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Thinking Outside the Box

Dividing funds by investment style helps investors compare similar funds. But does it handcuff managers by encouraging them to invest within narrow limits?

By Manuel Schiffres

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Just imagine what the world of figure skating would look like if Michelle Kwan were told the only jumps she could make were Salchows. No toe loops. No Lutzes. No Axels. Or consider what professional basketball -- and perhaps pop culture in general -- might look like had Michael Jordan's coach told him the only shots he could take were jumpers. No thunderous dunks. No acrobatic lay-ups. No gravity-defying leaps to the basket.

As remarkable as it may sound, the mutual fund industry seems to be evolving that way. Increasingly, stock funds are being required to hew to a predetermined investing style, often clearly indicated by the fund's name. The name may include a phrase like "midcap value" or "small-cap growth" (cap is short for capitalization, or market value). Sometimes the name includes more-amorphous terms, such as "Capital Appreciation" or "Aggressive Growth," but the fund's prospectus or other literature lays out the specific kinds of stocks it will buy.

This trend has given rise to an ominous-sounding cadre of watchdogs known as the "style police." Typically, these financial cops include investment consultants, financial planners and money managers who use funds. Their mission is to blow the whistle on any fund that doesn't stick to its stated -- or presumed -- style of stock picking. Funds that leave their designated investment territory are accused of "style drift."

This all may sound like inside baseball. At its core, though, the debate addresses the basic philosophy of how stock funds are to be run: Should their managers be required to invest only within the narrow constraints of a so-called style box? Or should they be allowed the freedom to invest in the stocks they believe will deliver the biggest gains, style boxes be damned?

How it got started

The notion of style-box investing is a relatively recent phenomenon. Until the early 1990s, stock-fund managers were guided, for the most part, by the investment objectives in their funds' prospectuses. Pure domestic stock funds were usually classified as growth-and-income, long-term-growth or capital-appreciation (or aggressive-growth) funds. The most famous manager of the 1980s, Fidelity Magellan's Peter Lynch, personified the go-anywhere approach to investing. Lynch sought to achieve Magellan's goal of capital appreciation by investing in big companies when they were attractive or smaller ones when they held more potential. At times, he'd invest heavily in fast-growing technology companies; at other times, he'd load up on sedate, relatively slow-growing savings-and-loan stocks.

The upheaval began in 1992 with Morningstar's introduction of the style-box concept. The style box is actually nine boxes arrayed in a three-by-three grid. The vertical axis represents a stock's size, as measured by its value in the stock market, or capitalization -- small, midsize or large. The horizontal axis depicts whether a fund invests primarily in value stocks (those that are bargain-priced, usually because the underlying companies are growing slowly or have some other problems) or growth stocks (those to which investors award lofty values -- such as high price-to-earnings or price-to-sales ratios -- because of a perception that the underlying companies are of higher quality or are growing at above-average rates). Funds that lie somewhere in the middle of the value-growth axis are considered blend funds.

Around the same time that Morningstar was devising its style boxes, the financial-advice business was mushrooming into a full-fledged industry. But whereas earlier generations of advisers specialized in picking individual stocks and bonds, many in the new generation of money managers understood that picking mutual funds was far easier. So, many newcomers set up shops in which their primary goal would be to assemble mutual fund portfolios for clients.

There was still another development that focused everyone's attention on style. In the old days (before the 1990s, that is), the conventional wisdom was that the most important determinant of investors' results was whether they were in or out of the stock market. Sure, there were periods when big-company stocks did better than small-company stocks, or vice versa, or when foreign stocks beat U.S. stocks, or the reverse. But the markets of the 1990s revealed differences that stunned investors. In 1998, for example, large-cap growth stocks returned 42%, while small-cap value stocks lost 8%. That was a huge divergence for segments within the U.S. stock market (you can get a sense of the way different markets and different styles have performed over the past 20 years by scanning the Callan Periodic Table of Investment Returns at www.callan.com/resource/periodic_table/pertbl.pdf).

Filling in the boxes

The wacky meanderings of the market played into the hands of the new breed of planners and money managers. It reinforced the notion that the markets are unpredictable and that the most useful function financial advisers could perform was to construct well-diversified portfolios that were consistent with the goals and risk-tolerance levels of their clients. Since no one could predict the course of the overall market *or* of sectors or styles within the market, that meant clients should invest in all, or nearly all, corners of the market. And that meant having some money in all of the style boxes.

Given that philosophy, it's no wonder many advisers obsess over style purity. "We must be able to analyze and look at our portfolios scientifically, and specific style allocations are part of that," says Neil Brown, of Burkett Financial Services, a financial-planning firm in West Columbia, S.C.

Moreover, advisers argue, the need to maintain broad and finely tuned diversification requires a rebalancing of holdings when allocations get out of whack because of either appreciation or depreciation. "Most investors do not have defined sell disciplines," says Roger Wohlner, an adviser in Arlington Heights, Ill. "Placing percentage limits on a given style may be the means to provide that discipline to many investors."

Holding style-pure funds makes portfolio assembly and rebalancing much easier. The adviser doesn't have to worry about the possibility that a fourth of that small-cap value fund's assets have drifted into the midcap growth category. Many money managers, such as Hal Schweiger, of Capital Financial Advisors, in San Diego, ensure style purity by investing only in unmanaged index funds. Says Schweiger: "We do not believe in active management since we cannot build portfolios and manage their risk when the fund manager can alter his style at will."

The counterrevolution

Not everyone is convinced that the emphasis on style purity is a healthy development. For starters, if you own style-specific funds, particularly style-specific index funds, your holdings will probably perform only as well, or as poorly, as that specific segment of the market. If the small-cap value category sours -- as it might soon, after six years of superior performance -- managers who must own cheap, small-company stocks will have little opportunity to escape from a lagging sector.

And style analysis is hardly pure science. Morningstar's system, for example, begins with a style designation for every stock, then essentially averages the styles of a fund's individual holdings. Funds that invest in companies of all sizes are typically considered midcap funds, but a fairer designation would probably be "all-cap" (our data provider, Standard & Poor's, does use several all-cap designations). Individual stocks can change from growth to value, or vice versa, before the rating services take note. And some funds hover near the borders of style categories and can easily and often switch from one designation to another.

Perhaps the biggest shortcoming of an overemphasis on style purity is that it discourages investing in funds run by top-flight managers who either go anywhere to invest or simply can't be pigeonholed by the style-box conceit. Consider two excellent value funds with nearly identical ten-year records: Legg Mason Value, run by Bill Miller, and Excelsior Value & Restructuring, managed by Dave Williams. Both have managers who invest in bargain-priced companies and hold on to them for long periods as their prospects improve and they morph into growth stocks. Morningstar, which provides year-to-year snapshots of a fund's style, shows Legg Mason Value regularly bouncing from large value to large blend to large growth and back. Its latest snapshot shows the fund to be in the large growth category, but its current designation of the fund, which is based on a longer period of time, is large blend. Over the past eight years, the Morningstar snapshot of Excelsior shows it as large-cap value, large-cap blend or midcap value. Overall, Morningstar categorizes Excelsior as a large-cap value fund.

Bouncing from box to box

The style-box concept falls particularly short with managers who have broad flexibility. One of the best examples of a great go-anywhere manager is Ken Heebner, who runs various CGM funds. The Morningstar snapshot of CGM Focus shows it to be midcap value one year, small-cap blend another year, large-cap blend at one time and, most recently, large-cap growth. Ron Muhlenkamp, manager of Muhlenkamp fund, and Don Yacktman, manager of Yacktman fund, are two others with excellent long-term records and funds that tend to bounce all over the style grid.

But despite their superior long-term records -- CGM Focus returned an astounding 25% annualized over the past five years (to December 1) -- many advisers who believe in style purity will not recommend these funds to clients. Says Jeff Broadhurst, an adviser in Lansdale, Pa.: "How can I build a risk-appropriate portfolio for a client if the underlying fund is all over the place? If I use a fund that is willing to invest in any segment of the market, I have no basis for knowing what the client is exposed to or of knowing the expected return" or how the fund correlates to others in the portfolio. Adds Steven Weydert, an adviser in Park Ridge, Ill.: "The bottom line is that you have to determine who you want managing your asset allocation -- you or a group of fund managers who have no way of coordinating with each other."

Of course, not every adviser favors a (style) police state. Some do embrace flexibility in funds and their managers. "Yacktman, Heebner and Muhlenkamp may have a bad year now and then, but over long periods of time, all three have tremendous records," says Eric Weigel, an adviser who is a former manager at the Pioneer funds. "That's because they go where they see opportunities." For Paul Winter, a financial planner in Holladay, Utah, it's more important for a manager to stick to a discipline than for a fund to always stick to its style box. "This is the true definition of style purity, and it identifies the great managers over the long term, such as Oakmark's Bill Nygren, and Marty Whitman of Third Avenue," says Winter.

A few fed-up advisers blame Morningstar for foisting the whole style business on the investing public. "The style box is a marketing ploy invented by Morningstar to allow investment advisers to provide economic justification for their services," says Robert O'Dell, an adviser in Wheaton, Ill. All of this puzzles Don Phillips, managing director of Morningstar. "People are at war with Morningstar because of an image of us they've created," he says. "There's nothing magical about the lines of the style box," and Morningstar itself isn't for or against style-pure funds.

The most important contribution of the style boxes, he continues, is that they allow you to compare the performance of similar funds and they give you a better picture of how your portfolio is aligned. Knowing the style of your fund holdings, Phillips says, can help you avoid becoming dangerously overweighted in the hottest area of the market, as many investors did when they loaded up on large growth funds in 1999 and early 2000. "Without the style box," he says, "investors would just be chasing last year's winners and always undermining their efforts to achieve better results."

By the way, Phillips is a big fan of Heebner and Yacktman.
