Do You Know What You Are Really Investing In?

The Line between Growth and Value Stocks Can Blur

"The way many think of style was very black and white. Now might be a good time to rethink the question of whether the old definitions of style really do help create a diversified portfolio ."

("Investors Get Used to a Stylistic Leap," *Financial Times,* October 17, 2002)

Every individual has different investment time horizons and different risk/reward goals. Some people are looking to invest for their retirement 20 years down the road. Others just want to stash some cash for a couple years to build equity for their first down payment on a home. The challenge for investors and their advisors is to build a portfolio that fits the risk/return tradeoff for each investor's unique needs. However, this may not be as easy as it appears on the surface.

To begin accomplishing this goal, individuals need to make sure they are really comparing apples to apples. It's important to select the correct underlying benchmarks, which accurately reflect the style of the manager. While investors understandably measure the performance of a value manager against a value-based benchmark, most popular value indexes include many stocks that actually are style neutral or somewhat growth oriented. So, when individuals think they are buying just apples and oranges, some broccoli and mushrooms are also in the mix. In that same vein, most growth indices include stocks that could be construed as neutral or as value stocks. To serve investors better, indices should accurately reflect the style they purport to mirror.

By Sanjay Arya

The Past to the Present

As style investing gained popularity in the 1980s, so did the need for indices that replicated various investment styles. From one- and two-factor models like the S&P/Barra and Russell indices, the field has evolved to more complex six- to nine-factor models such as those of Salomon Smith Barney and Dow Jones. For those readers not well versed in benchmark indices, here's a little background on two of the most commonly used style index families.

S&P/Barra. S&P, in cooperation with Barra, has created value and growth indices based on the S&P 500, S&P Mid Cap 400, and S&P Small Cap 600. S&P differentiates between value and growth strictly according to a company's book-to-price ratio (B/P), and the indices are reconstituted twice a year on June 30 and December 31. The stocks in the index universe are classified as either value or growth; 50 percent of the total capitalization goes to value component, and 50 percent of the capitalization goes to growth component. Although each index does not have an equal number of names, both indices have equal capitalization.

The Russell. Russell constructs its style indices by using two criteria for the differentiation between value and growth: B/P and I/B/E/S forecast earnings-growth measure. The Russell value and growth indices are reconstituted once a year on June 30, with a non-exclusive style split; 70 percent of the total number of companies in the indices is exclusively in one index or the other, and the remaining 30 percent is split between the two indices. Thus, some companies end up in both the Russell 1000 Value Index and the Russell 1000 Growth Index.

These indices seek to be flexible benchmarks that replicate the behavior of active managers. However, investment managers often rely on a number of investing strategies. So, any attempt to classify these funds by only one or two styles will, by definition, result in very broad indices. The matter is further complicated by the fact that many index publishers incorporate stock overlap in their indices. That is, they allow stocks on either side of a dividing line to be counted in both adjacent indices – representing broader opportunity sets of stocks for selection.

Growth and Value Have Become Diluted

The bottom line is that given these current definitions, it can be difficult for investors to truly focus their portfolios in a particular way. Morningstar's view is that such broad, overlapping style benchmarks have diluted the overall definition of growth and value (especially when a stock's market cap is split between two indices). Just look at Citigroup, IBM, Procter & Gamble, Merck, and Coca-Cola. All these stocks appear in both the Russell 1000 Value Index and the Russell 1000 Growth Index.

Managers appear to have conformed to these broad benchmarks by playing close to the middle, investing largely in stocks that demonstrate neither strong growth nor value traits. The overly broad nature of these indices makes it permissible for growth managers' portfolios to include not only a healthy sampling of core stocks, but even to cross over into the value category. Likewise, value managers are allowed to or even encouraged to hold decidedly non-value stocks, reaching into core and beyond into growth. The "sameness" of the most commonly used style indices not only reduces the true diversification potential available to investors, but it also makes it harder to tell which side of the field managers are playing.

In fact, research shows that many of the same stocks are among the top holdings of both growth and value mutual funds. We looked at the top 25 holdings of both growth and value funds and found several names in both groups: General Electric, Citigroup, Fannie Mae, AIG, IBM and Eli Lilly. ***Tables 1*** and ***2*** show overlap in the top 10 as well.

Meaningful Indexes Can Help Investors

Investors searching for accurate information on the funds and fund style in which they want to participate may be better served by more detailed indices. For example, wouldn't it be more helpful to rely on an index based on the most meaningful difference in stock style and capitalization, as opposed to simple broad indexes built using an overlap approach or those based on the collective decision of portfolio managers? Lay the cards on the table. This type of approach sets out to define the playing field, identifying

Table 1 – Top 10 Growth Stocks

US Growth Index	Weight %	Growth Mutual Funds	Number of Funds
Microsoft	7.71	Microsoft	473
Pfizer	6.48	Pfizer	389
Johnson & Johnson	5.50	**American Intl Grp**	**327**
Wal-Mart Stores	4.62	Johnson & Johnson	367
Intel	4.06	Viacom CIB	271
Cisco Systems	3.56	General Electric	291
Coca-Cola	3.23	Wal-Mart Stores	332
Amgen	2.27	Cisco Systems	410
Dell Computers	2.17	**Citigroup**	**313**
Viacom CIB	1.99	AOL Time Warner	183

Top 10 growth stocks held by mutual funds are ranked by aggregate assets held by all growth mutual funds

Table 2 – Top 10 Value Stocks

US Value Index	Weight %	Value Mutual Funds	Number of Funds
ExxonMobil	9.53	**Citigroup**	**293**
Bank of America	4.31	ExxonMobil	249
Verizon Comm	3.93	Bank of America	247
SBC Comm	2.87	Verizon Comm	263
Chevron Texaco	2.85	J.P. Morgan Chase	215
Fannie Mae	2.65	Chevron Texaco	221
First Union	2.01	Fannie Mae	181
J.P. Morgan Chase	1.88	SBC Comm	243
Hewlett-Packard	1.81	**American Intl Grp**	**201**
Bank One	1.75	Wells Fargo	205

Top 10 value stocks held by mutual funds are ranked by aggregate assets held by all value mutual funds which fundamental traits of individual securities are associated with which performance patterns.

Once the field has been defined, the behavior of the fund managers can be monitored for their profitability. It will become easier for investors to identify not only which managers add value but, more importantly, how they do so. Also, by marking the boundaries of the field, distinct and stylistically pure investable indices can be constructed that would allow investors to efficiently reposition their portfolios to the sections of the market to which they desire to gain exposure.

Figure 1- Morningstar Market Barometer

Morningstar used the above approach to create a new set of market indices – one they believe could lead to improved results for investors. Their family of 16 U.S. equity indices tracks the U.S. market by capitalization and investment style using a comprehensive and non-overlapping approach based on the methodology for the Morningstar Style Box. For detailed methodology of these indices see "Morningstar Index Construction Rules" at http://indexes.morningstar.com.

Most index providers have their index construction rulebook and general description about their indexes on their websites. To get more information on other indexes, investors can go to: www.russell.com, www.spglobal.com, www.dowjones.com, www.msci.com, and www.wilshire.com.

A More Stable Style Measure

The investment style of each individual security is determined by a comprehensive ten-factor methodology that separately measures both the value and growth characteristics of each security, using historical and forward-looking elements. The resulting classifications are more in line with the fund manager's view and more stable than traditional value measures, such as price-earnings and price-book multiples.

Another defining characteristics of Morningstar indices is its treatment of the "core" style for the stocks for which neither growth nor value characteristics dominate. Such stocks, including General Electric, Coca-Cola, and Procter & Gamble, merit their own category, allowing them to be treated as a distinct group. This type of treatment allows for the creation of value and growth indices, which are more precise and "stylistically pure." And, the bottom line is that they will more accurately reflect the accepted definitions that investors have perhaps come to rely upon in their stock selection.

A Better Tool for Market Monitoring

Wondering what's driving the head and tail winds behind the markets? Investors can turn to a new market-monitoring tool called Morningstar Market Barometer. As seen in ***Figure 1***, each index is shaded in varying degrees of blue and yellow according to performance, which allows market movements to be clearly revealed. This visual image helps investors instantly recognize the patterns in the market.

Investors need to understand in what type of fund they are really investing. This new type of indexing allows for individuals to see more easily core and neutral stocks and to gauge a more accurate idea of the type of style the fund manager is practicing in reality. If investors are seeking to measure historical returns and see the differing results from value and growth styles, reliance on these types of indices can prove invaluable. In an attempt to draw the "line in the sand" between value and growth styles, these Morningstar indices offer valuable tools for individuals looking to build truly diversified portfolios.

—Don Phillips and Paul Kaplan also contributed to this article.

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