Something's Fishy in the Russell Rebalancing

By Mariko Gordon
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Eating out with my pal Ernie, while always memorable, is not for the faint of heart. Ernie is in the seafood business, so he knows every chef from coast to coast worth paying a visit to - **but he does not coddle picky eaters.**

One time he took me to a place where I had to choose a fish out of a swimming pool in the middle of the restaurant floor and watch it get carted off, still thrashing in a net. A few minutes later my hapless friend returned as sashimi, so fresh it was all but quivering when it landed in front of me. (Good thing I'm the sort of gal who guts her own fish.)

And so when **I got together with Ernie during my super brief (26-hour) visit to L.A. last week,** I knew he'd have something intriguing in store. Sure enough, I soon found myself bellying up to a bar in Little Tokyo - a sushi bar, that is.

Once seated, we turned ourselves over to Mr. Hisaharu Kawabe of Toranoko, no questions asked. As a third generation Japanese American, I know to keep my mouth shut and eat what's presented to me, whether it be monkfish liver, a kelp shooter or a deep-fried shrimp carcass. No matter. The man is a genius and watching him whip out a blowtorch to cook pieces of toro tuna was just stunning.

While feasting on Mr. Kawabe's Scottish salmon sashimi in a jalapeno sauce, **Ernie and I discussed the fish business and, in particular, some of its marketing challenges.**

Consider, for example, the Patagonian toothfish. Does the thought of chowing down on a hunk of this beast start your mouth watering? Me neither, which is why they call it "Chilean sea bass" instead. Or how about a slab o' dogfish shark? Didn't think so. But dub it "filet of grayfish" and everyone's appetite miraculously returns.

The point is, we humanoids think in words; the labels we assign to things in our world - whether fish-related or investment-related - affect our perceptions. Two such mind-altering labels that are high on my list of **investment jargon pet peeves are**

"growth" and "value," at least as applied to individual stocks.

Think I'm crazy? Ponder this: the folks at Russell carefully assign growth and value weights to companies, often with a Solomonesque split between the two, so that a stock can be 70% value and 30% growth (I still haven't figured that one out). These weights change every year in June when Russell rebalances its indices.

And while this year, for the first time, the growth and value indices will be rebalanced in a band in order to reduce the number of stocks that get abruptly shuffled from one index to the other, **this annual reclassification ritual suggests more change (often significantly more) than is actually occurring beneath the surface.**

The problem is that unlike Russell, **we don't rebalance our portfolio every June.** Our *average* holding period is about two and a half years, and we've held stocks for as long as 10. Our best stocks, in fact, are those we buy when they are "value" and sell when they are so "growth" that the momentum guys bid them up to the point that we're forced to let them go.

This somewhat arbitrary change in labels each summer can cause our portfolio to flip-flop from "value-y" to "growth-y" or back again as it moves from one side of a rebalancing to another, even though our holdings may have not changed much at all.

During extreme market periods like late '08 and early '09 we end up buying great businesses at absurd prices. **Then, as the market recovers, they get reclassified as growth faster than our valuation discipline requires us to sell them.** Over the long haul you see the same pattern time and again: every June there's something squirrelly that happens to our style classification.

Does it matter? **Only because investors want to put their managers in a box.** They want to know that their managers are consistent about what they invest in and that they're not trying to change their stripes with every shift in market style popularity.

Yet how can investors tell if their managers are holding true to their style if their holdings are being relabeled annually?

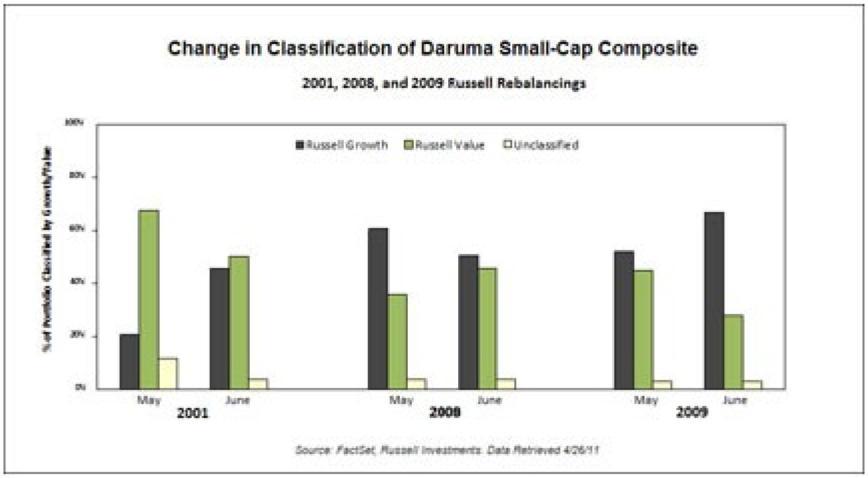
Simple... keep your eyes on the fish. **The labels may change, but what matters are the underlying creatures in which your managers are investing.** After all, when we decide to buy a stock, we look at the prospects for the business and how they're priced, not how the stock is classified or in which style index it lives.

Remember, while a fancy-pants Chilean sea bass may sell for more per pound than a plain old Patagonian toothfish, you're still eating the same darn fish.

Growth flips and value flops

No, I do not make this stuff up just because we send out a monthly newsletter.

Here are examples of what the Russell rebalancing did in 2001, 2008 and 2009 to the "growth" and "value" weights in our portfolio.



Click to enlarge

Look at the style weights in May versus June; you can see there was quite a lot of flip-flopping between the two labels. **Makes it look like we bought and sold a whole new portfolio, doesn't it?**

Wrong. 93% of the shift in weights in 2001 was due to the Russell reclassification. And in 2008 and 2009 it was 90% and 69% respectively.

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