Is the Style Box Obsolete?

Morningstar's trademarked style box diagram is often used to compare funds.

Since its introduction in 1992, the style box has been a popular way of categorizing and describing companies, funds, and portfolios by market capitalization and the style category within which they fall. The most well-known investment styles are value and growth; the above Morningstar style box provides the construct for each style and sub-style through its horizontal scale. A value investment involves buying companies that trade at a low price to underlying book value or earnings, while a growth approach involves purchasing companies with a high price to book value or earnings growth. Lynx believes a simple style box analysis falls short in several ways and this paper will explain why we are not in favor of exclusively using the traditional style box approach as a categorization method. Our arguments against this approach include the fundamental sector biases of value and growth styles, and that a focus on allocation by style box leads to inferior investment manager selection and elevated costs.

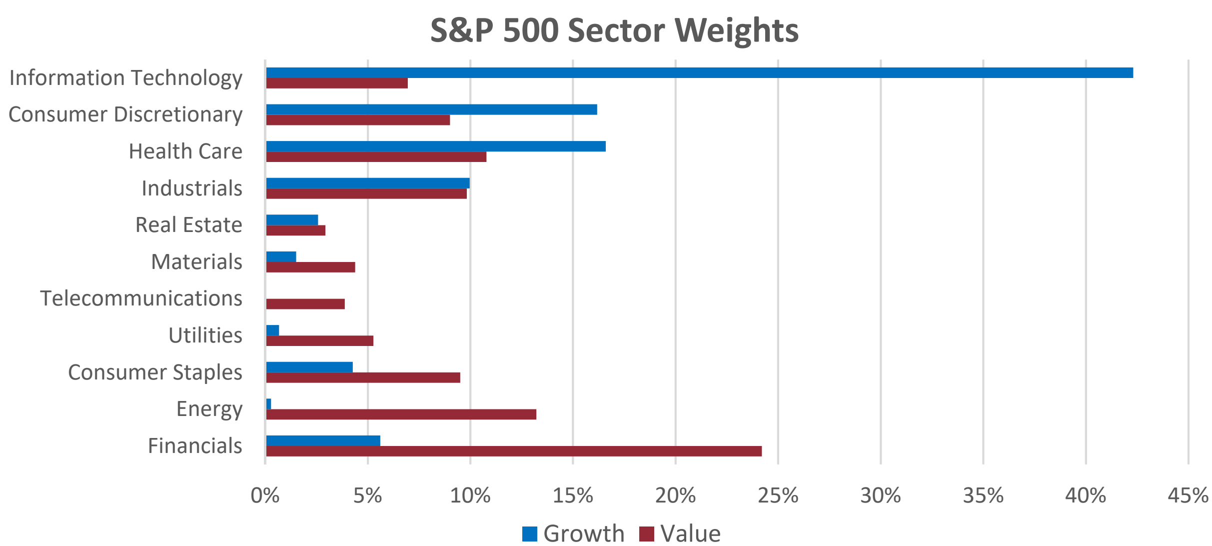
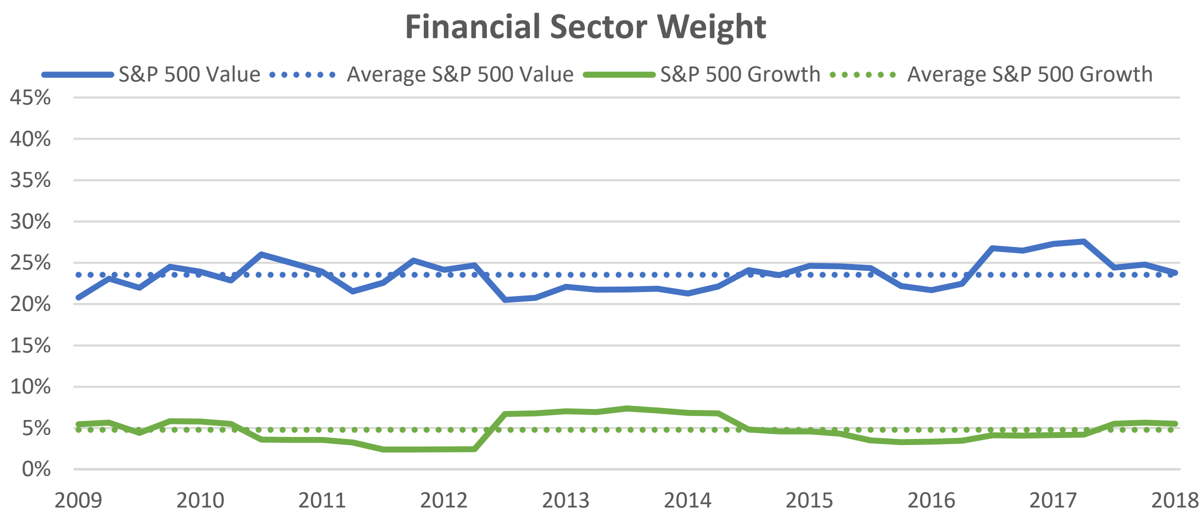


Figure 1: Value and growth styles have strong sector biases

Figure 1 above demonstrates that in terms of sectors, a fund or portfolio with a greater allocation to growth or value results in systematic sector biases relative to a broad market benchmark. The largest differences between the S&P 500 Growth and S&P 500 Value indices are their weights to Information Technology, Financials, Energy, and Consumer Discretionary sectors.



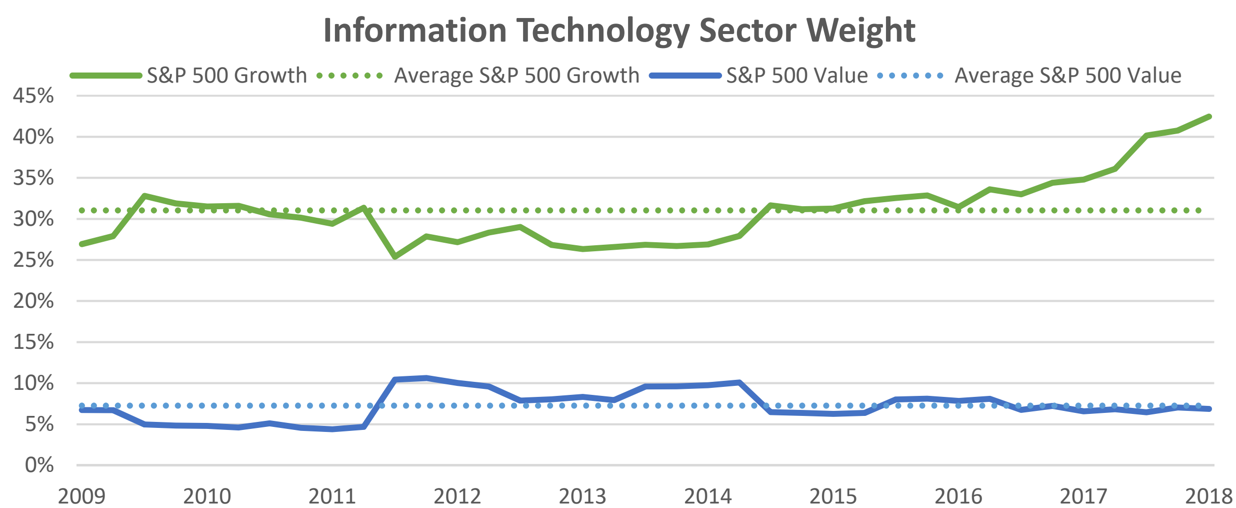


Figure 2: Relative sector bias is persistent across time

As shown in *Figure 2* above, the sector biases of growth and value have persisted throughout the years and are an important consideration which a style box analysis can obscure.

Since the financial crisis, a small handful of Information Technology firms have driven high returns for growth funds, while the low oil price and interest rate environment has led to the Financial and Energy sectors serving as relative laggards. As shown in *Figure 3* below, the relative performance of growth and value tends to occur in cycles lasting for several years. However, both growth and value have outperformed and underperformed during bull and bear markets generally, making connections between these styles and the business cycle difficult.

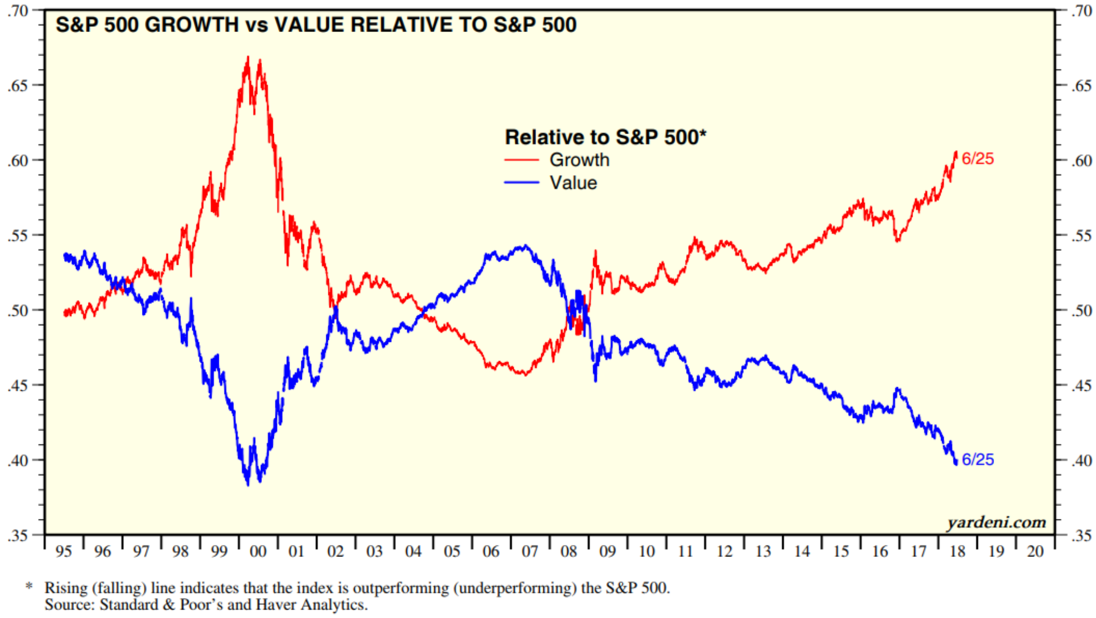


Figure 3: Growth and value styles tend to outperform in cycles lasting several years

Our final argument relates to manager selection and diversification across styles. Mangers who hold a relatively concentrated portfolio of a few dozen stocks at most and are not fixed to a given investment style box are more likely to add value over a complete market cycle. A necessity to 'check the box' by selecting a manger for each style results in overlooking many high quality concentrated managers whose investment strategy is not accurately described by the style box approach.

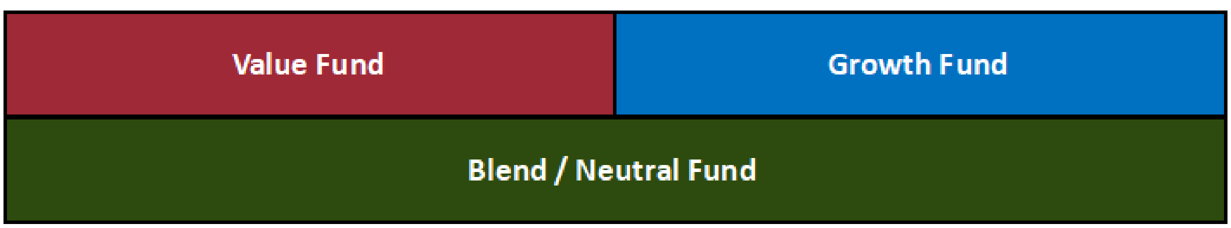


Figure 4: Value and growth style funds combined hold the same stocks as a single blend fund

A portfolio building approach focused on diversification across style boxes involves selecting an investment manager that falls within each box, such as large-cap value, large-cap blend, and large-cap growth. By selecting funds of opposing value and growth styles, the blended portfolio (also called "neutral index" on the above Morningstar chat), is equivalent to simply selecting a single blended/neutral total market fund. Moreover, specialized value and growth style funds typically have higher expense ratios than blended funds for both active and passive approaches. Thus, an investor who owns both style funds is essentially paying additional fees for the same exposure.

In conclusion, a focus on diversification through style box analysis obscures the underlying sector biases inherent to value and growth tilts and leads to inferior investment manager selection with higher costs for the same resulting portfolio. We believe the evaluation of investments and portfolio construction should take a holistic view to understand the risk factors underlying a portfolio rather than the simplistic and potentially misleading style box approach.

Paper Sources: S&P U.S Style Indices Methodology, Bloomberg Terminal Service, Yardeni Research