ADVISOR PERSPECTIVES

A Response to Improving on Morningstar Style Boxes

By C. Thomas Howard, PhD
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The following is in response to Stephen Dodson's article, [Improving on Morningstar Style Boxes](), which appeared last week.

I am pleased to see Stephen Dodson taking on the scourge of the active equity mutual fund industry: the style grid. I would like to build upon the arguments presented in his article.

A few years ago we conducted an extensive research trying to identify who launched the style grid. As part of this research, we spoke with Russell Investments who provided information for what we believe was its initial launch. In 1984, the number of active equity funds was exploding and Russell was casting about for ways to categorize funds so that advisors and investors could make sense of this bewildering array. They tapped Bill Sharpe to help them address this problem. During a brainstorming session, Sharpe, as business faculty are wont to do, wandered to a chalkboard and drew a two-by-two matrix.

As all good academics believe, business challenges – no matter how complex the finance, marketing, or management issues they involve can best be summarized in a two-by-two matrix. Since small-firm and low-PE effects were all the rage in 1984, he proposed the axes be market capitalization and the average PE of the stocks held by the fund.

Thus was born the style grid.

It was launched that year, and Russell was stunned when, by the following year, the investment industry identified "style drift" as a serious problem for active equity mutual funds. They knew there was no research behind the style grid; it was simply put forward as a way to organize the growing array of funds. But the law of unintended consequences had already taken effect.

Since then, a leaderless stampede has positioned the style grid, despite all its shortcomings, as a dominant organizing force in the industry. Investors pay a huge price for this costly dependence on an arbitrary categorization system.

Since that fateful day in 1984, the evidence has turned strongly against the style grid. As Dodson points out, knowing a fund's style box tells us little about the investment strategy its manager pursues. After all, the most critical thing to know about a manager is how he or she goes about earning excess returns. Isn't this central to the decision of whether or not to "hire" the manager?

Research studies conclude that, since they were first identified in the late 70's and early 80's, both the small firm and PE effects have disappeared. Other studies find that the greater the style drift, the greater the return. Thus constraining managers to a specific style box hurts performance, a result well known by Morningstar and other purveyors of the style grid. Morningstar specifically cautions against restricting a manager to a style box. But this does not stop legions of advisors and consultants from elevating style drift to one of the worst crimes a manager can commit. It is hard to imagine a worse system for categorizing active equity managers.

But if style boxes are so thoroughly unhelpful, then we are back to where we were in 1984, only with thousands of additional funds. I applaud Dodson for taking a stab at rectifying this major problem within the $5-trillion equity mutual fund industry. But whatever system is proposed needs to avoid the same problems that plague the style grid. I began a research project eight years ago that focused on this question. I've concluded that instead of categorizing managers based on the characteristics of the stocks they hold, it is better to form fund peer groups based on the equity strategy they pursue.

Using nearly 50,000 pieces of strategy information gathered from fund prospectuses, we constructed fund peer groups based on their own, self-declared strategy. This is like grouping quarterbacks with quarterbacks, linebackers with linebackers, and so on, rather than grouping football players by height and weight. Some will argue that you cannot trust what a manager says, and instead you need to look at what the manager is doing. Our experience is that fund managers and analysts are passionate about what they do and choose a particular strategy because they strongly believe it will allow them to earn superior returns. Fund companies, then, marshal their financial and human resources around their stated strategy. Because of this passion and support structure, it is very difficult for a fund to deviate from its stated strategy.

We have identified 10 primary equity strategies which you can learn more about by visiting AthenaInvest (see also Improving on Morningstar's Ratings: Moving Beyond Past Performance). Our strategy system has been subjected to extensive due diligence and has been confirmed as accurate describing the equity strategy being pursued by active equity managers. In addition, we have conducted extensive statistical tests on the strategy peers groups and find strong evidence that self-declared strategy is superior to the style grid when forming fund peer groups (i.e., funds are more alike within strategies than across strategies) . Even more amazing, the style grid is inferior to randomly forming fund peer groups. That is, funds within a style box pursue widely differing strategies as Dodson observed.

Again, it is hard to imagine a worse system than the style grid.

Obvious advantages of strategy peer groups are that the name provides information on how the manager analyzes, buys, and sells stocks, and furthermore this approach does not impede a manager from pursuing his or her strategy as does the style grid. As Dodson states at the end of his article, there are many investment strategies, and in fact we find that, when looking at managers at the most granular level, there is essentially as many strategies as there are funds. There are many ways to make money in the stock market.

Viewing managers in terms of the strategy they pursue makes it possible to identify, before the fact, those funds that have the best chance of outperforming going forward. These have managers who pursue a narrowly defined strategy (specialists tend to outperform generalists), who pursue their strategy consistently (organizing by stated strategy makes it easier to evaluate consistency), and who take high-conviction positions. It is current manager behavior, rather than past performance, that is the best predictor of future performance.

Since the style grid has no research basis, tells you very little about the manager's equity strategy, and hurts performance, we must wait to see what catalyst will trigger its wholesale rejection. The industry has grown numb to the grid's ill effects. I applaud Dodson for speaking out against this industry madness.

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