respected investment advisors who use ETFs—including Jim Kelly at Walnut Asset Management, Jim Pritchard of Pritchard Investments and Mike Dickerson at H.G. Wellington, to name a few—have found interesting applications for growth and value ETFs in sophisticated portfolio strategies. For most investors, however, adding value with style funds is difficult. Growth and value index funds have inherently higher component turnover than index funds based on capitalization alone, and hence, greater embedded transaction costs. Consequently, growth and value benchmarks, and funds based on them, are often a high-cost choice for the investor handling his own portfolio.

At the risk of contributing to the delinquency of some investors, I feel obligated to observe that value indexes have tended to outperform growth indexes. Relying on this historic tendency can be hazardous to your wealth in the short run. To amplify this note of caution, Burton G. Malkiel (2003) used growth and value characteristics to measure active fund performance (as Sharpe intended) and found no material fund performance difference based on style over the long 1937-2002 period. Investors should keep in mind the famous motto: TANSTAAFL. ⁶

Footnotes

- 1 Legg Mason website.
- 2 Peter L. Bernstein (1992) points out that even Graham and Dodd described intrinsic value as "an elusive concept."
- 3 Now that Amazon.com has earnings, we can look forward to the chaos that usually accompanies meaningful changes to the S&P 500.
- 4 Bernstein (1956) provides useful clarity and necessary complexity in discussing both growth and value characteristics.
- 5 Sharpe (1992).
- 6 There Ain't No Such Thing As A Free Lunch.

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