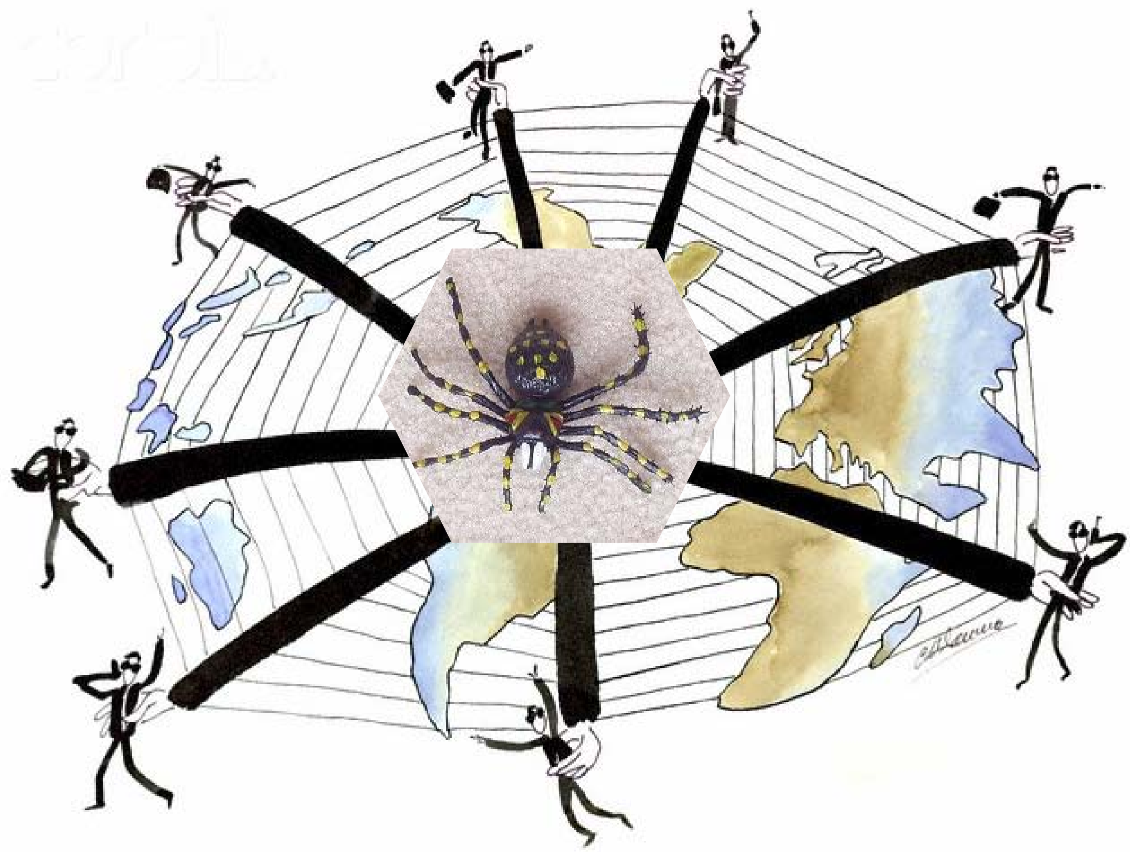
# Rescue Your Investment Managers From the SPDRs Web



The S&P as Core reduces the value added by active managers because it dilutes their decisions. The S&P contains value & growth stocks that active managers don't want to hold.

The new Centric non-dilutive Core complements active managers with stocks they're not authorized to hold, namely the stocks in between value and growth.

Adding 20% in Centric Core to a typical managed money program improves diversification by as much as adding 80% in the S&P500.

# Refining Core-Satellite Investing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Ron Surz   President PPCA Inc   Ron@PPCA-Inc.com   949/488-8339



*Centric core completes a Unified Managed Account (UMA) platform, filling in a void, and it frequently performs differently than both value and growth, similar to the way mid-cap performs differently than large and small. Traditional core-satellite investing uses a version of core that overlaps the satellite managers, diluting their decisions. By contrast, a centric core that is in between value and growth complements the satellites, and delivers the same diversification as traditional core with about one-fourth the allocation.*


Investors have a renewed interest in portfolio construction, due in large part to the current crisis, so core-satellite investing is regaining popularity. Both Vanguard and Putnam recently announced the addition of "core" products to their suite of funds. So why the interest in core? It could be for either of two reasons.

## Ballast or Completeness?

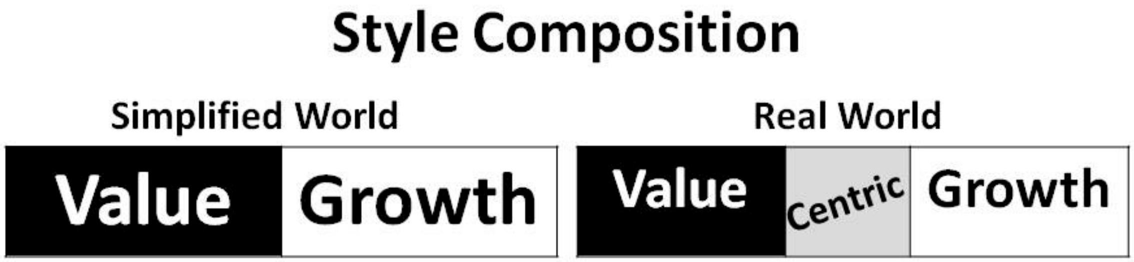
Some view core investing as a hedge against making active manager mistakes; core is ballast to keep the investment ship steady. The best core for this purpose is the entire market, like the Wilshire 5000, although the most popular choice is the S&P500. The intention is to dilute the active managers because the investor lacks confidence in them. In this context core is a compromise for those who are on the fence about the active-passive decision. Add some cheap passive core to the expensive active manager mix to simultaneously lower costs and guard against the risks of surprises by reducing the tracking error relative to the broad market. The amount in core is a reflection of the lack of confidence in the active manager roster and structure.  The more in core, the more market-like the performance. **Allocation to ballast core is a confidence barometer.**

By contrast, the original core idea was to diversify while simultaneously encouraging active managers to give it their best shot. The original core concept emerged from confidence in active managers, rather than concern about making mistakes, so it was a completeness fund that complemented active value and growth managers by adding what they are not – the absence of value & growth. The absence of value or growth is the stuff in the middle that neither value nor growth managers hold. "Core" in this context means "center." This provides license for the active managers to be undiversified, concentrating in their areas of expertise. This concept, introduced in the 1980s, gave way to style-based equity specialists and has evolved into an insistence on style purity today. There is a premium placed on adherence to style, and a corresponding necessity to fill in the void left in the middle between value and growth.

Both the hedge and the completeness versions of core improve diversification, but with different motivations related to confidence in active management. In this article we address the application of core for completeness, which was the original intention. The definitions of "core" are: center, heart or hub. Because it encompasses most of the market, the S&P meets none of these definitions. The good news is that there is an efficient completeness core, and it's easy to understand why it works best in diversifying portfolios of multiple active managers. The S&P500 and other broad market surrogates may make good ballast for those who are concerned about their active manager decisions, but we need something more specialized when it comes to completing allocations to real talent. **Allocation to completeness core is derived from the overlap among the active managers.**

## Welcome to the real world

Adherence to a style requires a definition of that style. Although there is disagreement on the specifics of style classifications, most concur that the real world is not black and white, with all value stocks clearly differentiable from all growth stocks. As shown in the graph below, there are stocks that are in a gray area, having characteristics of both value and growth; these are the "fuzzy" stocks, or the stocks in the middle that I call "Centric."




"Centric" stocks are assigned to both value and growth by Russell, MSCI and others. These index providers apportion the weight of a centric stock between the two styles. S&P ignores centric in their traditional indexes, but acknowledges it in their "Pure" indexes. PPCA maintains separate Surz Style Pure® Centric indexes for large, middle and small-sized companies. Centric is what should be used in completeness investing.

## New and improved completeness core

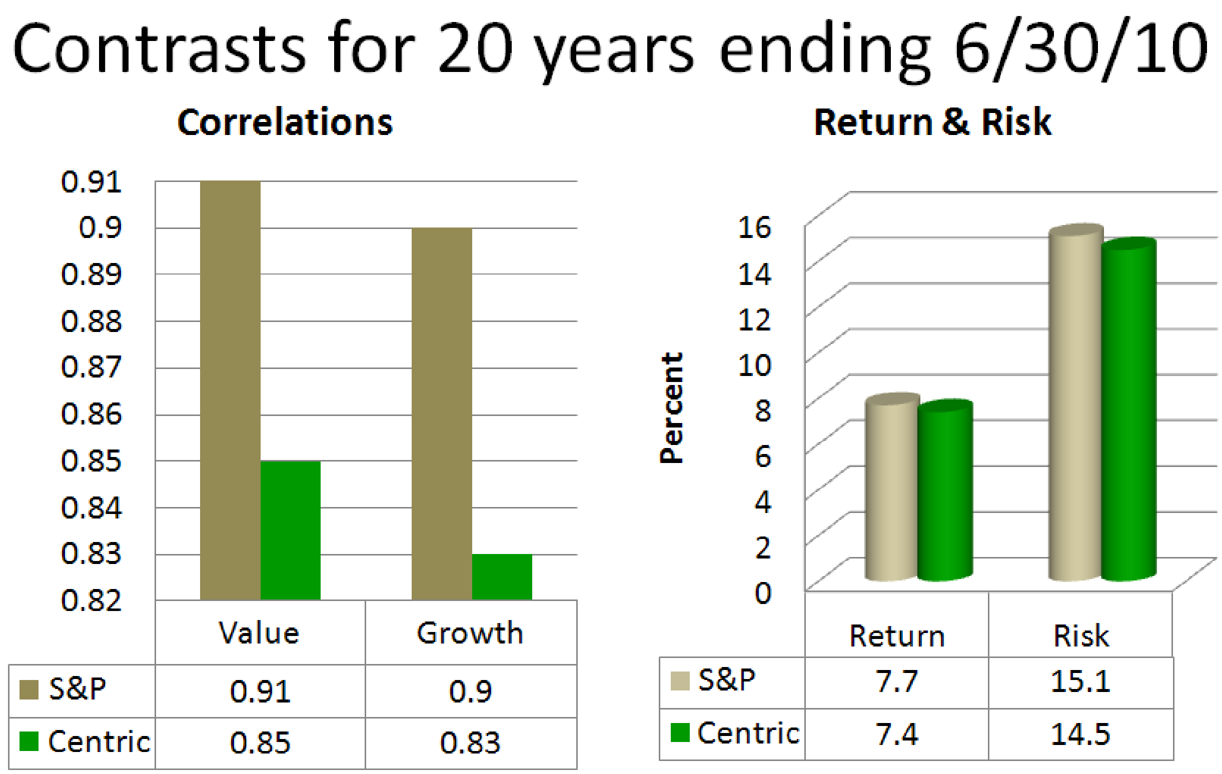
The S&P as core dilutes the decisions of the satellite value and growth managers because it includes value and growth, as well as centric. You can see this problem for yourself by using an asset allocation optimizer. For example, returns-based style analysis can be used to solve for allocations to an active-passive team of managers. Ask the optimizer to solve for the blend of managers that best tracks the Wilshire 5000. If the passive core is the S&P500, the optimizer will ask for 80% in the S&P, whereas it will settle for only 20% in centric; the same diversification with less passive core. Less core is more if you believe your active managers will add value.  If you don't believe they'll add value you're better off all passive. Why does the optimizer want so much S&P? It wants the centric part of the S&P but has to take the whole package in order to get the centric. You have to buy the entire Oreo cookie to get the sweet center.

In a similar vein, research conducted by Dr Frank Sortino of the Pension Research Institute and Sortino Investment Management indicates that allocations to active value and growth managers systematically underweight the middle of the market, i.e. centric. For more details see [Sortino, 2010] and [Surz, 2007].This is understandable in light of the scrutiny that most managers are under to maintain style purity. Managers are incented to sell companies that drift toward the middle, away from their declared style. The result is an unintended bet in multiple manager portfolios away from centric. This is a diversification mistake.

This is an easy mistake to remedy: add centric. Our definition of centric is the 20% in the middle – it's 20% of the market. It's a simple matter to merge the current managers with a model centric core to constitute 20% of equity holdings. Sometimes the simplest solutions are the most elegant. And this list is only 45 stocks, so it's easy to implement. The constituents of the current Surz Style Pure® large cap centric core index are provided in the Appendix.

## Evidence

In summary, Centric is a better complement to active value and growth managers because (1) it does not dilute active manager decisions and (2) it fills a large company centric void in most multiple manager programs. The following graph provides statistical evidence to support these assertions. The measure of a good diversification complement is low correlation. Centric is substantially less correlated to value and growth stocks than is the S&P500. Also, Centric has about the same return and risk as the S&P, so filling the void does not sacrifice performance or increase risk vis-à-vis the S&P.




Research conducted by PPCA, my company, confirms the obvious. If the active managers in a core-satellite structure add value, a centric core approach delivers better returns than an all-market core approach like the S&P500, and both approaches have about the same diversification and risk, as measured by R-squared to a broad market index and standard deviation. If the managers don't add value, the dilutive approach benefits performance. So the difference is dependent on active management performance.

We also find that allocating less than the optimized 80% to the S&P500 increases tracking error relative to the broad market; allocating 20% to the centric core provides better diversification than allocating less than 80% to the S&P. Less than 80% in the S&P compromises diversification although the dilution of active managers is also reduced.

The reader can readily confirm these findings. The S&P500 returns are ubiquitous and the Surz Centric Core returns are available on most research platforms, like Zephyr, MPI, PerTrac, Factset, etc. And if your service bureau does not carry the Centric Core series it can readily be downloaded from [http://www.ppca-inc.com/Downloads/surz.xls](http://www.ppca-inc.com/Downloads/surz.xls)

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## References

Sortino, Frank. ***The Sortino Framework for Constructing Portfolios***. Elsevier 2010

Surz, Ronald. "Getting to the Core of Model Portfolios", PPCA White Paper, April 2007

**Appendix:** Q3, 2010 Centric Core composition (Values are Capitalization in $Billions)

| | | | | | |
|---|---|---|---|---|---|
| ADP | 20.25 | AUTOMC DATA | MET | 30.98 | METLIFE INC |
| AMGN | 50.39 | AMGEN INC | MOS | 17.36 | MOSAIC CO |
| APA | 28.44 | APACHE CP | MRO | 22.04 | MARATHON |
| AVP | 11.37 | AVON PRODS | NSC | 19.56 | NORFOLK SO |
| AXP | 47.72 | AM EXPRESS | NTRS | 11.31 | NOR TRUST |
| BAX | 24.3 | BAXTER INTL | OXY | 62.66 | OCCID PETE |
| BDX | 15.78 | BECTON DICK | PEP | 97.09 | PEPSICO INC |
| BIIB | 11.48 | BIOGEN IDEC | PG | 172.74 | PROCTR & GM |
| BLK | 27.37 | BLACKROCK | PX | 23.25 | PRAXAIR INC |
| CL | 38.63 | COLGATE-PAL | QCOM | 52.84 | QUALCOMM IN |
| CMCS | 49.01 | COMCAST | RIMM | 27.14 | RSH IN MTN |
| CNI | 26.7 | CDN NATL RY | SPLS | 13.9 | STAPLES INC |
| COV | 20.13 | COVIDIEN PL | TGT | 36.33 | TARGET CORP |
| CPB | 12.11 | CAMPBL SOUP | TJX | 17.11 | TJX COS |
| CSX | 18.84 | CSX CORP | TROW | 11.42 | PRICE GROUP |
| DVN | 27.22 | DEVON ENRGY | TYC | 16.75 | TYCO INTL |
| EBAY | 25.73 | EBAY INC | UBS | 50.14 | UBS AG |
| EMR | 32.91 | EMERSON EL | UNP | 34.74 | UNION PAC |
| GILD | 30.92 | GILEAD SCI | UPS | 56.44 | UTD PARCEL |
| GIS | 23.32 | GEN MILLS | UTX | 60.31 | UTD TECHS |
| HD | 47.33 | HOME DEPOT | VIA. | 19.06 | VIACOM INC |
| HPQ | 101.49 | HEWLETT-PCK | VZ | 79.21 | VERIZON COM |
| JCI | 18.08 | JOHNSN CNTL | XRX | 11.12 | XEROX CP |
| K | 19.01 | KELLOGG CO | YUM | 18.23 | YUM BRANDS |
| LOW | 29.47 | LOWE'S COS | | | |

# Surz Centric Core Index

## Index Overview

### Objective

Centric Core completes a Unified Managed Account (UMA) platform, filling in a void, and it frequently performs differently than both value and growth, similar to the way mid-cap performs differently than large and small. Traditional core-satellite investing uses a version of core that overlaps the satellite managers, diluting their decisions. By contrast, a centric core that is in between value and growth complements the satellites, and delivers the same diversification as traditional core with about one-fourth the allocation.

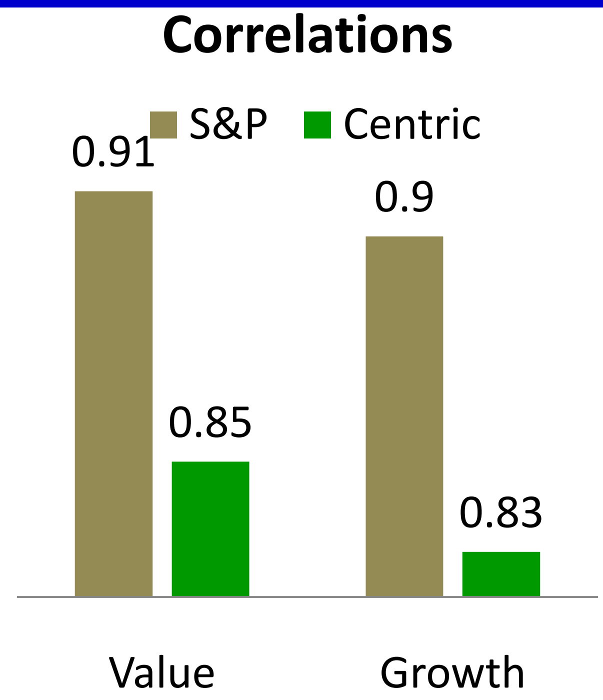
### Suitability

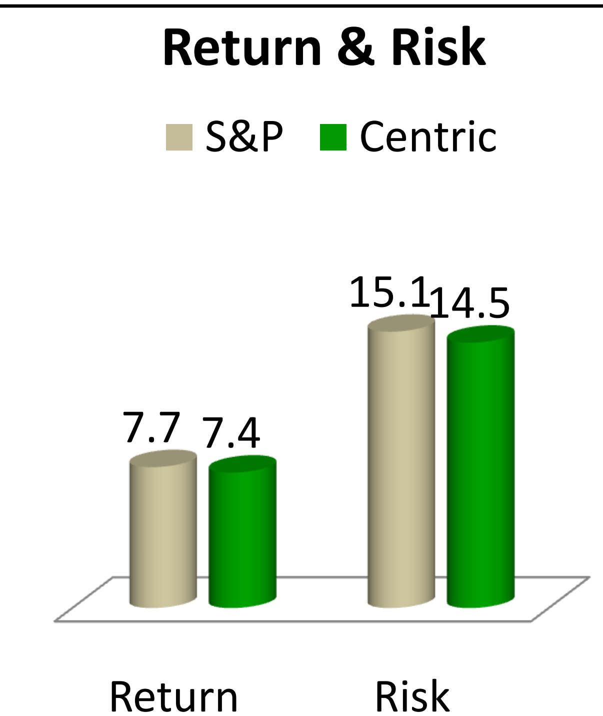
Active-passive portfolio structures, especially core-satellite domestic portfolios, should consider Centric Core as an alternative to the traditional S&P500. Centric Core is suitable for those who have confidence in their active managers and who do not want to dilute (dampen) their active stock selections. It is a completeness fund.

### Composition

Centric Core is derived from the Surz Style Pure® Large Cap Core index which classifies large companies as the top 65% of the Compustat database (generally about 250 stocks with capitalizations above $12 Billion). Then a value classification combines earnings yield, dividend yield and normalized book/price. The 20% in the middle is Core. Centric Core modifies this index to (1) control turnover and (2) execute a hybrid weighting scheme that tracks the industry profile of the broad market and equal weights stocks within industry sectors. Centric Core is rebalanced quarterly.

## 20 year Performance History




Backtests use monthly returns. Centric core is rebalanced quarterly. Past performance is not an indicator of future performance.