

WARNING: Market Meltdown Generates Index Mayhem

Ron Surz Friday, October 24, 2008 949/488-8339

I'm writing this as a warning to my performance evaluation friends, in time to be of valuable use to you as you begin third quarter performance reviews. Because they miss an important aspect of the market's composition, Russell, S&P and Morningstar index results for the year-to-date through 9/30/08 are dangerously misleading and are likely to cause bad decisions. And the problems spill over into the new and growing area of target date funds, although there are only a few indexes from which to choose.

Hire/fire decisions are complex enough in "normal" times, and they make my hair hurt in these crazy times, so index flaws are scary problems, in keeping with the current Halloween season and the continuing market turmoil.

The following commentary describes the problems and recommends solutions, beginning with U.S. equity investments and then target date funds.

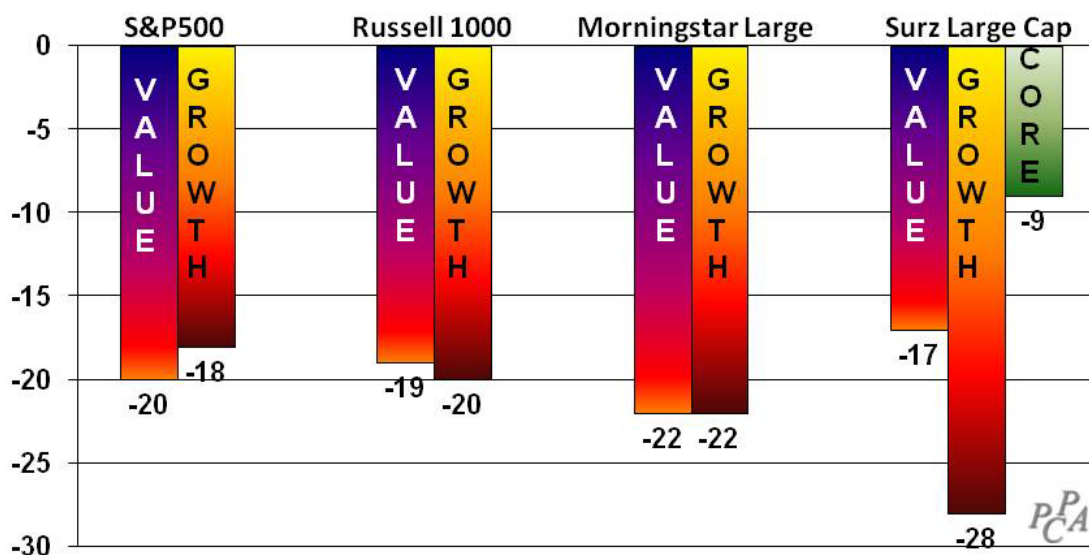
U.S. Stock Indexes

"It doesn't matter which style indexes you use because they're all about the same." We've heard this often enough and it would seem to be the case in the first nine months of 2008, but not so. As shown in the following exhibit, the most popular indexes – Russell, S&P and Morningstar – all agree that value and growth have lost about the same, roughly 20%. This concurrence should give us confidence that -20% is the right number, but both Russell and S&P are missing an important component of the market, namely the stuff in the middle, in between value and growth, that I call Core. Morningstar does include this important Core component, but it uses different rules than Surz Indexes described below, so their results are materially different. Surz Indexes were launched in 1986. Morningstar indexes were launched in 1997.

Year-to-Date Style Distortions Demonstrate The Importance of Core



The Market Structure Puzzle: Core is the stuff in the middle, in between value and growth



The inclusion of Core paints a dramatically different picture where Value has outperformed Growth, and Core has outperformed both Value and Growth. Morningstar's Core also outperforms its Value and Growth indexes, but their returns are different than Surz because their rules are different than Surz Index rules. Morningstar Core is down 15% year-to-date.

Why is this Core-Value-Growth performance ranking important? Because investment managers compared to the popular indexes will be misjudged at this very critical time of high investor anxiety. Core typically outperforms when investors lack conviction, favoring neither value nor growth. Also, Barry Mendelson, president of Capital Market Consultants, has recently written about his belief that investors should prefer the stocks in the middle during the current crisis – they are Goldilocks stocks.

Now more than ever it's important to get the benchmark right. Otherwise today's faulty decisions will undermine future performance.

This type of index discord, while infrequent, is explained by differences in methodology that can be best understood by considering how stocks in the gray area, between value and growth, are treated by index providers. There are degrees of value and growth, so some growth stocks are more aggressive growth than others, and some value stocks are deeper value than others. And some stocks have characteristics that are not clearly value or growth – they're the stuff in the middle. Russell deals with this issue by pro-rata allocating these fuzzy stocks into both value and growth. S&P ignores the problem altogether by drawing a hard line that divides half of the market's value between value and growth. By contrast, both Surz and Morningstar deal with this stocks-in-the-middle issue by defining a separate category called "Core". I'll describe the Surz classification rules so you can see how it works.

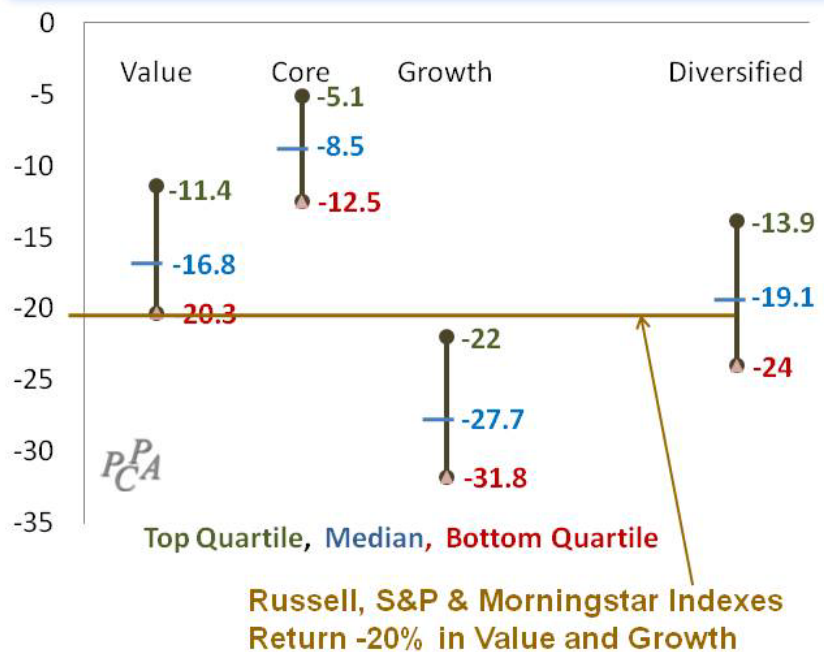
Surz indexes break out value, core, and growth stock groupings within each market cap by establishing an aggressiveness measure that combines dividend yield, price-to-earnings ratio, and price/book ratio. The top 40% (by count) of stocks in aggressiveness are designated as growth, while the bottom 40% are called value, with the 20% in the middle falling into core. The result is a family of indexes that are mutually exclusive and exhaustive, making them perfect for style analyses, both returns-based and holdings-based style analysis.

Core usually performs in between value and growth, but about a third of the time it does not, like the current year to date. **It is during these unusual times that the alternative to Russell and S&P provides conspicuously valuable insights.** Surz indexes have been around for more than 20 years, long enough to have stood the tests of time. A list of stocks classified as core is available upon request. Details of Surz index construction and behavior are available at [://www.p pca-inc.com/SurzStyles/surz_styles.htm](http://www.p pca-inc.com/SurzStyles/surz_styles.htm) .

So, what can you do to take advantage of this insight? Obviously, you can use the index results above, but I'm giving you something even better -- the gift in the next exhibit, which provides superior peer groups for your ranking pleasure and enlightenment. Just plot your fund's return against the appropriate group. As you can see there is very little overlap in the intra-quartiles, so misclassifying a manager will lead to erroneous evaluations. Also,

classification bias in traditional peer groups is likely to be problematic in the nine months to date. For an entertaining and informative discussion of this little known bias please visit [://www.ppca-inc.com/pdf/Blob-Peer-Group-Bias.pdf](http://www.ppca-inc.com/pdf/Blob-Peer-Group-Bias.pdf).

Exceptional Peer Groups for the Enlightened Evaluator 9 months ending 9/30/08



The universes in this exhibit are created using an unbiased scientific approach called Portfolio Opportunity Distributions (PODs). They represent all of the possible portfolios that managers could have held when selecting stocks from their respective indexes. In essence, hypothetical monkeys expand an index into a peer group by simulating all the portfolios that could have been formed from stocks in that index. By contrast, traditional peer groups are very poor barometers of success or failure because of their myriad biases. Everyone knows that it's easy to find a peer group provider that makes you look good, but for some reason the industry tolerates, even condones, this deceptive practice. PODs are bias free and are therefore a much more reliable performance evaluation backdrop, plus POD universes were available on October 2, many weeks before the "real" biased peer groups. As John Stossel says on ABC TV

News: "Give me a break." Please visit [://www.pcca-inc.com/PODs/pods.htm](http://www.pcca-inc.com/PODs/pods.htm) for more details on this important breakthrough.

Target Date Funds

Unlike the dozens of U.S. stock indexes, there are only three target date fund indexes. Dow Jones introduced their indexes first, in April 2005. Then my firm, Target Date Analytics (TDA), introduced our indexes in October 2007. And Standard and Poor's (S&P) just announced the creation of their new indexes. Plan Sponsor magazine adopted the TDA indexes in August of this year and re-branded them as the PLANSPONSOR On Target Indexes (OTI).

These three indexes differ substantially in composition and philosophy. Let's discuss philosophy first:

- The S&P indexes are industry averages, reflecting common practices among current target date fund offerings. S&P describes this construction as follows: *"Each index is representative of the investment opportunity available to investors for the corresponding target date horizon, with asset class exposures driven by a survey of available target date funds for that horizon."*
- The Dow indexes have a stated objective to: *"measure the performance of a lifecycle portfolio that seeks to grow and preserve real value over time."*
- The PLANSPONSOR On Target Indexes have two objectives: *"(1) Protect the purchasing power of contributions with a very high probability, and (2) Grow assets with a reasonably high probability, without jeopardizing the primary protection objective."*

The major difference between the Dow and OTI objectives is priority. Dow places equal emphasis on preservation and growth whereas OTI emphasizes preservation over growth. **In summary, the OTI and Dow indexes are standards – the way target date funds should be managed – and the S&P indexes are common practice aggregates.**

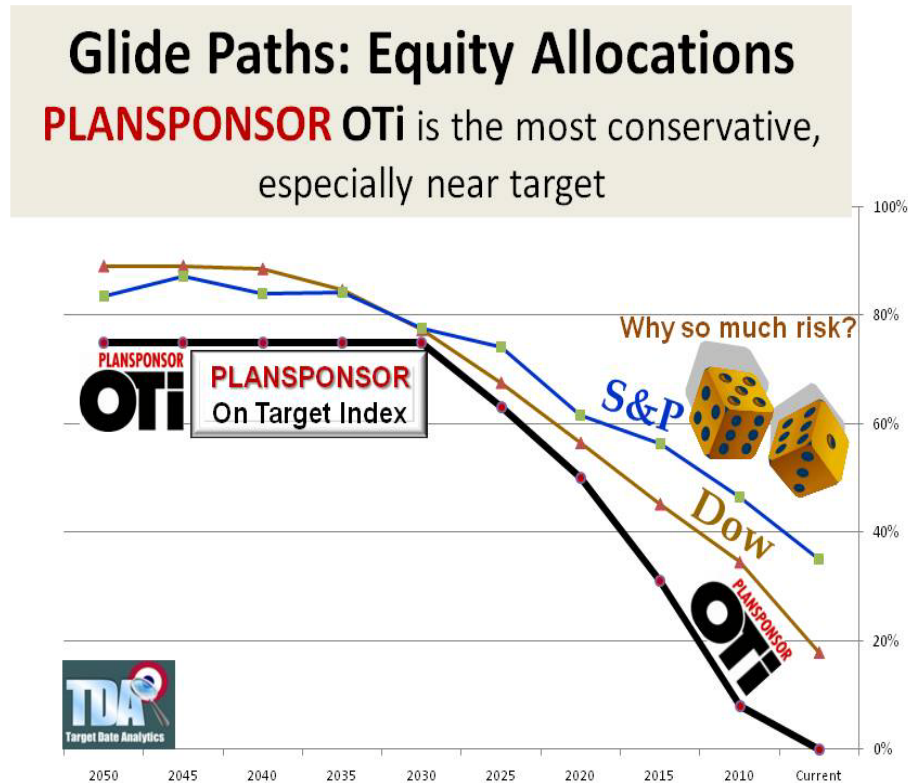
Unfortunately, we find common practice woefully lagging both the Dow and OTI standards. Target date funds are a great idea with awful execution, at least so far.

These differences in philosophy and objectives lead to materially different index compositions and results. The following exhibit summarizes composition differences at the broad equity allocation level.

As you can see, as the target date approaches the S&P indexes are the most aggressive, followed by the Dow, and then the PLANSponsor OTI are the most defensive. All 3 indexes are quite similar in equity allocation at the more distant dates.

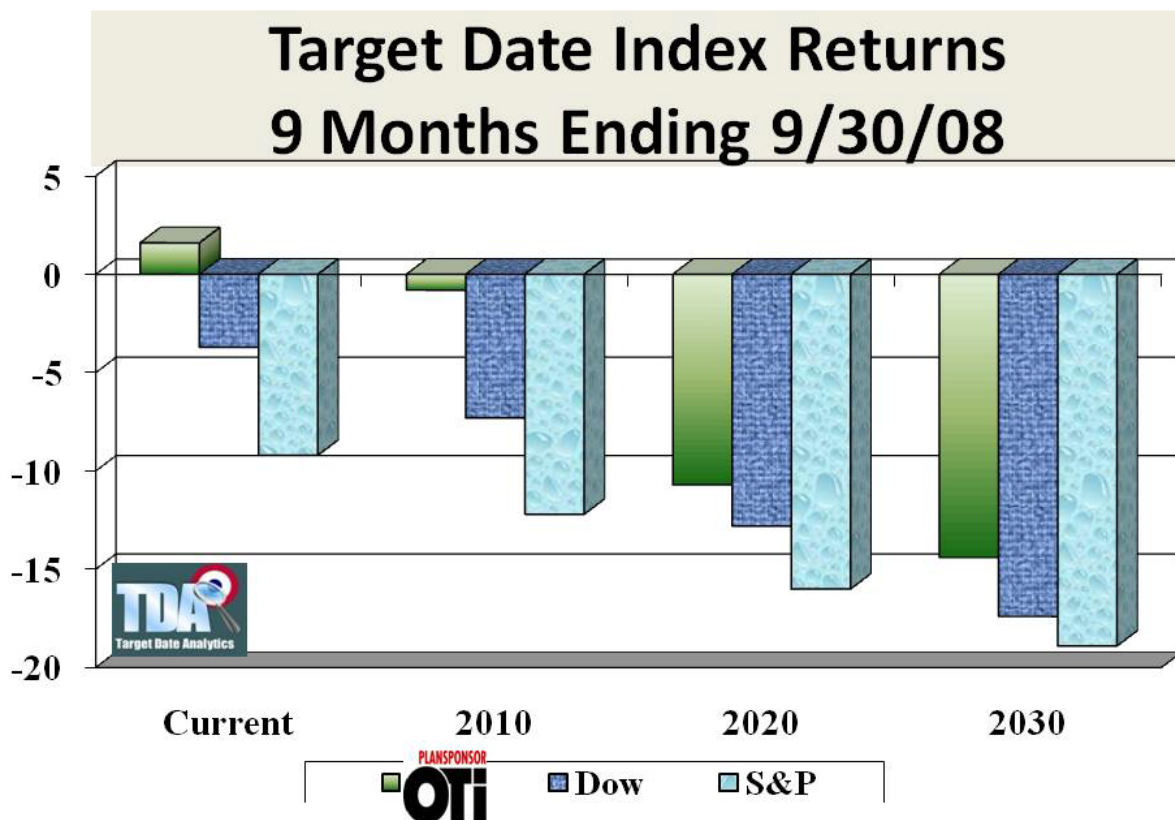
There is an ongoing debate raging in the target date industry regarding the purpose of target date funds. So far it's TDA versus the industry. We at TDA believe that target date funds should be limited to the accumulation phase of a participant's lifecycle, and that the distribution phase is best served by vehicles designed for this purpose, like annuities. [Vehicles designed to address longevity risk should be employed post-retirement because there is no glide path that can handle this life-long task.](#)

Accordingly, we believe that target date funds should be entirely in safe non-risky assets at target date, waiting for the participant to move to the next phase, which they should be thinking about long before retirement. But the industry doesn't see it our way. The target date fund industry sees target date funds continuing beyond the target date. Some see accumulation funds morphing into distribution funds at target date and continuing on, in some cases to death. This is akin to viewing the target date as a small speed bump on the highway of life. Truth in advertising dictates that funds taking this extended view should be re-labeled so the investor knows their intended lifespan. For example, 2010 funds that are intended to serve the investor for 30 years beyond retirement date should be re-labeled 2010-to-2040 funds. But not all fund companies extend their glidepaths. Some fund companies roll their target date funds into "Income



Funds”, which have the objective of throwing off reliable income while preserving principal, rather than managing longevity risk. Both approaches extend the investor’s participation beyond target date. What do you think the role of target date funds should be? Should they continue beyond target date?

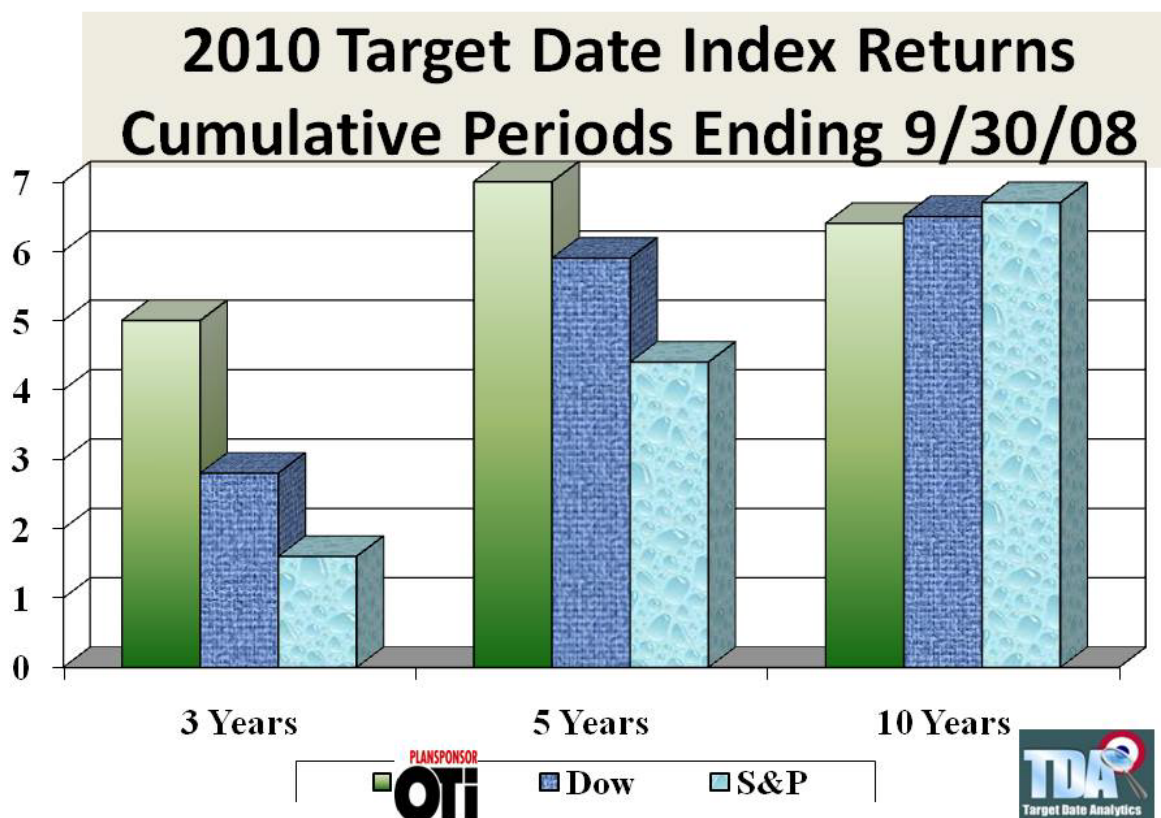
These composition and philosophical differences have significantly impacted target date index performance in the year to date, as shown in the next exhibit. The recent meltdown has been a wake-up call for the target date industry and gives TDA an “I told you so” that we wish we didn’t have. Our greatest concern is for investors in near-dated funds, who are at or near retirement, and have the most at stake both emotionally and monetarily. For the most part these 60-plus year old investors are in target date funds as a default option in their 401(K) plans, since target date funds are one of three qualified default investment alternatives (QDIAs). Do you suppose any of these folks were prepared for the kind of disastrous loss that has occurred in both the S&P and Dow indexes? Did they know the risks they were exposed to? That is, what is the better standard?



(S&P returns are approximate, and represented by TDA's peer group indexes.)

Your choice of index makes a big difference in your evaluation of target date fund results. [Choose the index that is most in line with the plan participants' understanding of what target funds should be.](#)

But the OTI defensive posture at target date is not the only difference among the indexes. Diversification is also an important distinction. The S&P indexes are not very well diversified, comprising mostly U.S. stocks and bonds, because this is the current industry practice. The Dow indexes are somewhat more diversified, and the newer Dow real return indexes are even better. But the most diversified indexes are the OTI, representing the world market. The benefits of diversification are shown in the following long-term performances of 2010 funds.



(S&P returns are approximate, and represented by TDA's peer group indexes.)

As you can see, the choice of target date index makes a big difference over longer horizons, extending back beyond the current meltdown into better times. So now you can make an informed selection.

Summary of Target Date Index Choices

	Objective	Theory
Dow	Safety & Growth with equal priority	None
S&P	Common practices – peer average	None
OTI	(1) Safety first – top priority (2) Growth with risk control	Efficient Frontier, Capital Market Line, Liability-Driven Investing, Loss Theory, Separation Theorem

For more information on target date indexes, please visit the following:

Dow: [://www.djindexes.com/targetdate/index.cfm?go=overview](http://www.djindexes.com/targetdate/index.cfm?go=overview)

S&P:

[://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_targetdate/2,3,6,0,0,0,0,0,0,0,0,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_targetdate/2,3,6,0,0,0,0,0,0,0,0,0,0,0,0,0.html)

PLANSponsor On Target Indexes: tdbench.com

Conclusion

This is one of those unfortunate times when consultants and investment managers will try to console their clients by explaining how their pain is less, hopefully, than most others. This will be awkward and delicate, and is likely to bring forth the difficult questions about bailing or doubling down. The answers to these difficult questions are

best formulated when accurate benchmarks are employed. Clients need to know who is succeeding and who is failing, rather than who can pick the benchmark that makes them look best.