



Improving on Morningstar Style Boxes

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No one would ever confuse a short man with dark hair and a tall one with light hair. But this is precisely what investors do when they categorize stocks as either growth or value. Those style definitions, championed by Morningstar and others, are flawed, and I have a way to fix them.

To illustrate, consider the following hypothetical conversation:

"I just got a new car. I love it."

"That's great. What color is it? Red?"

"No, it's a station wagon."

The investment community's version of this flawed logic:

"I just invested in this great fund."

"That's great. Is it a growth fund?"

"No, it's a value fund."

The general consensus is that value and growth are opposites of each other, as if those two qualities were as mutually exclusive as, say, hot and cold, dark and light, or shiny and dull.

The familiar, traditional style box has a horizontal axis that goes from value on the left to growth on the right, with a middle, catchall section, called core or blend depending on your vendor of choice. Typically, stocks that have a low price-to-earnings ratios fall into the value bucket; stocks of companies with high earnings growth rates fall into the growth bucket.

The problem with this framework is that these two variables don't have much to do with each other. The first is a measure of market price to current earnings, while the second measures earnings growth without factoring in the market price at all. These are measurements of different, unrelated things. It's as if someone making a style box to describe people put tall on one end of the axis and dark hair on the other.

By positioning these two styles as opposites of one another, you inevitably end up with categorizations that don't make sense. Companies with high growth rates and low P/E ratios end up in the same bucket (blend/core) as companies that have low earnings growth



and high P/E ratios — two stocks with the exact opposite features that the style box is trying to segregate. Short guys with light-hair end up in the same middle category as tall guys with dark hair. Maybe we'd call them both "blend."

Let's take a step back and think about the goal of a style box. A useful categorization system is one that gives an investor a quick, objective method to evaluate a manager's investment style.

Roughly speaking, there are two basic approaches to investing. One school of thought is value investing, which is simply buying a security for less than its worth. A value investor tries to calculate the value of a business, typically by attempting to predict how much it will earn in the future. The growth rate of those earnings, however, is just one variable in determining value.

The alternate school of investing attempts to predict future movements of stock price based on a various extrinsic factors – e.g., a change in ratings by a sell-side analyst, a news event, macroeconomic developments, shifting investor sentiment, the announcement of quarterly earnings better than the consensus of sell-side analysts ("beating earnings"), new product releases, etc. Earnings growth is only one aspect of this style of investing. This investment philosophy is better described as "momentum."

A value investor requires a long time horizon to see future earnings eventually reflected in the stock price. He or she is generally indifferent to near-term stock price movements; a momentum investor is attempting to predict and invest based on those near-term stock price movements.

How then does one distinguish between these two types of investors based on objective data? The traditional method is to look at what securities a fund or an investment manager holds. The flaw with this method is that two wildly different types of investors can own the same stock. Google is a company with a high growth rate and a positive momentum of good news, but many value investors consider its valuation low compared to what it can earn in the future. A better, but still imperfect, quantitative indicator of investment styles is an average holding period. A value investor may hold onto Google for years, while a momentum investor may only own it for six months.

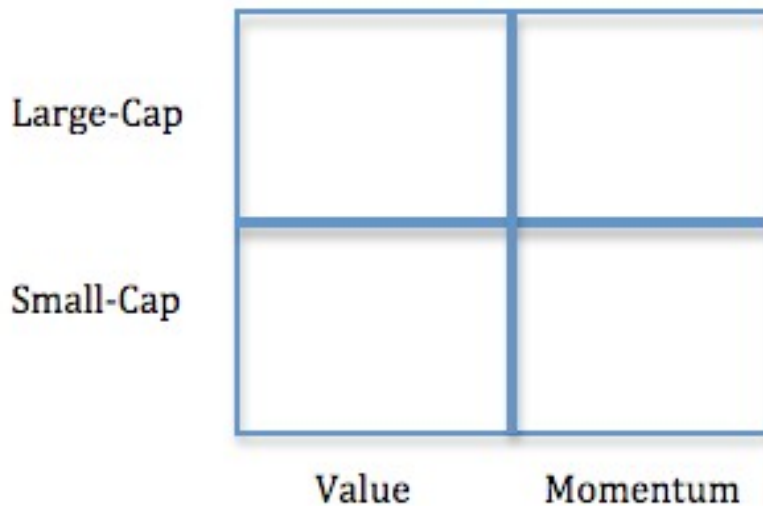
The average turnover for a fund is about 100%, which translates into an average holding period of one year. Many well-known value investors cite their time horizon as multiple years and generally don't have turnover ratios above 50% for more than a couple years. Therefore, a three-year average turnover of 75% is a reasonable threshold to demarcate between value and momentum, though a thorough data analysis may come up with a slightly different number.

The vertical axis of the traditional style box (small-, mid-, large-cap) is also flawed, but not as fundamentally as the horizontal axis. There are enough differences in behavior between

small-company investments and large-company investments to justify the axis, but breaking it into three categories can result in the same kind of mis-categorization as growth versus value. A fund that has 50% of its assets in small-cap stocks and 50% in large-caps would be labeled as a mid-cap fund without owning a single mid-cap investment.

Having two categories leads to more accurate descriptions while giving the investor an idea of what type of stocks a manager owns. A manager whose holdings are evenly split between small- and large-cap stocks would fall clearly on the boundary of those asset classes, and not somewhere in the mid-cap category, where he has no holdings.

This leaves us with a style box matrix that looks like this:



Evaluating an investment manager's style is a highly complex task that can't be captured with any two-dimensional style box. But when wading through a sea of funds, a properly constructed style box would quickly distinguish investment philosophies and styles. This methodology is more accurate, clearer and just as objective as the system we have now.

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