Bass Ackwards

Style Box Flukes Snare Index Huggers

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There is only one way to see things – until someone shows you how to look at them with different eyes. Pablo Picasso

The professional search for investment talent is currently being conducted in the same way that the drunk looks for his keys under the light of a lamppost. When asked where the keys were lost, the drunk replies "up the street, but the light is much better here." When it comes to investment fund selection and allocation, advisors are doing what is easy rather than what makes sense. They ought to be customizing the benchmark rather than limiting their comparisons to off-the-shelf indexes, like Russell and S&P, and they should allocate to talent rather than to style boxes. In other words, consultants should fish for talent with fly rods not flypaper. More thoughtful, albeit more difficult, angling for active managers will enrich investment talent harvests and their applications.

Skill First

Fund selection criteria currently favor index funds and index huggers, because style boxes undermine the search for skill. Equity allocations are pre-ordained to set style boxes, each with their own index, and managers are sought to track these indexes. **Risk is defined at the individual manager level as tracking error.** Today's approach begins with a decomposition of the stock market into style segments, for example 35% large growth, 35% large value, 15% small growth and 15% small value. Managers are chosen for each of these four assignments, and assets are allocated to the winners at the market weights. This simplifies the process but compromises the talent search.

Because risk is defined as tracking error, index huggers have an edge in manager searches. But recognize that alpha and R-squared are from different alphabets: low tracking error limits the alpha that can be achieved. Populating our asset allocations with index huggers makes for a mediocre but safe portfolio. So the problem with this current approach is that it's hard to make a good cioppino when all the ingredients are bland, even if they are safe. Our industry has drunk the index huggers' cool aid, and has reversed a process that had been in place for some time.

Not too long ago, we sought skill wherever we could find it. Then once a talent pool was filled, allocations across this pool were optimized for diversification. **Risk was defined in the aggregate as failure to achieve objectives and it was talent that mattered.** Dr. Frank Sortino continues this tradition with his latest work. Dr. Sortino develops his talent pool using a measure he calls "Omega Excess" which customizes the benchmark to each manager's style profile. He then allocates to this pool to maximize total portfolio Omega Excess while simultaneously minimizing style bets. Each manager comes into solution as a blend of styles.

Square Pegs

IF (and this is a big IF) some non-index managers have skill, this framework built for index huggers will not find them. Limiting our analyses to standard off-the-shelf indexes will routinely make bad judgments regarding liberated non-index-huggers, declaring losers to be winners, and successes to be failures. Treating everyone as if they were an index hugger is an evaluation mistake. We need to bring the best custom benchmark to each liberated manager, rather than force these square pegs into round holes. Otherwise, we will miss a lot of talent. Some investment firms are simply at their best when left unfettered from indexes. This doesn't take these firms off the benchmark hook; it customizes the hook.

Some say that there is no benchmark for a particular manager, especially hedge fund managers. This is usually an indication that we don't understand what this manager does. We should not invest in what we don't understand.

Bulging Nets

Trolling for talent isn't as easy as some think, unless the only catch you're after is index huggers. Indexed nets fill with porpoises. No offense to index huggers. Some of my best friends love their indexes, and I'm glad they have an edge.

In the 1980s there was significant interest in custom benchmarks, and a few firms sprung up to provide what were then called "normal portfolios", which are custom collections of stocks with custom weights. The CFA Institute's Benchmark Committee Report recommends the use of custom benchmarks over indexes and peer groups. The good news is that today we have a variety of tools, like style and factor analyses, that make it straightforward to construct custom benchmarks. Among other things, these tools give us a sense of how a manager differs from an off-the-shelf index to illustrate sources of performance differences. The tools are there waiting for the thoughtful user.

Sorting the Catch

Once the right benchmark is created, there are additional tools that can help us accurately evaluate investment performance. My firm offers one such tool, Portfolio Opportunity Distributions (PODs). PODs expand any benchmark into a peer group, and as such they are benchmark agnostic, although of course they work best when the benchmark is correct. Pick your favorite benchmark and PODs provide a performance ranking against the opportunities available to those who manage to that benchmark. For example, let's say you are analyzing the performance of a fund against the S&P 500. The problem with a strict comparison to the S&P 500 is that you will wait decades to gain statistical confidence in the manager's ability to beat this benchmark because the hypothesis test "Performance is good" is being conducted across time. By contrast, PODs conduct this hypothesis test in the cross section of all possible returns, by simulating portfolios made up exclusively of stocks in the benchmark. The middle, or median, of these simulated returns is the S&P 500 return. A POD rank in the top ten percent of all possibilities is significant at the 90% confidence level even if it is for a short time period, like a few months.

The Beneficiaries

PODs are only one tool that liberates advisors from the biases imposed by portfolio construction based on style boxes. Other tools, such as Dr. Sortino's Omega Excess and Gary Anderson's Benchmark Equivalence Line (BEL) can be used effectively to achieve this goal. The ultimate beneficiaries of these improved tools are our clients. You'd think investment managers would also benefit, but obfuscation is good in the very competitive investment game. Skilled sales and client relationship people thrive on benchmark subterfuge, presenting indexes and peer groups that make them look best. Dr. Meir Statman says this well:

"Today's money managers say they compete with other money managers by generating the highest alphas. They denigrate the role of marketing in the competition. Yet each money manager has ready stories about other money managers with low alphas who snatched clients through clever marketing….I hope that in the future the link between investment and marketing would become stronger and more explicit."

"What do Investors Want?" *The Journal of Portfolio Management,* 30th Anniversary Issue 2004, pp 153-161