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A Matter of Style

What are the causes and consequences of style drift?

The recent volatility in equity markets has impacted different style sectors in different ways. For example, the S&P Small Cap 600/Barra Growth Index returned 3.6 per cent during the first quarter of 2002, while the corresponding Small Cap Value Index returned a much higher 10.3 per cent. Since the average return and risk of an equity portfolio is so highly tied to its style orientation, plan sponsors must be able to accurately measure both the point-in-time style and the "style drift" that occurs over time for each of the plan's equity managers.

My study presents a new system of using portfolio holdings data to accomplish these goals, based on recent academic research. Besides advocating a new system for plan sponsors to precisely control their style balance at any given point in time, my methodology allows a study of the causes of style drift, as well as the performance consequences of such drift. In contrast, past methods of measuring style drift rely on extracting style loadings from the net returns of funds using, for example, Sharpe rolling regressions. While relatively simple to implement, these past methods are very imprecise.

I use manager holdings data to precisely measure and decompose style drift into the drift in each style dimension: large-vs. small-cap, growth vs. value, and momentum vs. contrarian strategies. In addition, I decompose style drift into "active" vs. "passive" drift, i.e., the style drift in a manager's portfolio that results from active trades versus passively holding a portfolio of stocks with changing characteristics over time.

In terms of the data and methodology, for style benchmarks and the manager dataset, all U.S.-listed stocks are ranked, each year, by their market capitalization. The five resulting cap-ranked portfolios are further subdivided into five book-to-market quintiles. Finally, each of these 25 portfolios is further subdivided into quintiles based on the 12-month past return of the stocks. This three-way ranking procedure results in 125 fractile portfolios, each having a distinct combination of size, book-to-market, and momentum characteristics. The style of a manager's portfolio is then characterized, in each dimension, by portfolio-weighting the resulting style portfolio numbers of the stocks held by that manager. I tested my approach on U.S. mutual funds with a domestic equity orientation during the 1985 to 2000 period.

For style drift, a manager's "active style drift" (ASD) is measured by comparing their current portfolio style characteristics with those which the manager might have had if he or she had passively held last year's portfolio until today. The remainder of the style drift from last year to this year is the manager's "passive style drift" (PSD).

While this study is still in its early stages, a few interesting findings stand out. First, less-experienced fund managers as well as managers with a good career stockpicking record tend to stray from their style mandates over time. These less-experienced managers tend to run smaller portfolios of small-cap stocks, which are likely more difficult to maintain style control over. Perhaps more interesting is the good past stockpicker result: are these managers so "overconfident" in their abilities that they feel free to move outside their style mandates?

The consequences of style drift are equally interesting: managers with higher levels of style drift produce higher alphas in the future, but the variability of these alphas is also higher. The bottom line is that high-drift managers produce an information ratio of 0.37, while low-drift managers produce an IR of only 0.18. Thus, to address our above question, good past stockpickers do not appear to be overconfident, but appear to have genuine skills in identifying stocks, of any style, that are underpriced.

To conclude, style drift is most accurately measured using portfolio holdings data—my study proposes a method for plan sponsors to measure and manage style drift. ■