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Understanding Style

To maximize returns, plan sponsors need to keep an eye on style biases and risks.

Institutional investors can be seduced by definitions of style that put managers into neat boxes based on large cap, small cap, value and growth characterizations. Despite these classifications, both managers and consultants frequently differ in their opinion of a particular manager's investment style.

We need to recognize that classifying managers on the basis of style is simply a loose, imperfect framework for building plan structures and evaluating managers. In fact, style is essentially any bias that causes significant non-systematic risk in a portfolio versus a benchmark.

This non-systematic risk is tolerated in the investment world because it is also the chief source of a manager's strength, as in the case of a manager with a high alpha-producing, small cap research team, for example. Clearly, style bias highlights a problem if a manager is taking risk in an area where the firm does not have expertise.

While there are a finite number of style descriptions, such as growth and value, the reality is there are as many examples of style as there are investment managers. For instance, a manager who uses a price-to-earnings screen to eliminate 'expensive' stocks will likely have a value bias. Less obvious is the case of a manager with an in-house dividend-discount model that will also have a style bias as it uses a common framework for evaluating stocks.

As well, a manager with a so-called strategic under/overweight in a country such as Japan also has a style bias. This can often highlight a lack or surfeit of resources dedicated to that particular region. Other less easily classified examples of style include low turnover, long time-horizon approaches, or their opposites, trading strategies.

The good news is that plan sponsors can pick a group of complementary specialist managers to diversify their investment strategy and, in turn, eliminate most of the non-systematic risk in the plan. However, it is the sponsor's responsibility to minimize total risk in the plan. To do this, it is essential for sponsors to understand the key sources of risk in their portfolio.

SOURCES OF RISK

The primary source of risk in an international equity portfolio is regional allocation. This style's impact on return can be significant, but the odds of getting it right are quite low. For example, the success of many EAFE managers can be explained by an overweight in Japan over the last 12 years. The main problem with regional allocation strategies is that it is difficult to predict which managers will successfully identify outperforming regions in the next 10 years.

The other sources of risk in a portfolio are size, style, currency, country, sector and stock selection, in decreasing order. There is some recent evidence that, within regions, sector may matter more than country. However, the important point is that stock selection is the most consistent source of return. Therefore, it is imperative that pension plans employing active managers are built around a core manager with a principal—if not sole—focus on stock selection.

The key to a multi-manager approach is knowing that no combination of active managers will give plan sponsors perfect style neutrality. Individual managers do not act in concert. Even if they look complementary at the time of hire, they will probably become less so over time. As a result, plan sponsors must know their appetite for style risk, and remain proactive. If a large style bias develops in the plan, they must fix it before it blows up. ■