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Style Boxes Hampering Manager Performance

by Kevin Burke

LAS VEGAS — When picking fund managers, RIAs should start thinking outside the style box. Fund managers that stray from their Lipper or Morningstar classifications tend to perform better than those who strictly adhere to it.

That was the argument laid out by two industry insiders, C. Thomas Howard, chief executive officer and director of research at consulting firm AthenaInvest, and Craig Callahan, president of Icon Advisers, who were speaking at the Schwab Institutional Impact 2007 conference here Monday.

“Quit handicapping managers by putting them in the boxes,” Callahan said.

The pair, former colleagues at the University of Denver, conducted research that shows a performance drag among funds that stick closely to their style box — large-cap growth, small-cap value or mid-cap blend, for example. Fund managers who ignore their style box tend to outperform those who adhere to it more closely by more than 300 basis points, they conclude.

Between 2002 and 2007, funds that drifted from their respective style boxes outperformed those that stayed squarely inside of it by 3.39% annually, according to the research. They also point to five other independent studies that have been conducted in recent years that illustrate the constraints style boxes put on managers.

“These boxes aren’t working out very well. The boxes seem to hurt performance and don’t provide risk control,” said Howard during a conference session entitled Alpha & Asset Allocation: Finding Alpha Through Investment Strategy. “In general, they’re not very useful.”

Callahan and Howard also tried to dispel what they believe to be common misconceptions surrounding the style box system.

The first "myth," they said, is that style boxes are part of modern portfolio theory. The second is that style boxes are a necessary risk measure. The last myth is that style boxes are asset classes. If they were asset classes, then there wouldn’t be so much confusion and overlap when different fund tracking firms lump funds together, they said.

Picking a Winner What RIAs can do to improve their manager lineups
1. Reconsider Active/Passive Decision
2. Buy Drifters, Not Huggers
3. Assemble Strategy-Focused Managers
4. Hire Specialists, Not Generalists
5. Demand Strategy Consistency
Source: AthenaInvest

Style boxes were first created in 1992 so that advisors could sift through the thousands of mutual funds that had flooded the market during the industry’s growth spurt. Howard conceded that at the time it was a prudent move. “It was organized and categorized,” he said.

However, style boxes have had unintended consequences. Using style box investing effectively denies managers the ability to hold a good stock and forces them into less desirable ones, Howard said. Essentially, it handicaps their potential.

Putting managers in a style box can cost fund managers a healthy chunk of their return and push them closer to their

benchmark, Callahan and Howard said. And it doesn't mitigate risk.

Rather than viewing the fund universe as a grid with nine boxes, Howard suggested that advisors classify managers according to 10 different investment strategies: competitive position, economic conditions, future growth, market conditions, opportunity, earnings surprises, profitability, quantitative, risk, social concerns and valuation.

Too often funds stick to the box system because it aids marketing and distribution efforts, Howard said. In other words, fund classifications make it easier to sell them.

Portfolio managers can be tempted to abandon their objectives and chase whatever has been performing well lately. Style drift, as it's called, can sometimes keep managers from being true active managers, Callahan said. Nobody wants to be accused of being a drifter, he said.

But despite its negative connotation in the industry, some level of style drift is actually a better way to add alpha than simply hovering around a benchmark. "Managers that have the most characteristic drift do the best," he said.

Callahan and Howard accuse most managers of being "closet indexers" who simply straddle the benchmark in their quest for returns. "If you're really an active manager, then you've got to make sector bets," Howard said. They warn against "getting caught in the middle" when deciding to choose passive or active investments.

They also urge advisors to choose managers that are specialists rather than generalists, ones that do a few things very well. Funds that have numerous facets to a strategy are worth passing on in favor of those that outline a simple, concise explanation in the prospectus.

Style boxes aren't without merit, however. They provide financial advisors with a simple, convenient way to organize a menu of funds for their clients. But they limit a manager's ability to view the whole spectrum of investments that are on the market.

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