

## Annual Style Index Reconstitution: Good or Bad?

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In just two weeks, at the end of June, the Russell style indexes will undergo their annual reconstitution. A lot has happened in the last year, especially to the finance sector. So here are the pressing questions for financial advisors:

- Is annual reconstitution too frequent or not frequent enough?
- What reality should advisors use to evaluate investment managers? The world as it existed a year ago, before the financial crisis, or the real world today?
- What alternatives are available to advisors? That is, what is today's reality?
- Should following the current reality, thereby creating a tracking error away from the market's June 2008 style composition, be prized or penalized?

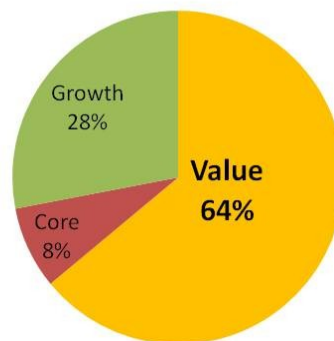
Investment managers can blindly follow the old reality, or they can make big bets away from the indexes, exposing themselves to business risk. *It's an ugly dilemma because the right thing for investors could be the wrong thing for their investment managers.* Russell has persuaded the industry to accept a practice that is in the best interests of investment managers rather than their clients – it makes life easier for indexers and index huggers.

### Large Financial Stocks Then & Now Style Compositions

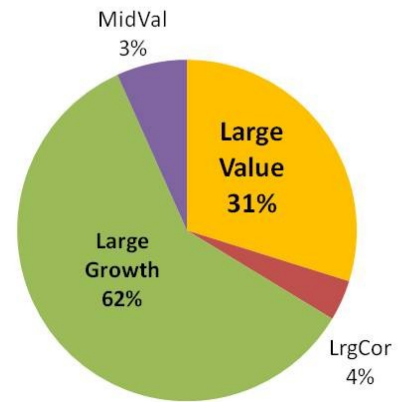
In this commentary I contrast contemporaneous performance evaluations to those locked back to June 2008. I examine the past 11 months, through May, 2009, and the first quarter of 2009.

Using my [methodology](#), the large cap finance sector has been transformed from value to growth. The picture on the right and the table below

Large Financial Stocks June, 2008



Same Stocks as of March, 2009





show what has happened to the 36 stocks that were classified as large company Finance in June 2008.

This transformation has changed the composition of Surz Style Pure<sup>SM</sup> (SSP<sup>SM</sup>) indexes, which are reconstituted quarterly. Specifically, the finance allocations changed as follows:

<b>Finance Allocation of SSP<sup>SM</sup> Then and Now</b>				
Value			Growth	
<u>6/08</u>	<u>3/09</u>		<u>6/08</u>	<u>3/09</u>
19%	10%		13%	19%

By not recognizing what has happened in the past 11 months, indexers and index huggers are overweighting finance by 9% in large value, and underweighting finance by 6% in large growth.

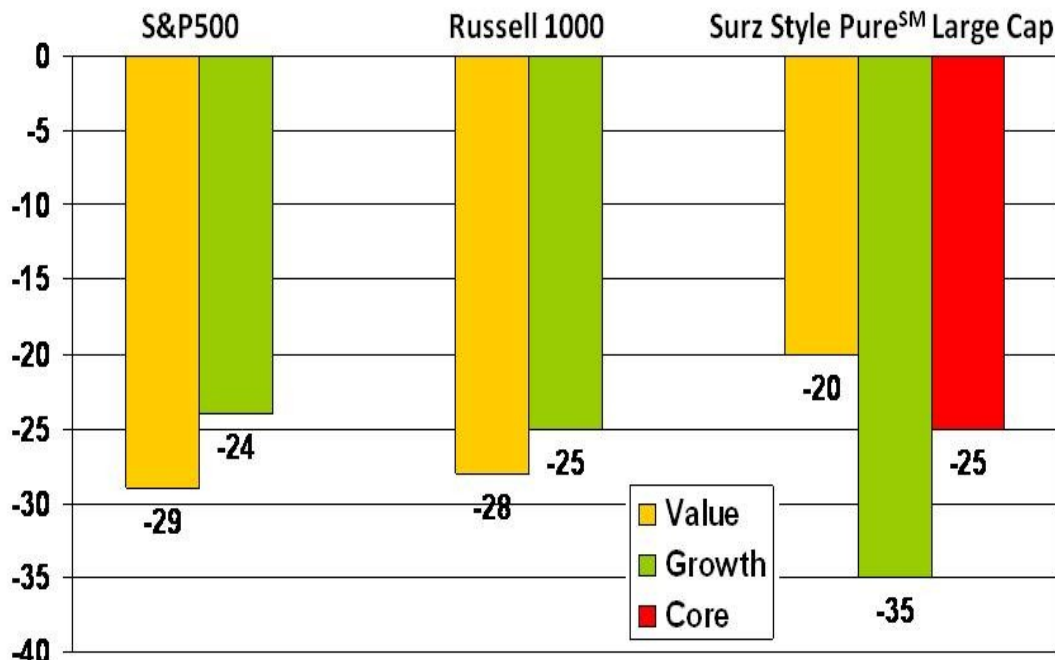
The effects of these “bets” can be seen in the performance of style indexes over the past 11 months, as shown in the exhibit below. The exhibit also shows the insights that are gained by defining an additional style (core) between value and growth. Both S&P and Russell show growth outperforming value, due in large part to the finance weighting in value. But much of finance has become pure growth, as reflected in the Surz Style Pure<sup>SM</sup> indexes, and pure growth has underperformed pure value using quarterly reconstitutions. Pure growth has suffered from its allocation to finance.

## The Past 11 Months Demonstrate The Importance of Both Core & Reconstitution



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

7/1/08 – 5/31/09



Also, pure core (between value and growth) has performed closer to pure value than to pure growth, which has implications for managers near the middle of the growth-value style spectrum.

**Pure growth managers should be lagging their popular indexes, while pure value managers should be beating their S&P and Russell bogies, where “pure” is defined as tracking the current reality.**

Looking at the first quarter of 2009, bets for or against the finance sector had a substantial impact on performance, especially for the core segment of the market.



### Details of Q1/09 US market performance

	STAP	DISC	HLTH	MATL	TECH	ENER	INDU	UTEL	FINC	TOTL
LGVL	-2.6	-15.2	-15.1	-3.8	15.0	-10.1	-24.8	-10.2	-26.7	-13.4
LGCO	-10.6	-11.9	-5.3	.0	-4.1	14.1	-18.0	-11.7	-30.0	-9.1
LGGR	-11.6	-5.3	-3.9	7.9	8.1	-23.5	-13.1	.0	-22.8	-7.8
MDVL	.8	-5.4	-1.5	-3.2	5.0	1.5	-14.3	-10.3	-26.0	-9.0
MDCO	-11.9	-6.8	-7.6	-12.9	-6.0	-1.0	-14.9	-12.5	-25.1	-12.5
MDGR	-8.3	-3.0	-3.9	1.0	2.9	1.0	-19.1	11.2	-21.0	-5.4
SCVL	-7.7	-4.1	-4.6	-12.0	3.1	-9.1	-19.6	-9.7	-23.6	-12.9
SCCO	-8.7	-6.7	-13.8	-13.2	-1.3	-15.1	-19.3	-5.8	-24.1	-12.9
SCGR	-11.3	-7.3	-7.1	12.2	2.5	-7.2	-18.1	.0	-26.1	-8.1
TOTL	-10.0	-7.5	-6.4	-1.1	3.6	-8.0	-19.7	-9.2	-24.3	-9.9

### Effect of the Current Under/Over-weights to Finance in Indexes that Have not Been Reconstituted

	Index Over/Under	Performance Impact
Large Value	+9%	-2%
Large Growth	-6%	+1.5%

### Summary

The performance of index huggers and indexes, like ETFs, has been significantly impacted by the freezing of allocations back in June, 2008. Specifically, it subtracted 2% from large value index returns in the first quarter, and added 1.5% to large growth. Infrequent reconstitution has taken its toll on index performance. And of course, performance in the second quarter could reverse the pattern of the first quarter, with finance outperforming.

For liberated non-index-huggers, a bet for or against finance in the first quarter of 2009 mattered most for large core managers. For example, a 5% finance bet in large core added or subtracted 104.5 basis points, moving the performance ranking more than one decile up or down. Accordingly, GARP (Growth at a Reasonable Price) managers (rather than aggressive growth) had the most at stake on both an absolute and a relative performance basis, as did relative value (as opposed to deep value).

### Large Finance Companies Then and Now (The 1<sup>st</sup> group of stocks maintained their style)

	0807			0904		
	Styl	Capzn	P/E	Styl	Capzn	P/E
ACE LTD	Valu	18.3	8.1	13.5	9.8	
AM EXPRESS	Valu	43.7	12.4	15.9	7.2	
BANK OF AME	Valu	106.3	13.0	43.7	8.1	
BERKSHIRE A	Grow	187.0	16.2	134.3	26.9	
CITIGRP	Grow	91.3	-5.5	13.9	-5	



CHUBB CORP	Valu	17.7	7.4		14.9	10.3
CME GROUP I	Grow	20.9	23.0		16.4	23.6
METLIFE INC	Valu	37.5	10.9		18.1	4.9
PNC FINL SV	Valu	19.8	13.2		13.0	12.0
STATE ST CP	Valu	27.6	15.1		13.4	7.6
TRAVELERS C	Valu	25.7	6.5		23.8	8.3
UBS AG	Grow	42.8	-2.3		27.1	-1.3
U S BANCORP	Valu	48.6	12.0		25.7	11.8
WELLS FAR	Valu	78.7	10.8		60.7	19.2
Style Changes	-- Large					
FRANKLN RES	Valu	21.7	12.7	Lgro	12.5	13.4
BANK OF NY	Valu	43.4	17.8	Lgro	32.6	32.5
BLACKROCK	Core	20.6	20.9	Lgro	15.3	26.9
DEUTSCHE AG	Valu	42.6	6.3	Lgro	25.1	-6.4
GOLDMAN SAC	Valu	69.0	7.9	Lgro	46.9	22.7
JPMORGAN CH	Valu	117.9	10.9	Lgro	99.9	42.9
MANULIFE	Valu	52.0	12.2	Lcor	18.0	43.1
MORGAN STAN	Grow	40.0	116.3	Lval	24.6	13.9
SCHWAB (CH)	Valu	23.5	19.0	Lgro	17.9	15.7
Style Changes	-- MidCap					
AEGON NV	Valu	19.6	7.8	Mgro	5.8	-3.0
AFLAC INC	Core	29.9	17.2	Mval	9.1	6.8
AM INTL GRP	Grow	66.0	-11.4	Mgro	2.7	.0
ALLSTATE CP	Valu	24.9	12.2	Mgro	10.3	-6.2
BROOKFIELD	Grow	18.9	25.6	Mval	7.9	13.3
FANNIE MAE	Grow	19.0	-3.2	Sgro	.8	.0
HARTFRD FNL	Valu	19.6	9.5	Mgro	2.4	-.9
LOEWS CORP	Core	24.8	14.4	Mgro	9.6	-50.0
PRUDNTL FIN	Valu	26.1	11.4	Mgro	8.0	-7.6
SUN LIFE FN	Valu	23.0	9.9	Mval	10.0	15.7
SIMON PPTY	Core	20.2	42.6	Mval	8.0	18.4
Gone						
MERRIL LYNC	Grow	31.3	-1.4			
WACHOVIA	Grow	33.2	-4.1			

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