

# Indexes Gone Wild

By: Ron Surz

Some wild things are happening to our favorite indexes this year:

- ✚ S&P shows domestic value stocks winning the performance race while Russell shows just the opposite, with growth outperforming value.
- ✚ Surz domestic indexes show the stuff in the middle going wild, with mid cap companies outperforming both large and small. At the same time, core companies, defined as neither value nor growth, have underperformed both value and growth.
- ✚ Outside the US, the EAFE (Europe Australia Far East) index has outstripped both S&P and Russell, but it has far underperformed the broad foreign market – the EAFE index has been easy to beat.

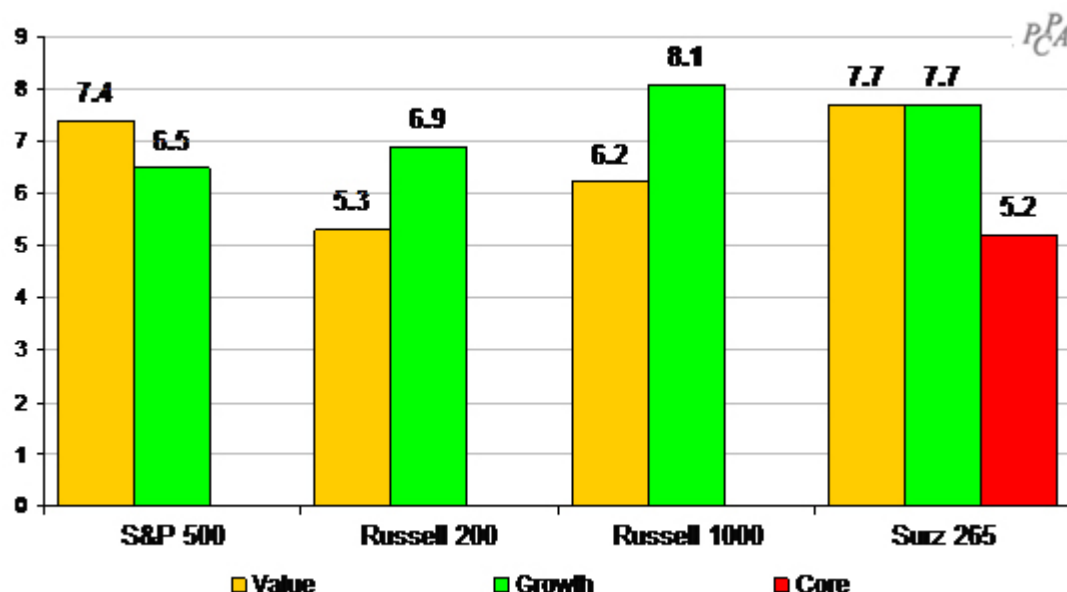
These are important considerations because we rely on these indexes to show us who is winning and losing. In the first half of 2007, our assessments of success or failure will rely very much on our choice of benchmarks.

## Name brands disagree in 1<sup>st</sup> half of 2007?

“It doesn’t matter which style indexes you use because they’re all about the same.” This statement is generally true, but not for the two most popular indexes, Russell and S&P, in the first half of 2007. The S&P large cap value index outperformed the Russell 200 value index by 210 basis points, and the Russell 200 growth index outperformed the S&P growth index by 40 basis points. Similar results are observed for the Russell 1000 indexes versus the S&P500. **In addition to the performance evaluation dilemma this creates for investors and consultants, investment managers will find that they have been rewarded or penalized for tracking one of these benchmarks.**

It’s very complicated. This type of discord, while infrequent, is explained by differences in methodology that can be best understood by considering how stocks in the gray area, between value and growth, are treated by S&P and Russell.

# Large Cap Style Index Returns Differ in the 1<sup>st</sup> Half of 2007



There are degrees of value and growth, so some growth stocks are more aggressive growth than others, and some value stocks are deeper value than others. And some stocks have characteristics that are not clearly value or growth – they’re the stuff in the middle. Russell deals with this issue by pro-rata allocating these fuzzy stocks into both value and growth. S&P ignores the problem altogether by drawing a hard line that divides half of the market’s value between value and growth.

A better way to deal with this medial stock issue is to define a separate classification called “core.” Surz indexes break out value, core, and growth stock groupings within each market cap by establishing an aggressiveness measure that combines dividend yield, price-to-earnings ratio, and price/book ratio. The top 40% (by count) of stocks in aggressiveness are designated as growth, while the bottom 40% are called value, with the 20% in the middle falling into core. The result is a family of indexes that are mutually exclusive and exhaustive, making them perfect for returns-based style

analysis. In the first half of 2007, large core performed substantially worse than both large value and large growth. The exhibit above contrasts 1<sup>st</sup> half style results for these three approaches and provides the explanation for the contradictions between S&P and Russell style returns – namely the S&P has more core in its growth index, while Russell has more core in its value index.

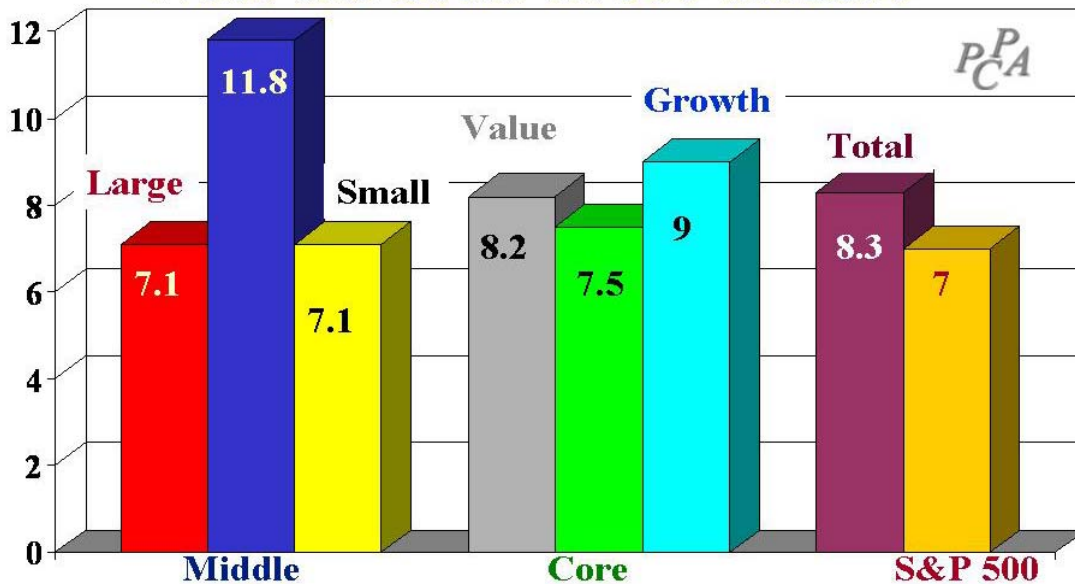
Core usually performs in between value and growth, but about a third of the time it does not, like the current year to date. **It is during these unusual times that the alternative to Russell and S&P provides conspicuously valuable insights.** Surz indexes have been around for 20 years, long enough to have stood the tests of time. A list of stocks classified as core is available upon request. Details of Surz index construction and behavior are available at [http://www.pcca-inc.com/SurzStyles/surz\\_styles.htm](http://www.pcca-inc.com/SurzStyles/surz_styles.htm) . We use a further breakout of these indexes in the next section.

### **Core and mid-cap are extreme – not in the middle as expected**

The next exhibit shows that the stuff in the middle has surprised so far this year. In this section we use styles for the total market, whereas we use large company versions of these styles in the previous section.

## Style Returns Through 6/30/07

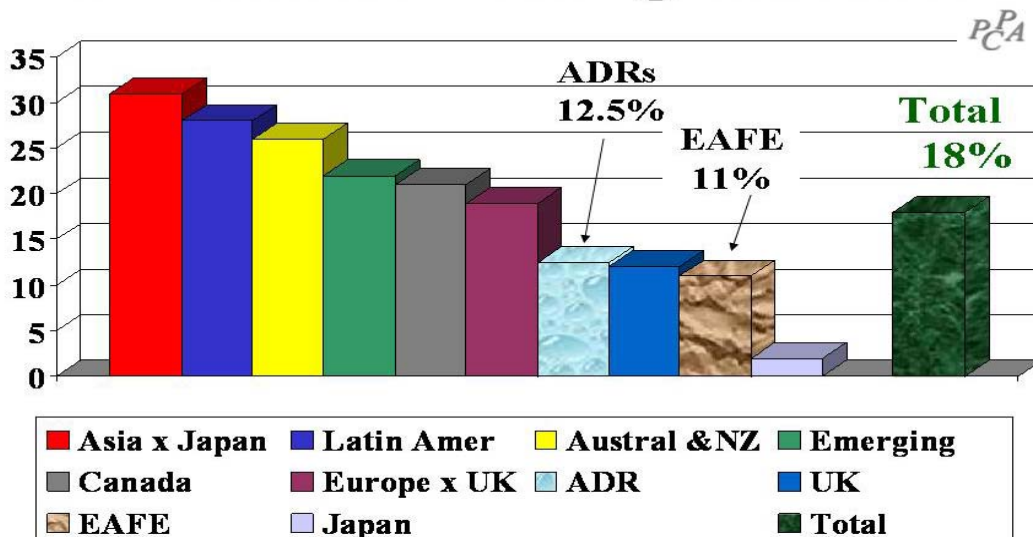
### Note the Stuff in the Middle



### EAFE has been easy to beat

Including some non-EAFE countries and companies in your portfolio has made a big difference this year. EAFE excludes some of the best performing countries in the world, and has generally underperformed where it has country exposure because smaller companies have fared best. The following chart puts foreign market performance into perspective.

## 1<sup>st</sup> Half 2007 Foreign Returns



As you can see, EAFE lags the total non-US market by 700 basis points. The ADR (American Depository Receipt) market has fared somewhat better than EAFE, but still lags the broad market by a substantial margin.

### **So what?**

We can't identify skill if we don't know who is winning and who is losing. A first half success against a Russell index can easily be a failure against a comparable S&P index. And a mid cap manager should shine, regardless of style, while a more style neutral, or core, manager should lag. Similarly, any non-EAFE exposure is likely to benefit foreign portfolios. So now that you're alerted to these current nuances you're better equipped to make the distinction between winners and losers. Success and failure are relative.

Ronald J. Surz is president of PPCA, Inc. in San Clemente, California and a Principal of RCG LLP. He is a pension consulting veteran, having started with A.G. Becker in the 1970's. Ron earned an MBA in Finance at the University of Chicago and an MS in Applied Mathematics at the University of Illinois, and holds a CIMA (Certified Investment Management Analyst) designation. He can be reached at [Ron@PPCA-Inc.com](mailto:Ron@PPCA-Inc.com) or (949)488-8339.