



Do Cultural Biases Inhibit Performance?: The Case of Style Boxes

By John Minahan

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John Minahan, PhD, CFA, is a Senior Investment Strategist at NEPC, a Boston-based investment consulting firm. This article is adapted from the forthcoming book **Investment Management: The Noble Challenges of Global Stewardship**. This book will be available in September, 2008. For more information, inquire at farjones@q.net.

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Many times I have evaluated value managers whose strategy might be summarized as follows: purchase stocks of companies which are fundamentally troubled, but where the manager believes a catalyst is present which will turn the situation around and that catalyst is not yet priced into the stock. Then hold such stocks until either the thesis has played itself out, or it becomes apparent the thesis is unlikely to play out.

I was new to the industry the first time I encountered such a manager. The manager came to my attention because she showed up in a holdings-based style analysis, having migrated from value to growth, and this set off alarms regarding "style discipline". The manager had very good performance, and this happened during a period of time when growth was outperforming value, so on the surface it looked like the manager had broken her value discipline because growth was where the returns were.

A closer examination of the portfolio revealed the manager had very little turnover during this period, and the stocks which were now plotting as growth had plotted as value when the manager bought them. All that had really happened was that the manager was correct with many of these stocks: earnings were up and their prices were up even more, and the stocks were now plotting as growth stocks. She was able to explain the investment thesis for any stock I asked about and for those she still held, justifying that the thesis was still intact. This led me to suspect the style-box program I was using just wasn't subtle enough to accurately capture the manager's style, and the style was in fact consistent through this period.

When I discussed my concerns with the more senior consultant with whom I worked on this account, he dismissed my interpretation. He claimed the style analyzer was "objective" whereas the manager's explanation was "spin". He told



me that when I get a little more experience I will learn to be more skeptical of charming managers who will “say whatever it takes” to win or keep the business.

I have seen variants of this scenario play out many times, from both sides of the consultant-manager divide. The situation looks somewhat different from the manager's perspective. Not only are these situations very frustrating, but ironically, they can lead managers to make difficult decisions between staying true to their investment style or changing their style to conform to a consultant's notion of style discipline. I know of several cases where managers' product development efforts reverse-engineered consultants' evaluation criteria, and effectively said "Who are we to question what the market wants? If the market wants style boxes instead of superior returns, we can do that."

Some comments on and lessons from this example are:

- Consultants and managers can have very different beliefs about what is important, about what information is valid, and about what kinds of information define a manager's style. Consultants are concerned with classification of managers so performance can be assessed relative to a benchmark or peer group and multi-manager portfolios can be constructed to ensure a certain spectrum of market coverage. "Style consistency" for the consultant means having stable measures for those financial ratios that define style boxes. Managers are primarily concerned with exploiting their skill to find undervalued securities, and the intersection of skill and opportunity does not necessarily produce stable financial ratios through time. To many managers it is puzzling why that should be important.
- A key mechanism by which culturally-based belief systems sustain themselves is the socialization and sorting of new members of the cultural group. An important part of this can be the "stripping down" of new members who, often inadvertently, violate the norms of the culture. Such new members will usually either adapt to the norms or exit the group, so that surviving members of the group share the norms, and validate them for each other. This sorting and subsequent social validation is a key reason why cultures resist change.
- Social validation of a culture's beliefs does not necessarily mean that such beliefs contribute to the environmental competitiveness of the culture. In the case of style boxes, a key dysfunction derives from their encouraging uneconomic buying and selling of securities. For example, our value manager may feel pressed to sell a stock before the thesis has fully played out to insure that she still plots in her style



box. This creates an incentive for managers not constrained by style boxes (e.g. hedge funds) to pick up the money left on the table by style-box managers. Although there are presumably many reasons for the rise of hedge funds in recent years, one reason may be the opportunity for flexible, skill-based investing left unexploited by managers constrained by style boxes. The poor performance of tightly constrained portfolios also puts pressure on the business model of consultants advocating such approaches. Interestingly, many consultants formerly constrained by the style box framework have now embraced "alternatives" due to their superior risk/return characteristics.¹

- Holdings-based style analysis is extremely useful, but the rigid use of it can be a crutch. I would never have come to understand the value manager described above as well as I did if holdings-based analysis didn't raise some questions for me. However, one has to wonder if the prevalence of rigidly-defined style boxes is due to their giving consultants a sense of purpose, a "substitute problem" if you will, which diverts attention from the real problem – finding talented investment managers and building sensible portfolios of them – which may be beyond the consultant's reach.²
- The balance of cultures in a money management firm can be influenced by consultants and clients. It has often been noted that some investment management firms have an investing culture and others have an asset-gathering culture. This is an accurate observation, but I would add that some investment firms have both an investing subculture and an asset-gathering subculture existing in tension with each other. While one will likely dominate at any point in time given the direction from the top, as a firm's environment changes, there may be opportunities for the latent subculture to assert itself. Consultants and clients, as key elements of a manager's environment, are in position to influence the balance between subcultures. I believe that a rigid adherence to the style box framework on the part of consultants tips the balance of money manager cultures towards asset-gathering.

¹ Unconstrained investing has its own challenges, not the least of which is the risk that managers and consultants will operate outside of their skill set. Another challenge is determining the appropriate benchmarks for evaluating performance.

² A possible middle-ground between rigid style boxes and unconstrained investing is discussed by Ron Surz in a separate chapter of the forthcoming book.



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