



Refining Core-Satellite Investing

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Thanks in large part to the current crisis, investors are showing renewed interest in portfolio construction, and core-satellite investing is regaining popularity. Both Vanguard and Putnam recently announced the addition of “core” products to their suite of funds.

So why the interest in core? It could be for either of two reasons – hedging or completeness – as I will explain.

Ballast or completeness?

Some view core investing as a hedge against underperformance of active managers; in their minds, core is ballast to keep the investment ship steady. The best core for this purpose is the entire market, like the Wilshire 5000, although the most popular choice is the S&P 500. The goal is to dilute the effect of active managers because the investor lacks confidence in them.

In this context, core is a compromise for those who are on the fence in the active-passive debate. Add some cheap passive core to the expensive active manager mix to simultaneously lower costs and guard against the risk of surprises by reducing the tracking error relative to the broad market. The amount such an investor puts in core is a reflection of the lack of confidence in the active manager roster and structure. The more in core, the more market-like one’s performance will be. *Allocation to ballast core is a confidence barometer.*

By contrast, the original core idea was to diversify while simultaneously encouraging active managers to give it their best shot. The original core concept emerged from confidence in active managers, rather than concern about their making mistakes, so it was a completeness concept that complemented active value and growth managers by adding what they are not – the absence of value and growth. The absence of value or growth is the stuff in the middle that neither value nor growth managers hold. “Core” in this context means “center.” This provides license for the active managers to be undiversified, concentrating in their areas of expertise. This concept, introduced in the 1980s, gave way to style-based equity specialists and has evolved into an insistence on style purity today. There is a premium placed on adherence to style, and a corresponding necessity to fill in the void left in the middle between value and growth.



Both the hedging and the completeness versions of core improve diversification, but they imply different levels of confidence in active management. In this article, I address the application of core for completeness, which was its original intention.

The word “core” refers to a center, a heart, or a hub, but because it encompasses most of the market, the S&P meets none of these definitions. The good news is that there is an efficient completeness core, and it’s easy to understand why it works best in diversifying portfolios of multiple active managers. The S&P 500 and other broad market surrogates may make good ballast for those who are concerned about their active manager decisions, but we need something more specialized when it comes to completing allocations to real talent. *Allocation to completeness core is derived from the overlap among active managers.*

Welcome to the real world

Adherence to a style requires a definition of that style. Although there is disagreement on the specifics of style classifications, most agree that the real world is not black and white, with all value stocks clearly differentiable from all growth stocks. As shown in the graph below, there are stocks that fall in a gray area, having characteristics of both value and growth; these are the “fuzzy” stocks, or the stocks in the middle that I call “Centric.”

“Centric” stocks, as I define them, are stocks assigned to both value and growth by Russell, MSCI and others.

Style Composition



These index providers apportion the weight of a centric stock between the two styles. S&P ignores centric in their traditional indexes, but acknowledges it in their “pure” indexes. My company, PPCA maintains separate Surz Style Pure® Centric indexes for large-, middle- and small-sized companies. Centric is what should be used in completeness investing.

New and improved completeness core

Using the S&P as core dilutes the decisions of the satellite value and growth managers because it includes value and growth, as well as centric. You can see this problem by using an asset allocation optimizer. For example, returns-based style analysis can be used to solve for allocations to an active-passive team of managers. Ask the optimizer to solve



for the blend of managers that best tracks the Wilshire 5000. If the passive core is the S&P500, the optimizer will ask for 80% in the S&P, whereas it will settle for only 20% in centric; the same diversification with a less passive core. Less core is more if you believe your active managers will add value. If you don't believe they'll add value, you're better off all passive. Why does the optimizer want so much S&P? It wants the centric part of the S&P but has to take the whole package in order to get the centric. You have to buy the entire Oreo cookie to get the cream filling.

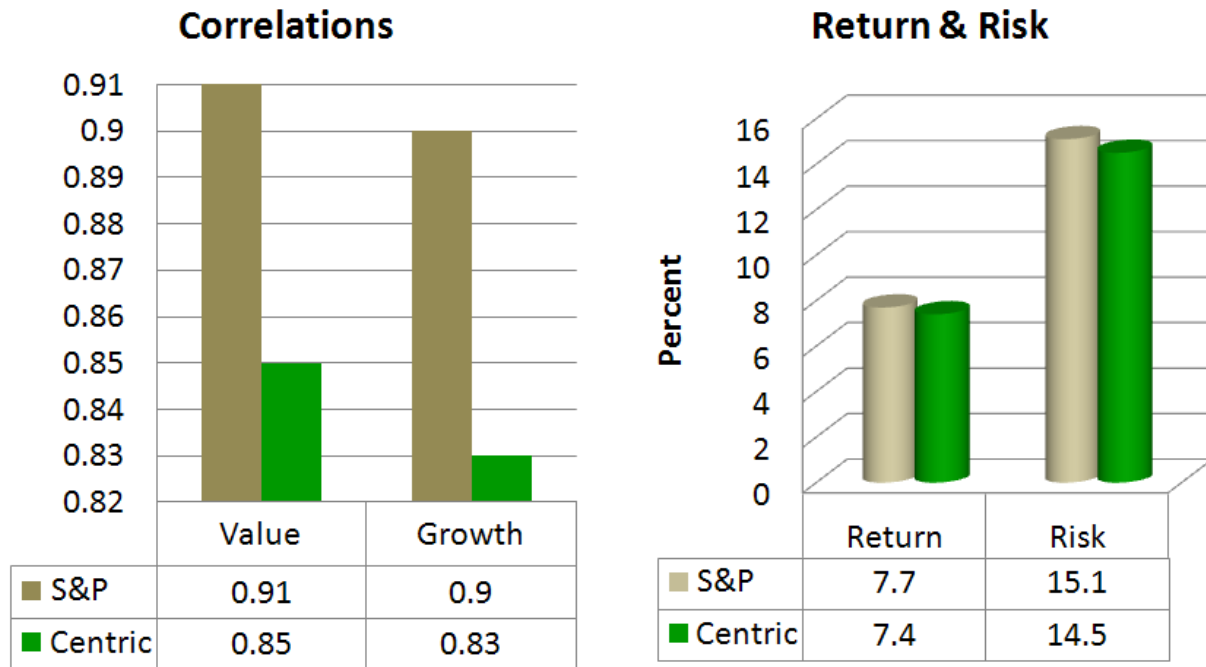
In a similar vein, research conducted by Dr. Frank Sortino of the Pension Research Institute and Sortino Investment Management indicates that allocations to active value and growth managers systematically underweight the middle of the market, i.e. centric stocks. This is understandable in light of the pressure that most managers are under to maintain style purity. Scrutiny incents managers to sell companies that drift toward the middle, away from their declared style. The result is an unintended bet in multiple manager portfolios away from centric. This is a diversification mistake.

Fortunately, it is an easy mistake to remedy: add centric. Our definition of centric is the 20% in the middle – it's 20% of the market. It's a simple matter to merge the current managers with a model centric core to constitute 20% of equity holdings. Sometimes the simplest solutions are the most elegant. And this list is only 45 stocks, so it's easy to implement. The constituents of the current Surz Style Pure[®] large cap centric core index are provided in the Appendix.

Evidence

Centric is a better complement to active value and growth managers because (1) it does not dilute active manager decisions and (2) it fills a large-company centric void in most multiple-manager programs. The following graph, with which I will conclude, provides statistical evidence to support these assertions. The measure of a good diversification complement is low correlation. Centric correlates substantially less to value and growth stocks than does the S&P500. Also, centric has about the same return and risk as the S&P, so filling the void does not sacrifice performance or increase risk vis-à-vis the S&P.

Contrasts for 20 years ending 6/30/10



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Appendix

Q3, 2010 Centric Core composition (Values are Capitalization in \$Billions)

ADP	20.25	AUTOMC DATA	MET	30.98	METLIFE INC
AMGN	50.39	AMGEN INC	MOS	17.36	MOSAIC CO
APA	28.44	APACHE CP	MRO	22.04	MARATHON
AVP	11.37	AVON PRODS	NSC	19.56	NORFOLK SO
AXP	47.72	AM EXPRESS	NTRS	11.31	NOR TRUST
BAX	24.3	BAXTER INTL	OXY	62.66	OCCID PETE
BDX	15.78	BECTON DICK	PEP	97.09	PEPSICO INC
BIIB	11.48	BIOGEN IDEC	PG	172.74	PROCTR & GM
BLK	27.37	BLACKROCK	PX	23.25	PRAXAIR INC
CL	38.63	COLGATE-PAL	QCOM	52.84	QUALCOMM IN
CMCS	49.01	COMCAST	RIMM	27.14	RSH IN MTN



CNI	26.7	CDN NATL RY	SPLS	13.9	STAPLES INC
COV	20.13	COVIDIEN PL	TGT	36.33	TARGET CORP
CPB	12.11	CAMPBL SOUP	TJX	17.11	TJX COS
CSX	18.84	CSX CORP	TROW	11.42	PRICE GROUP
DVN	27.22	DEVON ENRGY	TYC	16.75	TYCO INTL
EBAY	25.73	EBAY INC	UBS	50.14	UBS AG
EMR	32.91	EMERSON EL	UNP	34.74	UNION PAC
GILD	30.92	GILEAD SCI	UPS	56.44	UTD PARCEL
GIS	23.32	GEN MILLS	UTX	60.31	UTD TECHS
HD	47.33	HOME DEPOT	VIA.	19.06	VIACOM INC
HPQ	101.49	HEWLETT-PCK	VZ	79.21	VERIZON COM
JCI	18.08	JOHNSN CNTL	XRX	11.12	XEROX CP
K	19.01	KELLOGG CO	YUM	18.23	YUM BRANDS
LOW	29.47	LOWE'S COS			

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