

Index Alert: Beware the Distortions Wreaked by the Crisis

Ron Surz January 12, 2009

"Nothing is so simple that it cannot be misunderstood" Gypsy Teague, Author

As we begin 2008 performance reviews we expect some heads will fly, and some deserve it, but we need to be especially careful this year about our judgments of success or failure. The economic crisis has wreaked havoc on style indexes, causing S&P and Russell to disagree, and distorting sector compositions, especially allocations to financial stocks.

Yes, it's true that a **loss** in excess of 30% might be judged a winner, but perhaps it should not. As usual, it depends on the style of the investment manager, but these are unusual times. The leading indexes are showing contradictory results. S&P shows Growth outperforming Value, while Russell shows just the opposite, Value outperforming Growth. The reason for this disagreement is that neither Russell nor S&P have Core, and this has distorted their results, so be forewarned.

Our definition of "Core" is the stuff in the middle, between Value and Growth. Our style definitions are mutually exclusive and exhaustive, making them excellent for style analyses, both returns-based and holdings-based. Core tends to shine when investors lack conviction, unsure about which style to emphasize. Large core has defended best in 2008, losing "only" 29%, versus 32% and 45% losses in large Value and large Growth, respectively. Any tilt toward Core should benefit performance, so aggressive Growth managers should do worse than typical Growth managers, and ordinary Value managers should do better than deep Value managers. It's easy to confuse style with skill but difficult to make good decisions once this mistake has been made. **Hues of Value and Growth matter a lot in 2008.** Comparisons and evaluations to off-the-shelf indexes only make sense for index huggers; for liberated managers we need to customize the benchmark by blending styles that are mutually exclusive and exhaustive.

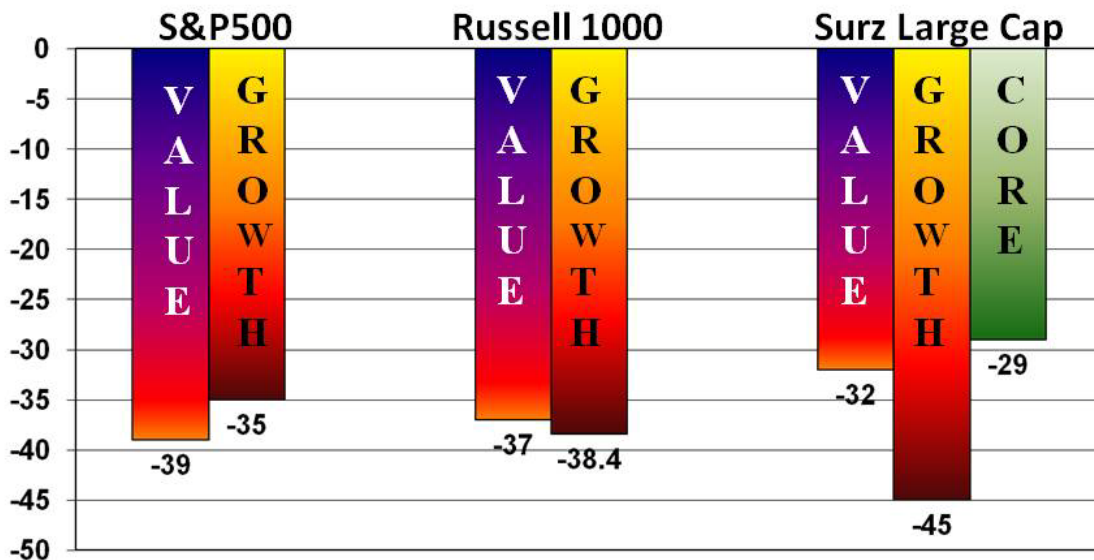
Also, peer group classification biases should be particularly pronounced in 2008 performance rankings, with most Value managers outperforming their indexes and most Growth managers trailing their indexes. This is not skill, or lack thereof. It is style.

2008 Style Quandary

Demonstrates The Importance of Core



The Market Structure Puzzle: Core is the stuff in the middle, in between value and growth

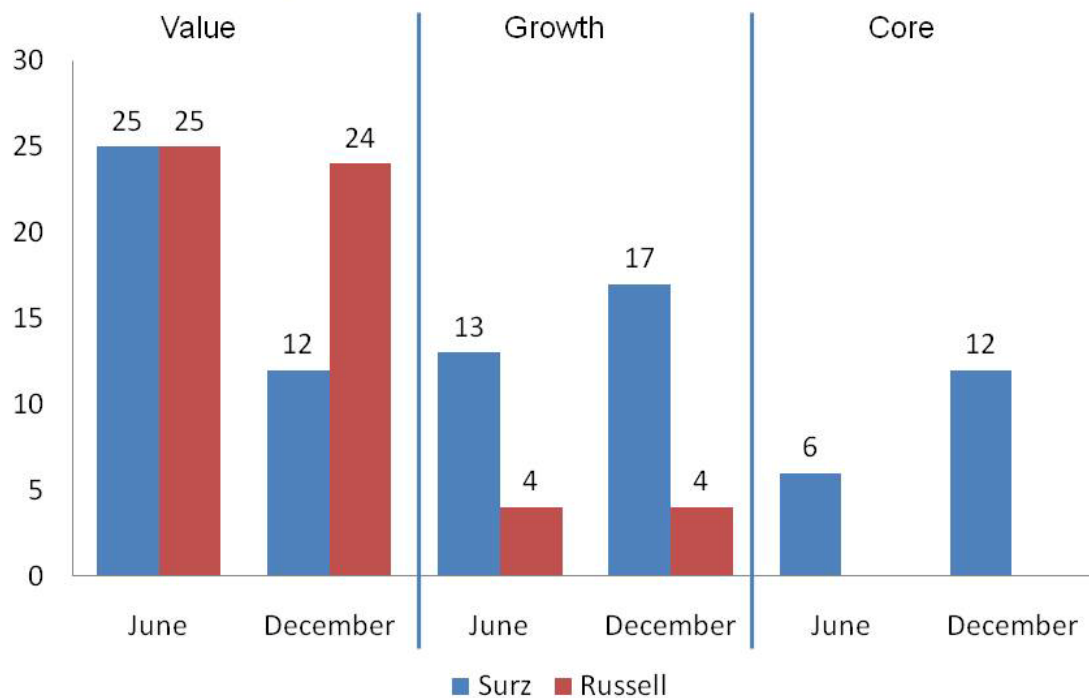


A related challenge in this year's performance reviews is the classification of Financial stocks, which have been decimated by the crisis, especially in the last half of the year. While these stocks have suffered price reductions, their earnings have also plummeted, and in many cases Price/Earnings ratios have increased substantially as a result. Many Financial stocks have morphed from Value stocks to Growth stocks in the second half of the year, but this fact is not recognized by the Russell indexes because they are rebalanced only once a year, in June. By contrast, Surz style classifications are reset quarterly.

The following graph demonstrates the impact of the shifting profiles of Financial stocks. In mid year 2008, Financials represented 25% of the Surz large Value index, but this percentage decreased by more than half to 12% by year end. By contrast, the Russell

large Value index maintained roughly the same 25% weight in Financials throughout the second half of 2008. Where did Financials move to in the Surz classifications? To Core and Growth. In the same timeframe, the Financial component of the Russell Growth indexes has remained level at 4%, rather than increasing. Similar peculiarities can be found in the Health Care and Industrial sectors, and to a lesser extent with S&P's sector allocations.

Finance Component of Surz & Russell Large Company Style Indexes



Why does this Financial allocation matter? Index huggers will have kept their sector allocations in line with the Russell indexes, with the consequent impact on performance, namely worse Value performance and better Growth performance than a liberated non-index-hugger. **Performance reviewers should be careful to understand these differences, and to attribute success or failure accordingly.** Complicated? You bet, but these are extremely complex times.