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Style is dead. Long live style!

- **Style is a basic but critical concept.** The practice of categorizing an investment manager's "style" was initiated to differentiate between investment philosophies. Classification by style remains important because it allows investors to select a diversified range of strategies and managers.
- **Current style frameworks mislead clients.** The most prevalent equity manager classification systems—the ubiquitous growth-core-value style boxes and the popular style benchmarks—are disappointing investors. The simplicity of these frameworks does not appropriately differentiate between manager types, nor correctly assess their performance.
- **Clients are already urging change.** Sophisticated institutional and retail buyers have recognized the need for a multi-faceted view of style—a "style footprint"—that better distinguishes between managers and better explains their performance. Armed with new technology, these buyers are systematically highlighting the differences between managers traditionally grouped within the same style box.
- **Skill will increasingly drive manager selection.** In the future, there will be a greater appreciation of and demand for *skill*. (We define "skill" as the excess return added *after* controlling for broad market movements and style exposures.) Skill rather than style will become the dominant criterion for selecting a manager.
- **Focus on skill creates opportunity.** Managers that can articulate their investment philosophy, document their style footprint, and validate their investment skill, will stand out from those who cannot.

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CQA specializes in providing merchant banking and strategic advisory services exclusively to the investment management industry. CQA delivers value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

1. Introduction

This paper is motivated by our belief that the current popular frameworks for defining investment style are not working well. Investors have been let down by the current style classification schemes, benchmarks, and style peer groups. This has been particularly acute recently as many investors have found that their portfolios are not as diversified by style as they expected, resulting in significant unanticipated risk exposures and performance shortfalls. Therefore, we advocate that these schemes be abandoned—“style is dead.”

However, investment style is a critical concept that must be preserved. Institutional investors, financial planners, and other retail intermediaries are becoming more sophisticated. They are using new tools to develop a deeper

The popular style frameworks have not worked well enough—we believe there is a better way.

understanding of individual managers’ investment style and a more accurate measure of their investment skill. Deeper manager understanding will lead to improvements in manager categorization and better serve clients—“long live style!”

What is wrong with the popular style frameworks? What can take their place? How should investment management firms and their clients respond to these changes? In answering these questions, our paper develops as follows:

- First, we review the evolution of *style*. It began as a straightforward concept: how to represent, and thereby differentiate, a manager’s investment philosophy. It has evolved into a series of benchmarks and style boxes.

- Second, we describe how the current classification and measurement schemes are poorly serving investors. The simplicity of these systems neither appropriately differentiates between managers nor appropriately assesses their performance. As a result, investors seeking diversification may be taking on unintentional risk.
- Third, we present a better method for evaluating managers. This method appropriately differentiates between managers because it focuses on *skill*, not on performance relative to inadequately constructed market indices or broad peer groups.
- Finally, we outline how managers and clients can take advantage of these trends. While the world is not yet ready to totally abandon style boxes, managers and their clients can reap benefits today by better articulating and documenting their true style and validating their investment management skill.

2. The evolution of style

“Investment style” has specific meaning to investors. It describes in broad terms the characteristics of an investment manager’s portfolio (the combination of companies in which they invest). This classification process is important: categorizing managers enables construction of aggregate equity portfolios that are diversified by investment approach. A summary of the evolution of style classification is useful as a prelude to our examination of its effectiveness.

STYLE REFLECTS PHILOSOPHY

Investment “philosophy” drives the primary distinctions between managers. It incorporates the underlying tenets as to how a manager identifies superior investment opportunities. To what extent is valuation indicative of outperformance? How important are measures of price momentum? Where do market inefficiencies exist? Clearly, philosophies are complex concepts and managers differ, if only in nuances, on many aspects of “what makes for a great stock?”

“Style” is a succinct, tangible reference for a manager’s investment philosophy. Style classification attempts to capture a manager’s philosophy within a finite nomenclature. For example, “contrarian” is a category of the value-style that focuses on firms with deeply discounted valuation characteristics. In addition to qualitative descriptions, style may also be defined quantitatively. For example, a manager might be defined as contrarian if it only buys stocks below a certain price-to-earnings ratio. Of course, multiple quantitative measures might also be combined.

A FRAMEWORK EMERGES

In the late 1960s and 1970s, as institutional investment pools grew significantly in size, it became beneficial to hire multiple managers for equity securities and other asset

classes. Selecting managers with different investment philosophies provided two primary benefits. First, performance risk was diversified because complementary philosophies were expected to perform differently over market cycles. Second, better aggregate performance was anticipated from combining managers that specialize in specific market niches rather than in broad market mandates.

To efficiently select complementary and more specialized managers, investors required a classification scheme. Beginning in the late 1980s, institutions began to accept a nine-segment framework for domestic equity investing. Three categories were used to classify investment approach: growth, core and value. The growth category represented managers seeking companies with above average growth (in earnings, revenue, and cash flow, for

Style was intended to reflect an investment philosophy ...

example). A value approach represented investment in companies whose current market value was believed to be below the long-term value. Managers that considered companies across the market and did not focus exclusively on either growth or value characteristics typified a core approach. Three categories were used to classify capitalization: large, small and, later, middle. Large capitalization was defined as market values over \$1 billion and small capitalization below \$1 billion, although over time these ranges have shifted.

In the early 1990s, several firms, notably Morningstar, brought this style scheme to a broader retail audience with the introduction of the now ubiquitous three-by-three style box matrix. This innovation had a significant impact on retail investors, who could now easily distinguish between managers, and their portfolios could enjoy the benefits of diversification and specialization.

Exhibit 1 : Events in the evolution of style

- 1987** Frank Russell creates large cap style indices
- 1987** Wilshire creates large and small style indices
- 1992** S&P and Barra create large cap style indices
- 1992** Morningstar introduces the concept of style boxes
- 1995** Morningstar begins categorizing managers according to style boxes
- 1996** S&P and Barra create small cap style indices

COMPARING PEERS

An important consequence of these categorization schemes was that they created a framework to more appropriately compare manager performance. Comparing managers within style boxes made sense for the same reasons that diversifying by investment philosophy made sense: over time market conditions favor different types of equity securities. For example, there are periods when small capitalization investing is out of favor compared to large capitalization or when value investing outperforms growth investing. Style categories allow investors to compare performance among a peer group of managers that face similar market conditions.

Advisors began to develop formal peer groups for the purpose of manager evaluation and comparison. Institutional consultants created custom peer groups and relative performance rankings within their manager databases. Retail-oriented firms created mutual fund comparisons: for example, Morningstar's style boxes and star system create a basis for comparison.

BENCHMARKS ARRIVE

During this same period, another performance measurement tool, namely benchmarks, became widely accepted. A good benchmark for a manager includes securities that

broadly reflect its investment philosophy. Benchmark characteristics should be stable over time. In the late 1980s and early 1990s, capitalization- and investment-approach-specific benchmarks were introduced. (Exhibit 1 provides an abbreviated history of benchmarks and style classification schemes.) These benchmarks were intended to be an objective measure of manager success: it is more accurate to compare a value-style manager with the performance of stocks with value attributes than with the entire universe of securities.

STYLE DICTATES PHILOSOPHY

These style-based ranking systems have become well entrenched and highly influential. A primary criterion for selecting an institutional manager is its three-year performance relative to peer managers. Also, institutional active managers are usually monitored for their conformity to a specified benchmark ("tracking error"). In the retail markets, the overwhelming majority of mutual fund flows go to funds rated with four and five stars by Morningstar. In both markets, portfolios precisely linked to a specific benchmark (including the leading market indices) are gaining in popularity.

... now managers are under pressure to conform to a style.

As a result of the influence wielded by current classification and measurement schemes, a subtle shift has occurred in the use of style. Originally, style was intended to objectively reflect an investment philosophy. Now, managers are under pressure to conform to a style, as defined by benchmarks and style boxes, or risk being poorly perceived by the marketplace.

3. Style, as we know it, is dead

Both managers and clients are placing enormous faith in the most prominent style classification schemes and substantial funds as well. The industry faces significant consequences if these peer comparisons and benchmarks are not constructed appropriately. At stake is whether managers are being appropriately evaluated and whether client portfolios are properly diversified.

In this chapter, we describe why the current classification schemes are too simplistic to adequately perform the important roles that the industry is asking them to play and why clients are demanding better.

REPRESENTING COMPLEX IDEAS

We have already described how style is intended to encapsulate a very complex concept: the characterization of a manager's investment philosophy. Managers can consider an infinite number of combinations of fundamental or security characteristics. The ways in which these combinations are put together to determine superior investment ideas is as much an art as a science. Capturing the essence

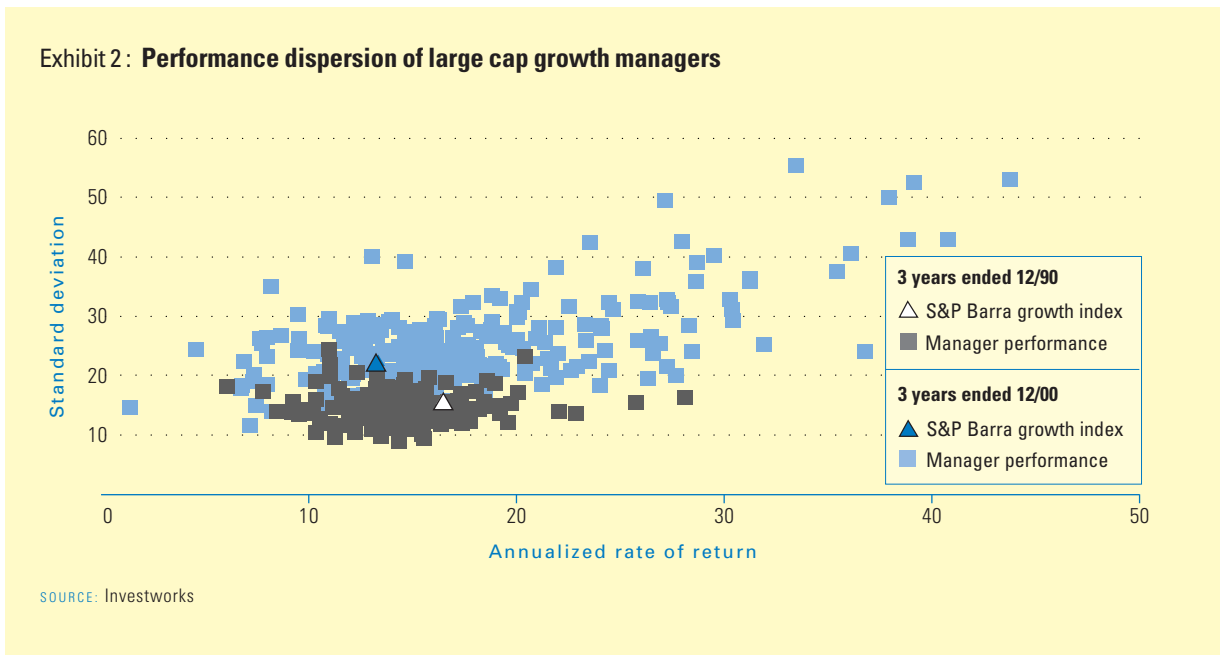
of this process in simple qualitative or quantitative measures is difficult.

The current style classification schemes use only one or two specific characteristics to differentiate managers and define benchmarks. For example, Morningstar uses a combination of two quantitative portfolio attributes (price-to-earnings and price-to-book measures) to classify managers according to growth, core, or value investment approaches. The S&P/Barra style benchmarks use only market capitalization and price-to-book value measures to divide the universe of securities.

Consequently, a complex, multidimensional concept is being represented by one- or two-dimensional classification schemes. Is the parsimony of these schemes creating a systematic mismatch between managers' true investment philosophies and the benchmark or peer group against which they are forced to compete?

PEER COMPARISONS ARE TOO BROAD

An effective peer group compares managers of similar investment philosophy. Because market conditions effect like managers similarly, peer comparisons are fair. As a



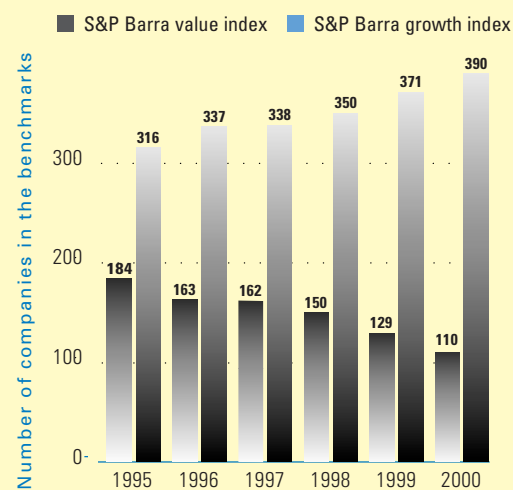
result, peer performance should be reasonably evenly distributed around that of an appropriate benchmark.

Exhibit 2 provides a simple test of peer group integrity. Here, we compare the performance of institutional large capitalization growth managers as classified by Barra RogersCasey's *Investworks*. The exhibit presents performance dispersion over two time periods: the three years ended December 1990 and the three years ended December 2000. In the more recent period, the spread of returns and risk was dramatically higher—seemingly too high for variations in skill among managers classified within the same peer group.

What accounts for this variation? The dramatic market conditions over the latter period serve to highlight the problems inherent in style classification. Over the three years, a portfolio's exposure to securities with strong price momentum characteristics explained a large percentage of its performance. Managers whose investment philosophies embraced price momentum characteristics outperformed while those growth managers with a keener eye on valuations—sometimes referred to as “growth at a reasonable price,” or GARP—did not. Therefore, the broad variation in returns was driven by fundamental differences in investment philosophy.

Investors seeking to hire an investment manager in this latter period would have been poorly served by the peer group comparison. Using the three-year performance records, the chosen “growth” manager would have likely been one that did de-emphasize valuation metrics. Given the dramatic sell-off in technology stocks in 2001, the investor would have been disappointed in its choice. In a similar vein, we are surprised at the number of value-style managers who lost investment mandates in this same period—just before the turn in the value market.

Exhibit 3: S&P Barra style benchmarks



SOURCE: Casey, Quirk & Acito

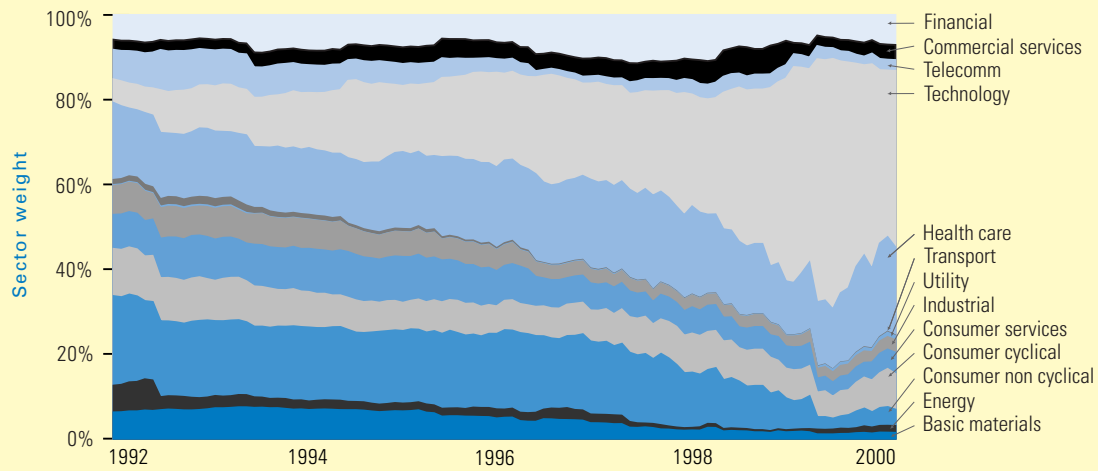
BENCHMARKS ARE SUSPECT

As with peer groups, benchmarks are effective when they are relatively stable over time. Benchmarks should contain securities that appropriately reflect the universe of stocks most representative of a manager's investment philosophy; since manager philosophies do not change dramatically over time, neither should their benchmark, apart from ongoing re-balancing.

Exhibits 3 and 4 present evidence of the instability of common style benchmarks. Exhibit 3 demonstrates how the number of securities in each of the S&P/Barra style indices has changed over time. A number of former “growth” stocks are now included in the value benchmark—not because the companies have changed characteristics, but because of a mechanical process that preserves equal aggregate capitalization among the two indices. As a result, the “value” benchmark has been assuming more significant growth characteristics.

Exhibit 4 (see page 8) presents the sector exposures of the Russell 1000 Growth index during the previous ten

Exhibit 4 : **Russell 1000 Growth sector exposures** (12/92-4/01)



SOURCES: Casey, Quirk & Acito/ Frank Russell data

years. Significant changes in these exposures are evident, the most obvious occurring in the technology sector—both the secular increase from about 10% of the index to over 50% at its peak and the dramatic variation in the recent two years.

Many managers have faced a style benchmark trap: they must choose between remaining true to their investment philosophy or changing their style to manage to their appointed benchmark. In the extreme, managers risked losing business whether they stayed true to their investment philosophy or whether they deviated from their philosophy to conform to the changing benchmark if, in either case, they underperformed. Clearly the single factor basis for constructing style benchmarks creates an unstable and inappropriate basis for comparing manager performance. Even institutional consultants, who construct peer groups based on more complex categorizations of manager philosophies, still measure performance against these one-dimensional benchmarks.

WHAT WILL DRIVE CHANGE?

The problems created by overly diverse peer groups and unstable benchmarks have not gone unnoticed. Investment managers have been aware of and complained about these inadequacies for some time. Their protestations, however, will not drive change: if a client wants a product measured against a poorly constructed benchmark, the manager must manage against it.

Clients, and the intermediaries who advise them, will drive reform. Individuals, who after the fact recognized that they were significantly over-exposed to technology stocks, now understand the flaws of style boxes. The financial planner who must explain why certain “value” managers are performing very well in the current period, while others are not, has learned that not all value managers represent the same flavor of value. The institutional client seeking to build a portfolio with broad style and risk factor exposure needs a more precise way to classify and combine managers. All of these investors will demand a more effective approach to defining and classifying style because, while the concept is sound, the current implementation has let them down.

4. The way forward: long live style!

If the current style categorization and measurement systems are flawed, how can the industry do better?

BACK TO BASICS

We return to the basic notion that the key criterion for classifying an investment manager is investment philosophy. Since philosophies can be complex, objectively defining and classifying them requires a richer framework, both qualitative and quantitative, than is broadly in use today.

Qualitatively, evaluators of managers must be disciplined as to how they assess an investment process. They must begin with an analysis as to whether the manager's philosophy is clear and compelling. Articulating a philoso-

A "style footprint" quantitatively defines the characteristics of a manager's philosophy.

phy is surprisingly difficult. Next, evaluators should have a framework for understanding how this philosophy influences every stage of the investment process, including data collection, research, security selection, and portfolio construction. The framework should provide insight into the nuances of how managers make decisions and will therefore help classify a manager's style in a more precise manner. Historically, structured qualitative evaluation has only been part of the institutional market segment; however, it is now becoming an important part of the evaluation methodology used in all market segments including financial planners and retail-oriented intermediaries.

Quantitatively, manager classification can be done in a purely objective manner. Historically, investors used style analysis tools that were based on best-fit regressions of performance data. These tools provide insight, but in the

end are dependent on style benchmarks to define a specific style, so the results are not as robust as they should be. Today, tools based on an analysis of individual portfolio holdings provide much greater detail on a manager's investment style and its resulting impact on performance. Sophisticated tools like multi-factor risk models can provide detailed feedback on historic portfolio characteristics. We believe that quantitative tools have thus far been underutilized in the classification of style. Below, we explore two important quantitative concepts: the style footprint and skill.

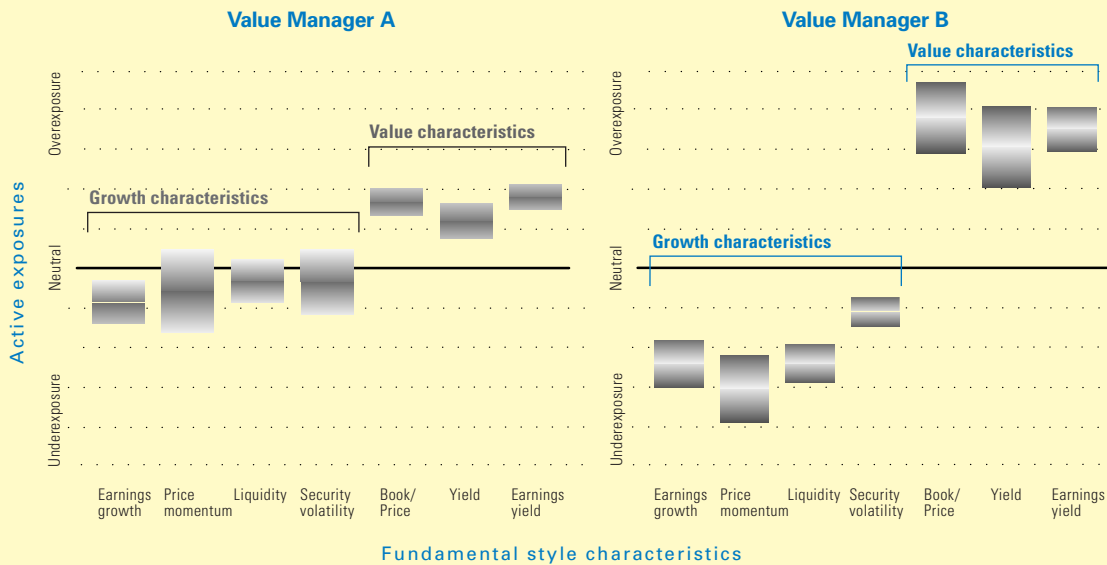
THE STYLE FOOTPRINT

Each manager's philosophy, if consistently implemented, results in a unique set of quantitative attributes. We define these features as a "style footprint." Components of a style footprint can be industry sector weightings, exposures to style characteristics, and other quantitative characteristics of the securities held within the portfolio. The style footprint is multidimensional and can, therefore, precisely differentiate between approaches to investing.

To demonstrate how dramatic the differences between two managers can be, we examined two prominent managers both typically grouped within the value-style large capitalization peer groups. Using portfolio holdings-based analysis, we compared the historic style exposures of each manager. We found that their exposures to a number of fundamental style characteristics were very different.

The managers' style footprints are presented in Exhibit 5 (see page 10). These footprints show the historical exposures to seven quantitative attributes: four associated with "growth" investing (earnings growth, price momentum, liquidity, and security volatility) and three associated with "value" investing (price-to-book, yield, and earnings yield).

Exhibit 5: Managers' style footprints
3 year historical style exposure ranges



SOURCE: Casey, Quirk & Acito

These exposure comparisons are made relative to a large capitalization broad market benchmark. The bars represent the range of exposures measured for each factor over a three-year period.

As demonstrated in Exhibit 5, *Manager A* is slightly underexposed or neutral to growth-oriented characteristics and moderately overexposed to traditional value measures. This footprint is representative of a “relative value”-type manager, that places considerable emphasis on valuation, but is willing to pay a modest premium for companies with very strong growth prospects.

Manager B has a very different profile. The style footprint indicates a significant underexposure to price momentum and significantly high exposure to value characteristics. Manager B has the style footprint of a deep value or contrarian manager that does not compromise on strict valuation criteria.

Should Managers A and B be compared as peers? Under most style classification schemes, they currently are, both

being considered “value” managers. However, examining the multiple dimensions of a style-footprint clearly indicates two very different investment philosophies. These two managers would be expected to perform differently under different market conditions. In fact, over the last two quarters in which more traditional valuation measures have been rewarded, Manager A has done well, but Manager B has outperformed. In the prior two years, Manager A outperformed, given its moderate exposure to technology; Manager B ranked near the bottom performance decile, given its “old economy” approach.

A better evaluation scheme would compare Managers A and B not against each other, but against managers with similar style footprints. Clearly, nine categorizations of managers are inadequate. In this more detailed regime, managers can be judged on their true skill, not on whether their style exposures are in favor.

SKILL WILL DRIVE DEMAND

A greater ability to differentiate between managers implies that skill, rather than style, becomes the most important criterion for choosing managers. By our definition, investment manager skill is equal to the excess return of a portfolio compared to an appropriate benchmark. Skill can be decomposed into various sources of excess return.* For example, we consider four sources in our analysis:

- Exposure to broad market movements (“beta policy”)
- Under or overexposure to style factors (e.g., price momentum)
- Under or overexposure to industry sectors
- Security selection

Ideally, the sources of manager skill should be consistent with the manager’s stated objectives. For example, if the manager claims to be a bottom-up stock picker, the majority of excess-return should be derived from security selection. If a manager claims to be skilled in rotating among industries, the majority should originate from sector selection.

The following example (Exhibit 6) shows how to control for the influence of a manager’s philosophy or style characteristics, so that skill can be more clearly measured. We present two managers with value-style large capitalization products that have similar levels of risk and performance. (14.0% and 14.4% annualized return). Both managers beat the Russell 1000 benchmark (12.3% return); however, the way in which they did so was very different. Manager A delivered 250 basis points of excess return through stock

*For another helpful description of skill versus style see “Evaluate Skill, not Style: An Invitation” by Ron Surz in *Investment Management Consultants Association’s May/June issue of The Monitor*.

Exhibit 6 : Attribution of manager skill

3 years ended December 2000

	Manager A	Manager B
Performance (annualized %)		
Large cap value product	14.0	14.4
Russell 1000	<u>12.3</u>	<u>12.3</u>
Total excess return	1.7	2.1
Performance decomposition (basis points)		
Beta policy	-20	30
Style impact	-90	70
Sector exposure	30	50
Security selection	<u>250</u>	<u>60</u>
Total excess return	170	210

SOURCES: Casey, Quirk & Acito/ Frank Russell data

selection, but lost 90 basis points by being exposed to style factors that were out of favor. Manager B delivered similar excess return, but through a balance of stock selection (60 basis points) and style exposures (70 basis points).

Which manager displayed greater skill? If both promised to deliver value through security selection, Manager A should be viewed favorably: despite having an investment philosophy that was out of favor, the manager consistently selected better stocks among the relevant universe.

A combination of style footprints and performance attribution is the correct method by which to compare managers. First, style footprints should be used to objectively create peer groups that are directly comparable. Next, attribution analysis can determine the amount of skill demonstrated by each manager. Peer groups based on style footprints will neutralize the impact of different investment philosophies so that differences in performance will be due to differences in manager skill—security selection, not style impact, should explain the variation in returns.

Of course, qualitative assessment of a manager's investment process is also critical. It will determine whether the style footprint being generated is consistent with the underlying investment process. A poorly structured process, or one that is inconsistent with the style footprint (or both), should be a cause for concern.

THE FUTURE

Will investors implement these concepts? We believe that the broad answer is yes, with variation by market segment.

In the individual investor marketplace, style boxes will remain because they are a convenient vehicle for communicating critical differences among managers. Many investors are unlikely to have the personal interest or financial sophistication to appreciate style footprints or attribution analysis.

Style footprints and performance attribution should form the basis for manager evaluation.

However, these concepts will influence style box frameworks in two ways. First, the three-by-three matrix can be expanded. The value, core and growth classifications can be refined into more precise groups that represent more specific investment philosophies. For example, growth could be separated into growth at a reasonable price (GARP), traditional growth and momentum growth. The value spectrum might include contrarian, traditional value, and relative value. The core category may recognize style tilts. Capitalization groupings may also be expanded; perhaps a "smid" category should capture products that bridge the small- and mid-capitalization ranges.

Secondly, manager classification will become more sophisticated. The classification process will incorporate the combination of qualitative and quantitative methods described in this report. Both of these methods, not just one or two variables, will be factors behind placing a manager into a style box. The result will be a more precise and stable classification. Many gatekeepers for intermediaries are beginning to conduct such analyses on behalf of their individual clients.

As a result of greater complexity in classification, individual investors will increasingly need intermediaries for support in choosing managers and in constructing investment programs. This is not a trend to be feared, since selecting investment managers was never easy in the first place. The new schemes will allow retail investors, particularly with the help of their advisors, to construct better-diversified total portfolios and reduce the risk of surprises. We believe that the increase in complexity is outweighed by the benefits of transparency and diversification.

Institutional investors and intermediaries are already adopting techniques akin to the style footprint and attribution-based skill analysis and are downplaying the style box framework altogether.

For these investors, such improvements fit well with new trends in buying behavior. For example, sophisticated investors are adopting an active risk budgeting approach to hiring investment managers. That is, they are beginning to explicitly budget their aggregate active risk. Risk budgeting will increasingly require managers to specify the risk factors to which they will be systematically exposed and the returns they hope to generate. A manager's detailed specification of a style footprint enables a clear articulation of these risks to current and potential clients.

A risk budgeting approach typically results in a core and satellite investment structure where the greatest active risk is taken with managers that have demonstrated the

greatest ability to generate risk-adjusted returns. In this allocation scheme, a premium is placed on managers capable of demonstrating significant skill. If investors do not have confidence in their ability to identify a skilled manager, passive alternatives exist.

A final tangible implication of the evolution of style is that benchmarks must evolve to better reflect, but not drive, greater style definition. Benchmarks should be constructed to more precisely reflect a manager's philosophy. Consequently, we expect that the broad market benchmarks and custom benchmarks will be increasingly used. Broad market benchmarks will measure consistency of a manager's style footprint and managers will be judged on how they beat the benchmark. Managers will use custom benchmarks to communicate their style and validate their skill. These custom benchmarks will control for the fundamental exposures of a manager's specific investment philosophy. Sometimes called normal portfolios, they will be used to create benchmarks that specifically represent a manager's investment style. If, for example, a manager has a security screening process, the output of that screen could be used as a custom benchmark against which per-

formance could be compared to validate investment skill.

Identifying managers with high risk-adjusted returns requires a sophisticated understanding of how managers add value and an ability to disentangle the impact of investment style. The onus of validating investment skill now falls on investment managers. It is not enough to beat the benchmark or be above the peer group median; managers must show how they beat the benchmark and the median manager. The sources of value-added must be consistent with product objectives.

LONG LIVE STYLE

To summarize this chapter, we expect a more meaningful definition of style to evolve, significantly changing the way investment capabilities are evaluated. The new definition will recognize the multiple dimensions of investment style, alter the manner in which capabilities are categorized, and require managers to provide enough performance transparency to validate their investment skill. Investors are concentrating on understanding managers' philosophies, recognizing that philosophy drives portfolio characteristics and investment style.

The market also recognizes that style is multidimen-

Exhibit 7 : **The evolution of style**

Style is dead.

- Benchmark defines style
- Two dimensional definition of style
- Style box
- Broad peer groups
- What's your style?
- Did you beat the benchmark?
- Allocations to style boxes



Long live style!

- Investment philosophy defines style
- Multidimensional definition of style
- Style footprint
- Precise peer groups
- What's the impact of your style?
- How did you beat the benchmark?
- Risk budgeting

sional and that traditional style benchmarks are not representative of managers' philosophies. Style footprints will replace style boxes, precise peer groups will replace broad or benchmark based peer groups. The questions "what is the impact of your style?" and "how did you beat the

Style footprints replace style boxes.

benchmark?" will replace "what is your style?" and "did you beat the benchmark?" Finally, risk budgeting will replace allocations to style boxes. This evolution is summarized in Exhibit 7 (see page 13).

5. The opportunity

The revitalization of style is both a blessing and a challenge for managers.

Managers have been among the most vocal critics of the current classification schemes. At one point or another, many managers have been punished by the vagaries of style boxes or benchmarks. We believe that managers will welcome the opportunity to accurately portray their investment philosophy and be judged on how they add value relative to a truly comparable peer group or benchmark.

The challenge is that skill (or lack thereof) will be easier than ever to identify. Managers will not be able to take credit for performance resulting from a favorable market environment. Instead, with greater performance transparency, managers will be fairly judged based on the real value they add.

REQUIRED CAPABILITIES

Increased buyer sophistication creates a significant opportunity for managers to differentiate their capabilities, both in terms of quality and in product positioning. The ability to clearly define investment product philosophies using style footprints enables managers to set appropriate expectations, clearly explain the impact of their philosophy on investment performance, and validate sources of skill. The ability to clearly articulate those sources will provide significant competitive advantage.

Successful managers will be prepared, so that as these changes evolve they will be leading the change and educating the market. Strong product development, performance monitoring and sophisticated sales and client service professionals are all capabilities required for success.

Strong product development capabilities are essential to understand the specific product requirements of each market segment. With this knowledge, firms can focus on developing products and client relationships that have the

greatest affinity with a given investment philosophy. Also, products can be designed to meet the demands for style exposures, active risk, capitalization, and other attributes.

Systematic performance monitoring provides validation of the investment philosophy's effectiveness and helps assure style consistency. Leading managers will calculate their style footprint on an ongoing basis, using it to educate portfolio managers and sales professionals as well as clients. Ongoing attribution analysis provides proof statements showing the primary sources of value-added, and helps to explain periods of over or underperformance.

Sales and relationship management professionals should be able to represent the style footprint and attribution analysis to clients and prospects. Style transparency

Skill, or lack thereof, will be easier than ever to identify.

internalized in this way allows a range of professionals to correctly position a product, establish performance expectations, identify the sources of value-added and explain the impact of style biases. This is critical for managing client expectations, explaining performance, and creating consistent outward-looking "persona" for the firm. Building this knowledge also increases the credibility of the sales and client service professionals, helping to prevent investment managers from having to participate in every client or prospect meeting. During times of difficult relative performance, forward-thinking firms can better retain clients and assets, and even grow, because of greater performance transparency and better management of client expectations.

6. Conclusion

As the asset management industry matures, the classification of investment style is being transformed. Investors recognize that investment style has multiple dimensions and that it is a reflection of a manager's investment philosophy. Further, they understand that to effectively evaluate a manager's investment skill, the impact of style must be properly considered and disentangled from total performance.

Successful asset management firms will lead the way in the implementation of these changes. They recognize that the historic style box framework is becoming outmoded due to greater investor sophistication, advancing technology, and changes in buyer behavior. While conforming to the product demand of clients, these firms will seek to clearly document and communicate their investment philosophy to improve investors' understanding of the specific nuances of their investment style. Leaders will introduce the concept of a style footprint to improve their style and performance transparency and validate their sources of skill.

We strongly believe that the asset management industry can better serve itself and its clients by actively championing these enhancements.



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August 2001

**Style is dead. Long
live style!**

CQA specializes in providing merchant banking and strategic advisory services exclusively to the investment management industry. CQA delivers value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

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