



Howard is Right...The World is Flat!

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The following is in response to our article two weeks ago, [The New Ptolemains](#), by C. Thomas Howard.

I have to admit, C. Thomas Howard is right. In response to my Advisor Perspectives article ([When Will Objectivity Enter the Active v. Passive Debate](#)) he introduces many rational critiques of my article that anyone who is objective would have to acknowledge. Like me, he questions “why market cap and PE” (although I think most of the academic work is based on book to market, not PE) should, or should not be used to categorize funds.

He is also right that defenders of geocentric theory (the earth being the center of the universe) invented convoluted calculations in attempts to defend their treasured theory in the face of the mounting evidence Copernicus had that proved otherwise.

I share with Howard (and have written in many of my papers) the notion that all of this slicing and dicing of the markets into style and market cap boxes is not really creating new asset classes and is just manufacturing non-diversified pieces of markets and thus it is worthy of skepticism. Forcing managers to stick to a style box wasn't something of my creation, yet there are many, many funds that self select themselves into one of those style boxes by choice, often to get a better “peer” ranking. That is why in www.fundgrades.com, we permit the user to grade their funds against any of 31 sub asset classes (including 13 domestic equity classes, not 31 - Howard's minor error).

Howard is right about one more point. If I take all 5,745 of the domestic equity funds from my original response to Howard's criticism of Wermers (those funds that had some semblance of matching any one of THIRTEEN domestic equity classes and sub classes) 60.15% of them BEAT THE S&P500 in the first three years of the six year period, and 58.91% beat the S&P500 over the entire six year period. Howard is right! Most domestic equity funds beat the S&P500! Therefore, skill is the cause and managers are getting more skillful as Howard's original response to Wermers stated. I thank Howard for helping me see the errors of my ways.



How's that for objective?

Of course, in looking at this one would have to question why we are comparing all of the different flavors of these various types of domestic equity funds to the S&P500 when most of them don't own it. Why not compare them to bonds or real estate, gold or oil? That would obviously be nuts, comparing **apples to oranges** as I (and many other readers commenting on Howard's first "research" response to Wermers) pointed out, but he evaded in his response shifting to subjective peer groups for which he provided no evidence of skill. Howard failed to respond to my basic criticisms of his choice of a large cap blend benchmark to grade all domestic equity funds. At the end of his article, he acknowledged that luck indeed exists, but ignored responding that the premise of his "research" showing an increasing "alpha slope" assumed that *luck cannot exist and all out performance was therefore skill*. Instead, like many sailors before Columbus who thought the world was flat based on their limited visual horizon benchmark, Howard criticizes objective attempts to measure how much skill and luck exist as if it were data mining.

Howard is right, not all funds are, nor should be, compared to style boxes. His answer is "Focus on Strategy," even though the evidence in his supposed research didn't measure it that way and instead benchmarked it against the S&P500. This is a very interesting logical quandary. Howard states that skill is increasing **because** more and more funds have been beating the S&P500, or have been doing so to a greater extent. Then, he argues that we shouldn't benchmark them against an index at all, but instead base it on something completely subjective, "Strategy Peer Groups." He offers no measurements here to prove the increase in skill, and I think that I might know why.

Let's lose the style boxes, as Howard argues we should, and let's make the assumption that managers will demonstrate skill by security selection, style shifts, and market cap movements, freely among all reasonably tradable domestic equity securities. There is a large mish mosh of strategies being deployed amongst these managers. Presumably, Dr. Howard would accept these assumptions. Let's also assume that skill doesn't necessarily evidence itself as higher returns and might also be represented by lower risk. Then, let's take all those 5,745 funds of various domestic equity flavors from my initial response to Howard and compare them to a benchmark that is more similar to the securities they can choose from for their portfolios, like the Russell 3000 which represents 98% of the investable domestic equity market.

Why didn't Howard use the Russell 3000 or Wilshire 5000 as his benchmark for his "alpha slope research" instead of the S&P500, which is only 75% of domestic equities by market capitalization? The only answer I could come up with is it didn't show that the earth was flat. Looking beyond his large cap horizon and



taking all domestic equity funds versus a benchmark of basically all domestic equities comes up with a different answer. That answer, of the 5,745 domestic “any” funds, only 47.33% had higher return and only 27.46% had less risk over the entire six years. In the first three years, 48.38% had higher returns and 36% had less risk. An increasing alpha slope indeed!

Howard’s lack of attention to his critic’s fundamental questions impugns his credibility. I, along with others, identified that his regression alpha slope trend line demonstrated nothing other than large cap blend stocks are something that is easy or hard to beat at different times. He did not really materially respond to this assertion.

Like Howard, I could acknowledge that many domestic equity funds do not stick strictly to style boxes and may even have some foreign exposure. But, isn’t choosing some foreign stocks part of the skill managers might have? After all, aren’t stocks, stocks? Is where a company locates its headquarters really moving it between asset classes? Chrysler has moved back and forth from foreign and domestic several times over recent years. It is still a company trying to make profits and has since moved to another invented asset class, “private equity.” There are foreign stocks in many domestic equity funds, so maybe we should benchmark all equity funds, of all types, against a World Equity benchmark? Why choose an easy benchmark that is just one box in the style box matrix Howard and I both hate so much?

Of course, based on the random noise of Howard’s alpha analysis relative to the S&P500 in his “alpha slope,” he would not like the results of such a comparison to World Equities. (Incidentally, I do not see where Howard calculated the r-squared of his randomly bouncing alpha dots to see if his trend line was statistically significant.) Howard would likely complain that World Equities is bad benchmark for domestic equity funds, yet he would still automatically credit all domestic funds that had some foreign exposure as being “skilled.” Likewise, small cap funds are skilled for beating the S&P500, which somehow is a good benchmark *for them*.

Expanding the universe to be all equity funds of any flavor against global equities we find only 27.27% beat the index for return and only 29.59% have less risk. Now, as an objectivist, I’m not going to state this means anything other than over the measurement period observed, foreign stocks generally did better than domestic and the universe was statistically over populated with a lot of funds that had little to no foreign stocks relative to the World Equities benchmark. Like Howard’s “increasing alpha slope research,” it does not mean anything of any value. This is no different than Howard’s universe that had the vast majority of the funds populating the universe that were something other than large blend. The only difference is Howard’s mismatched benchmark made alpha look easy



and my mismatched benchmark is an idiotic example that made it look hard. Both are still idiotic. Neither are good measures of anything other than noise. Shouldn't we acknowledge that it is equally misleading to compare a bunch of funds that are not large cap blend funds to an easy to beat large cap blend benchmark? C'mon...toss your critics a bone here and admit it.

And where did all of this series of debates begin? Advisor Perspectives started the debate by publishing an article about Wermers' research that attempted to statistically measure how much skill *and how much luck* existed in a universe. Howard followed with an article that criticized Wermers' objective piece supposedly *showing growing skill* based on past performance of funds *relative to a recently easy to beat (and mismatched benchmark)*, the premise thereof **assumed luck does not exist**. I, among several other letters to the editor, exposed the slippery slope of comparing apples to oranges and the assumption in Howard's analysis that ALL out performance was skill, and luck cannot exist at all. Howard's response completely evaded the benchmark mismatch (maybe he has some rationale for using one box in the style box matrix he hates?) and merely commented that luck exists while his alpha slope assumed luck does not exist. He uses this alpha slope as "evidence" skill is increasing despite acknowledging that luck exists in his response to my letter.

Neither Wermers nor I said skill does not exist. In fact, both of us said it probably does. Neither of us stated there is a small or value premium, as Howard pontificated as the basis of the style boxes I used in my initial response to him, yet ignored that many managers themselves self select as benchmarks for their funds. The bottom line concept is that all we said is luck exists, analysis attempting to identify skill should include this fact too instead of ignoring it. So, Howard does have to worry about sailing off the end of the earth. It might look flat when compared to the S&P500 horizon, but the convoluted math that proves it is round is real science.

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