Ron Surz has been a leader in building better style indices. So why isn't he famous?

A Style All His Own

By James Picerno

THERE CAN NEVER BE TOO MANY CHOICES WHEN IT COMES TO investment indices, judging by the insatiable appetite for new financial metrics and related products. Witness the bull market in investable indices, for instance, evidenced by Wall Street's fondness for launching exchange-traded funds in recent years.

The ever-lengthening list of indices may qualify as progress, but no one ever said evolution in finance was transparent and uncomplicated. Since the launch in 1896 of the Dow Jones Industrials—the world's first equity index—the inventory has grown to the point where selecting and analyzing benchmarks is a profession unto itself. Charles Dow would no doubt be proud of how far his creation has come. Yet indexing's originator would need a consultant in the 21st century when it comes to sorting through indices for money management and related analytics.

The task is especially thorny when it comes to style analysis. There are, of course, several established sets of style indices available from the usual suspects, such as Standard & Poor's and Frank Russell Company. But ubiquity and quality aren't necessarily synonymous in the world of indexing, argues Ron Surz, president and founder of PPCA Inc. (ppca-inc.com), a San Clemente, Calif. consultancy that offers its own suite of portfolio evaluation tools and proprietary indices.

PPCA's chief is a man on a mission to convince the world that his benchmarks are the enlightened alternative for analyzing money managers. In fact, he's a veteran in this role, albeit a somewhat frustrated veteran. Although his indices were launched in 1992, they still suffer a low profile in an industry dominated by corporate behemoths. Nonetheless, Surz insists his benchmarks have an important edge in analysis over most of the competition. The reason: The Surz Style Indices fully embrace the advice of the Nobel Laureate who first proposed style analysis 18 years ago.

Professor William Sharpe, who shared a Nobel Prize for his work on developing the Capital Asset Pricing Model, laid out the theory for returns-based style analysis in a 1988 paper. The strategy calls for evaluating, say, a mutual fund's returns by regressing performance against various indices for determining what's driving the portfolio's returns. In essence, style analysis is a quick, dependable method of x-raying a portfolio's history.

For example, by running a returns-based style analysis on an actively managed large-cap U.S. stock fund, one might learn that the benchmark-beating results came primarily from loading up on small-cap companies. There's nothing wrong with that, unless the fund manager is promising superior big-cap stock selection. If so, besting large-cap indices, like the S&P 500, by surreptitiously owning small-cap companies is disingenuous, to say the least.

Style analysis can act as a statistical policeman by uncovering the true nature of a fund's strategy and, perhaps, revealing that the performance history is less impressive than it appears.

So it goes in the world of analyzing managers. The quest for bonafide apples-to-apples comparisons is the bane of analysts who are forever trying to separate alpha's wheat from beta's chaff. Talent, after all, isn't easily defined, and is less than obvious when poring over performance numbers out of context. No wonder, then, that returns-based style analysis has proven so popular. Among its selling points: manager participation not required.

Since Sharpe's paper was published in the *Investment Management Review* in 1988, the advisory community has embraced his technique because it provides a degree of on-the-fly transparency for evaluations. Holdings-based analysis is said to be superior, but getting fresh portfolio updates on the actual securities is problematic, particularly in the secretive world of hedge funds. Even that realm is being cracked by more innovative applications of style analysis, including evaluations by Markov Processes International, a Summit, N.J. software firm specializing in investment analytics.

In fact, a variety of software products catering to returns-based analysis are available—Zephyr StyleAdvisor and Ibbotson Associates' EnCorr Attribution, to name two more. Sharpe's theory, in short, has long been transformed into practical application.

But style analysis is too often less than what it could be, charges Surz, who holds an MBA in finance and an MS in applied mathematics from the University of Chicago and University of Illinois, respectively. The critical issue is choosing the right indices for analysis.

As advice goes in investment analytics, few disagree with Surz's counsel. "Using different indices can give you different results," says Paul Kaplan, the vice president of quantitative research at Morningstar, Ibbotson's corporate parent.

So, how does one define the "right" indices? For returns-based style analysis, the answer starts by considering Sharpe's call for mutually exclusive and exhaustive benchmarks. But not every index shines by this standard, Surz reminds. Thus the raison d'être for rolling out his own benchmarks, which are available gratis from PPCA and also in some software products, such as Ibbotson's EnCorr.

Kaplan agrees: "You can argue that any set of indices that are mutually exclusive and exhaustive are better than any set that aren't."

Such thinking gives Surz ammunition for questioning the leading index vendors. "If you've read Sharpe's article," he asserts, "you'll see that he clearly lays out how the so-called style palette

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ought to be constructed. The operative rules [for indices] are mutually exclusive and exhaustive." Surz goes on to note that there's a "strong statistical reason" for that. "If the indices aren't mutually exclusive, it creates a problem called multicollinearity," which is essentially one of redundancy: one index providing similar, if not identical, information.

For example, consider two indices that measure value and growth stocks by dividing the universe into two camps, but on a non-exclusive basis. That's a problem because overlap (a portion of companies show up in both indices) distorts the analysis compared with using style indices that don't overlap. Unfortunately, overlap in style indices isn't unknown, although there's a seemingly good argument for the practice. Many stocks share growth and value attributes. As a result, tolerating dualism in labeling stocks introduces the proverbial gray area, but at a price: double counting.

The Frank Russell Company's growth and value indices allow overlap by roughly one-third, measured by number of securities as well as by dollar value, says Surz. "A third of the companies wind up in both the value and growth benchmarks. That means that you have the statistical problem of multicollinearity if you use the Russell indices in your style analysis." And that introduces "erroneous style profiles because the indices don't meet the criteria set out by the guy who developed the idea," he continues. "That's like writing down instructions to build the world's best car, and then decide on substituting a different carburetor. The car's not going to run the way it was designed to run."

The good news is that the major index vendors are aware of the problem. Indeed, there have been efforts of late to fix the glitch. The bad news: Some solutions trade one problem for another.

The new style indices from Standard & Poor's solve part of the problem, Surz says. But progress isn't perfect. The mutually exclusive challenge is resolved, but the solution comes at the expense of introducing another glitch. "If you were to just use S&P's Style and Pure Style indices, you'd be well served in the mutually exclusive area," he explains. "But you won't meet the exhaustive criteria because the indices throw out the stuff in the middle...stocks with healthy doses of both value and growth attributes. And since S&P doesn't offer a core index, the middle slice of the equity market is lost as it relates to the new style indices."

At the very least, investors should know their indices—warts and all. Indeed, some indices aren't necessarily designed for style analysis. Some benchmarks are crafted with investability in mind, and fulfilling specific niches that may or may not satisfy the rigors of analytical needs.

But for anyone interested in returns-based style analysis, "the stuff in the middle is important," Surz counsels. He emphasizes that the core should be treated as a distinct asset class and made available for returns-based style analysis. In fact, the Surz Style Indices do just that.

The reason for having a dedicated core index is that the middle can and does exhibit different performance results from value and growth at times, even if it contains stocks that don't obviously fit into either the growth or value buckets. Accordingly, ignoring core can introduce a number of risks when analyzing returns. For example, he points out that in 2005's second quarter, core stocks fell by 0.2 percent as per Surz Style Indices. Meanwhile, value and growth stocks each were up by more than 2 percent during that span. Overall, core stocks go their own way about one-third of the time, he says, and so overlooking the equities in returns-based style analysis could deliver misleading results.

Therein lies another selling point for Surz's indices. His large-, mid- and small-cap indices are at once mutually exclusive when it comes to the value and growth benchmarks, and exhaustive by including all stocks by way of core indices. "I don't throw out any companies," he says.

But while Surz insists that using a non-overlapping core index to augment the value and growth sides is the unquestionably superior choice, there is a catch—or so says Morningstar's Kaplan, who opines that isolating core stocks is "debatable" when it comes to returns-based style analysis. Kaplan agrees that using a core index improves the ability to analyze portfolios, but he points out that adding a core also increases, if only slightly, the chance for multicollinearity.

Surz disagrees, countering the point by explaining that "the notion of multicollinearity is that you have overlap in the composition of the indices." Since the Surz indices are mutually exclusive, adding a core doesn't increase multicollinearity, he concludes. "Multicollinearity should not happen at all with my version of core."

To be sure, Russell, S&P and the other major index vendors aren't exactly worried. Meanwhile, Morningstar stole much of Surz's thunder in 2002 by introducing what he says is the only other set of mutually exclusive, exhaustive style indices. But while Surz's benchmarks have continued to remain primarily a tool for his 22 clients, by way of his own analytical software that uses the Surz Style Indices, the Morningstar indices have gone on to become the foundation for exchange traded funds by way of the iShares series from Barclays. In fact, Surz had hoped for no less with his indices. "I'd love to be in that space," he says of the style-ETF marketplace.

But Surz is a tiny—albeit innovative—fish in a big pond when it comes to the equity index business. All of which reminds us that it's debatable that the world will beat a path to your door if you build a better mousetrap. Surz originally launched his style indices because he couldn't find a set that lived up to Sharpe's recommendations. The desire to build better indices was clearly inspired, if a bit early. Fame and fortune, however, so far remain elusive for Surz and his indices.

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