# Update on Style Classifications of Financial Stocks: Q1/2012

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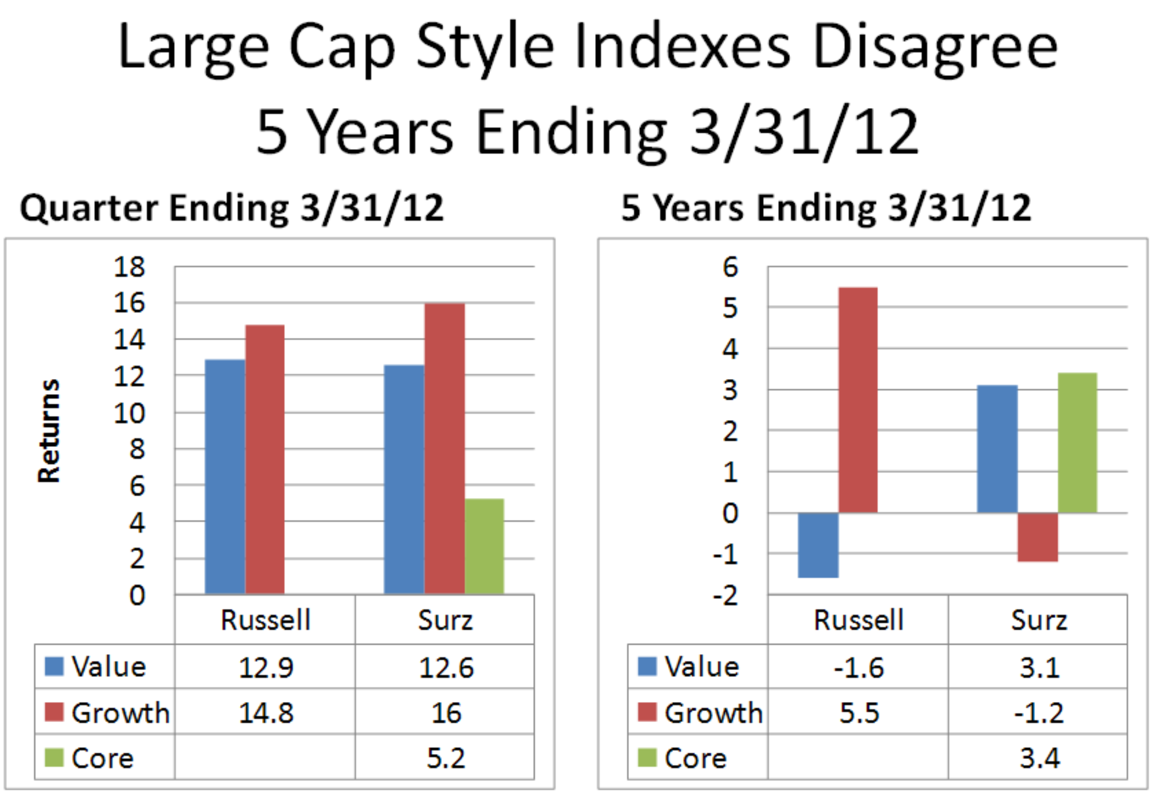
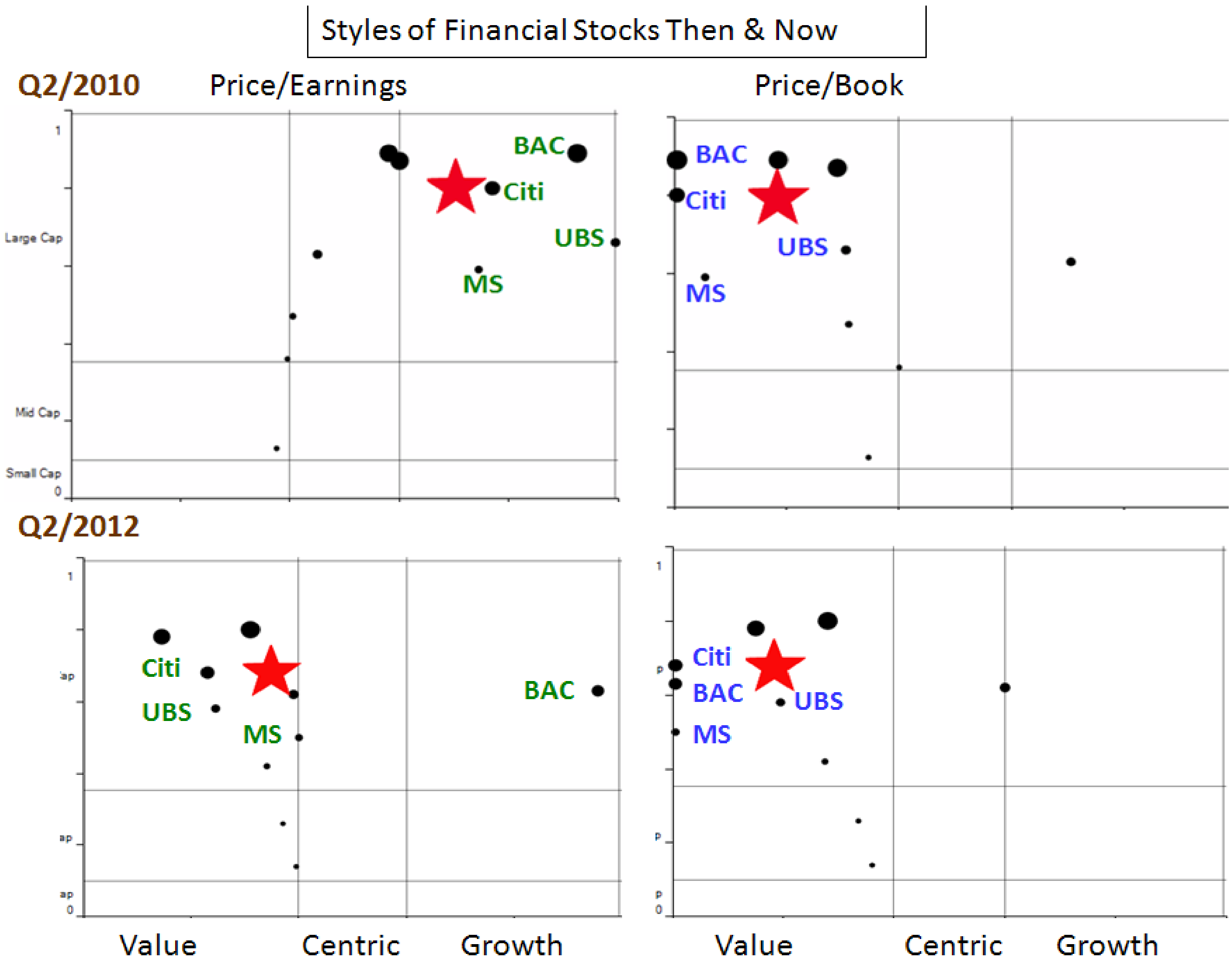
Three years ago I started writing about the big disagreement in the style classification of fallen financials. Indexes that use Price/Book as the classification variable, like Russell, view these stocks as value while my Surz Style Pure® classification scheme sees these same stocks as growth because I use Price/Earnings. I defended my position by noting that the book values of these fallen financials are overstated because they have not been fully adjusted for bad debts.

Depending on where your view is regarding the recession, growth should lead value or vise versa. The idea is that during a recession, safety and therefore value is in favor. Then as we recover, growth leads the way. When did the recession really end, or has it?

A lot has happened in the past 3 years, including movement toward agreement. Surz Style Pure classifications agreed with Russell prior to the 2008 meltdown, and then disagreed in 2008 through 2011, and now they agree again. We disagreed primarily because of financials, but now the Price/Earnings ratios of many of these stocks place them into the Surz value style again, in concert with Russell.



As shown in the following style map which uses [Style Scan]() Russell and Surz classifications have migrated to agreement, primarily because the prices of the fallen financials have declined.




Despite the current agreement, the history of disagreement remains in the performance results forever. So why do you care? Investment managers are evaluated relative to their styles. In most market environments it doesn't matter much whose style definition you use, but that has not been the case in this financial crisis. Accordingly, a fair evaluation needs to address the proper classification of distressed financials. Now you know, so you can decide which reality you like best, placing branding aside.

# More to think about

Despite their popularity, the Russell indexes might not be your best choice. As stated above, reliance on Price/Book as the style classification variable has led to questionable style assignments recently. In addition there are two other construction rules that could be better: (1) A third of the stocks and a third of the dollars are in both value and growth so the Russell style indexes overlap in membership and are not mutually exclusive, and (2) Indexes are rebalanced annually, despite frequent changes in the true style of many stocks.  By contrast, Surz Style Pure indexes are mutually exclusive and exhaustive, and rebalanced quarterly.

**Overlapping membership**

Classifying stocks as both value and growth creates a statistical problem in returns-based style analysis called "multicollinearity" which overstates the goodness of fit $R^2$ and can lead to spurious (erroneous) style profiles. Dr. William F. Sharpe in his seminal article that introduced returns-based style analysis recommends that the regression indexes should be mutually exclusive an exhaustive.

In addition to returns-based style analysis, holdings-based style analysis is also complicated by the overlap since you need to either classify the overlapping stocks as "blend" or force them into either value or growth.

**Annual rebalancing**

Unlike sector classification, styles of individual stocks change through time – value today, growth tomorrow. And it usually happens when it happens, rather than on June 30 when Russell rebalances. It is comical to watch the Surz Style Pure profiles of index huggers as value manages drift into growth and leap back into value each June. The real world doesn't adjust each June.