

Oktoberfist: Digesting October's Sucker Punch

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Introduction

In April of this year I began writing about the miserable stock markets we've experienced in this first decade of the 21st century, recommending heightened due diligence and suggesting that things might even get worse.



They have, big time.

My last update on this mess was released on October 5, and covered the year to date through September. Then toward the end of October I alerted readers to some serious problems in style indexes and target date indexes. Now this writing brings these latest two commentaries up to date through an ugly October. I normally wouldn't bother with a monthly commentary, but October 2008 was like a punch to the stomach by a giant fist – an October Fist. I'd like to help you and your clients get your wind back, so I've updated my suggestions and observations in the following. Please let me know what you think. These are tough times and I'm here to help.

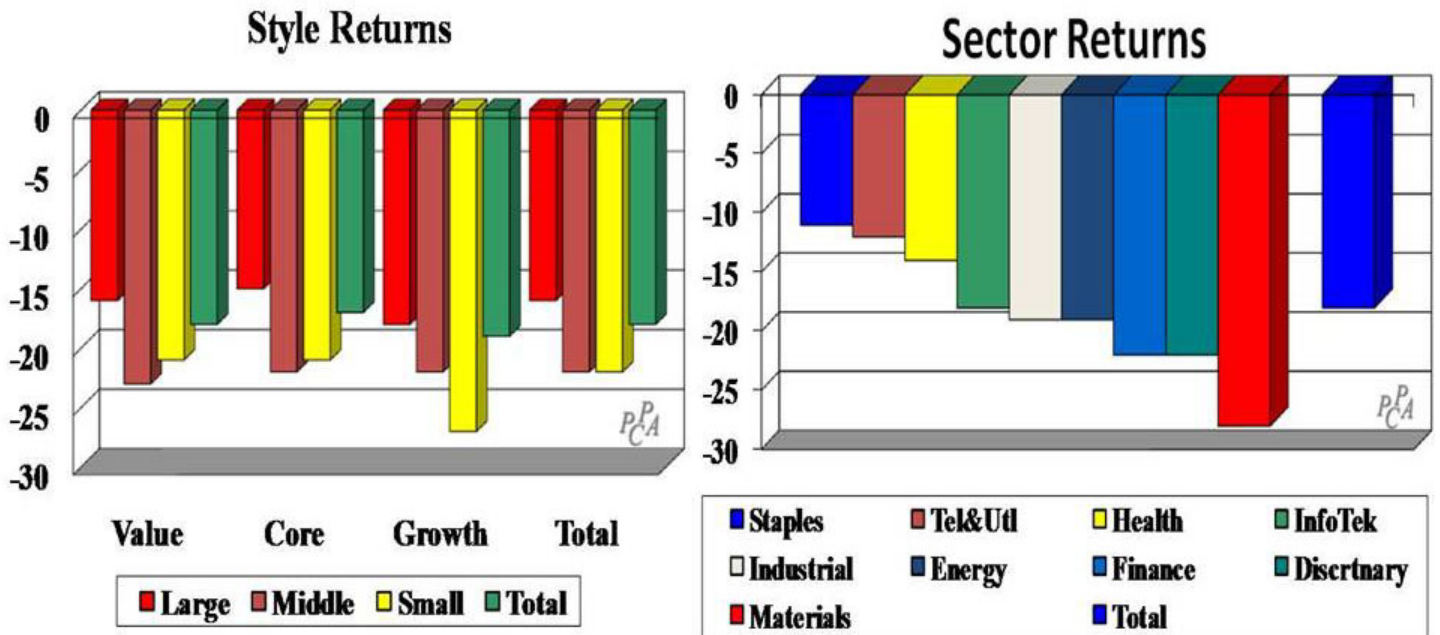
Update to "[A Decrepit Decade Continues](#)"

We are experiencing the worst decade ever in stock market history, and it just keeps deteriorating. Because of the 17% October loss, the year 2008 could be legendary and could clinch the race for the worst decade as well. We are now down 34% for the year-to-date, in an inflationary environment that has increased 4% so far, so our real (net of inflation loss) is 38%. As shown in the following exhibit, there have been only 3 calendar years with real losses in excess of 30%: 1931, 1937 and 1974. There's some good news and some bad news about being in this infamous club. First the good news. All three of these years were followed by years with positive returns, and 1938 and 1975 were particularly good, both returning about 30% real.

Now for the potentially bad news. Stock markets, as measured by the S&P500, have had 12-month periods with far worse losses than -30%-plus real returns of

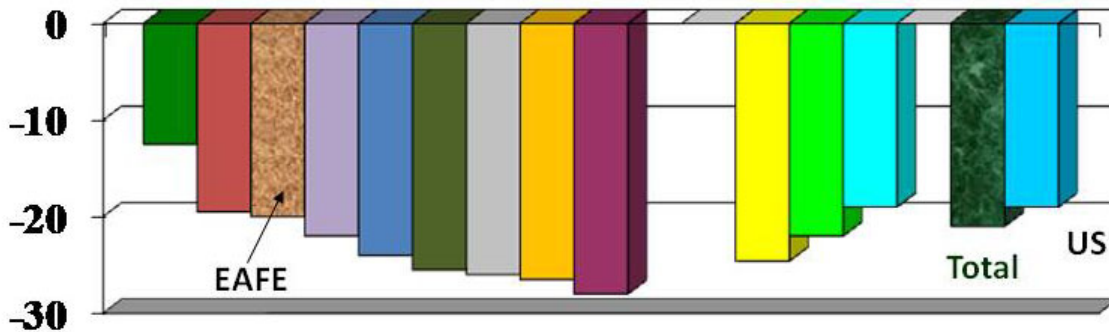
can be explained by a combination of continued deleveraging, selling past winners, plus expected cutbacks in consumer spending.

On the US style front, every style lost value, with the stuff in the middle surprising us by not performing in between. Large core has defended best, losing only 15%, versus 16% and 18% losses in large value and large growth, respectively. Our definition of “Core” is the stuff in the middle, between value and growth. Our style definitions are mutually exclusive and exhaustive, making them excellent for style analyses, both returns-based and holdings-based. Core tends to shine when investors lack conviction, unsure about which style to emphasize. We use Surz Styles and Countries throughout this commentary, as described at [<Surz Style Indexes>](#). See the section that follows on “Warning” for more on the importance of Core, especially this year.



Fleeing the country has only made things worse, especially in October. Currency effects in the month subtracted 5% from returns as the dollar strengthened, bringing the year-to-date currency effect to minus 13%. Foreign markets have kept pace with the US in local currencies. The overall foreign markets have lost 21% in October and EAFE performed somewhat better, declining 20%, due mostly to its absence of exposure to Emerging Markets and its overweight in Japan. The worst performing region was Emerging Markets, and the best was Japan. Fleeing the country has not been a good move in the current crisis, leading some to observe that international diversification fails when it's needed most. It is indeed a world market.

Country Returns



Update to [“Warning: Market Meltdown Generates Index Mayhem”](#)

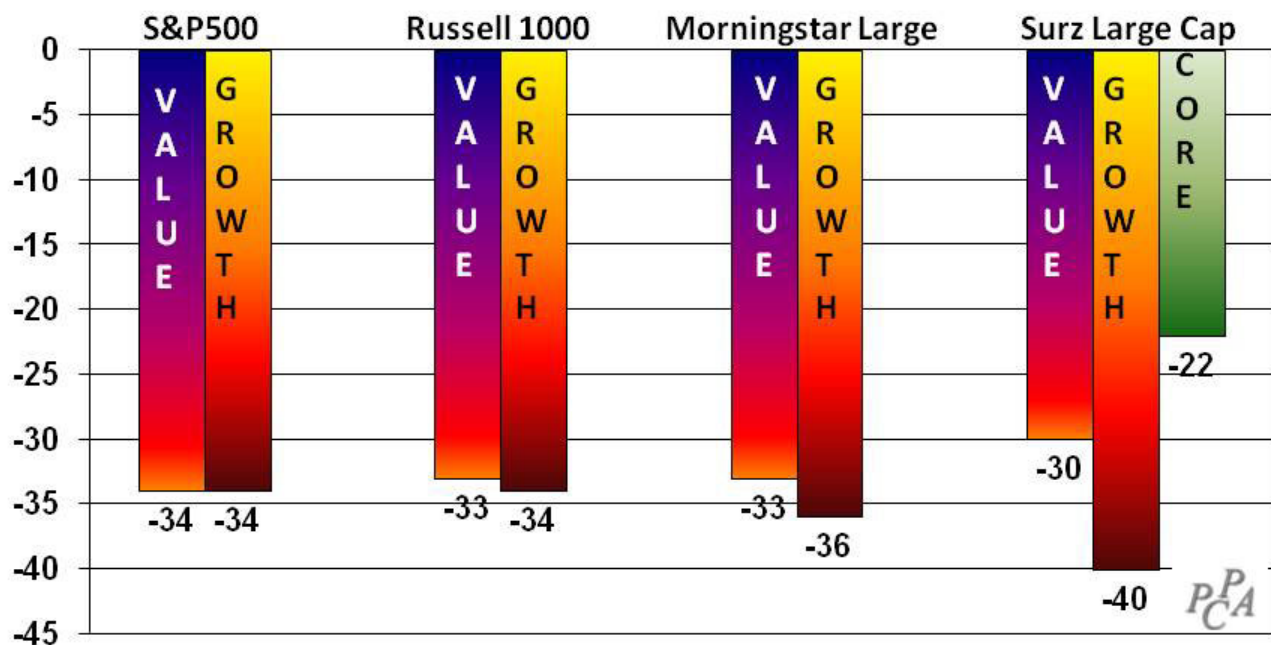
Toward the end of October I released a warning about the problems with indexes for styles and for target date funds. The following updates these warnings through October.

“It doesn’t matter which style indexes you use because they’re all about the same.” We’ve heard this often enough and it would seem to be the case in the first ten months of 2008, but not so. As shown in the following exhibit, the most popular indexes – Russell, S&P and Morningstar – all agree that value and growth have lost about the same, roughly 34% year-to-date through October, 2008. This concurrence should give us confidence that -34% is the right number, but both Russell and S&P are missing an important component of the market, namely the stuff in the middle, in between value and growth, that I call Core. Morningstar does include this important Core component, but it uses different rules than Surz Indexes described below, so their results are materially different. Surz Indexes were launched in 1986, and are described at [<Surz Style Indexes>](#). Morningstar indexes were launched in 1997.

Year-to-Date Style Distortions Demonstrate The Importance of Core



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



The inclusion of Core paints a dramatically different picture where Value has outperformed Growth, and Core has outperformed both Value and Growth. Morningstar's Core also outperformed its Value and Growth indexes, but their returns are different than Surz because their rules are different than Surz Index rules. Morningstar Core is down 28% year-to-date. Morningstar's definition of large Core is quite broad, representing more than 23% of the market, which is almost twice the 13% Surz definition.

Why is this Core-Value-Growth performance ranking important? **Because investment managers compared to the popular indexes will be misjudged at this very critical time of high investor anxiety.** Core typically outperforms when investors lack conviction, favoring neither value nor growth. Also, Barry Mendelson, president of Capital Market Consultants, has recently written about his belief that investors should prefer the stocks in the middle during the current



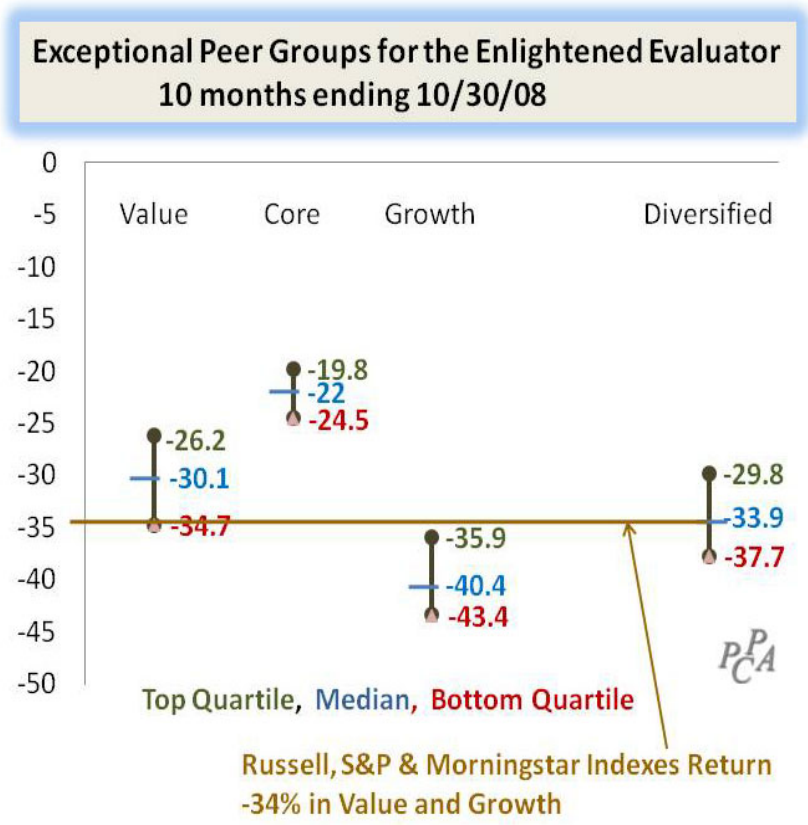
crisis – they are Goldilocks stocks, not too extreme in cheapness or expensiveness.

Now more than ever it's important to get the benchmark right. Otherwise today's faulty decisions will undermine future performance.

This type of index discord, while infrequent, is explained by differences in methodology that can be best understood by considering how stocks in the gray area, between value and growth, are treated by index providers. There are degrees of value and growth, so some growth stocks are more aggressive growth than others, and some value stocks are deeper value than others. And some stocks have characteristics that are not clearly value or growth – they're the stuff in the middle. Russell deals with this issue by pro-rata allocating these fuzzy stocks into both value and growth. S&P ignores the problem altogether by drawing a hard line that divides half of the market's value between value and growth. By contrast, both Surz and Morningstar deal with this stocks-in-the-middle issue by defining a separate category called "Core". I'll describe the Surz classification rules so you can see how it works.

Surz indexes break out value, core, and growth stock groupings within each market cap by establishing an aggressiveness measure that combines dividend yield, price-to-earnings ratio, and price/book ratio. The top 40% (by count) of stocks in aggressiveness are designated as growth, while the bottom 40% are called value, with the 20% in the middle falling into core. The result is a family of indexes that are mutually exclusive and exhaustive, making them perfect for style analyses, both returns-based and holdings-based style analysis.

Core usually performs in between value and growth, but about a third of the time it does not, like the current year to date. It is during these unusual times that Surz indexes, as an alternative to Russell and S&P, provide conspicuously valuable insights. Surz indexes have been around for more than 20 years, long enough to have





stood the tests of time. A list of stocks classified as core is available upon request.

So, what can you do to take advantage of this insight? Obviously, you can use the index results above, but I'm giving you something even better -- the gift in the next exhibit, which provides superior peer groups for your ranking pleasure and enlightenment. Just plot your fund's return against the appropriate group. As you can see there is very little overlap in the intra-quartiles, so misclassifying a manager will lead to erroneous evaluations. Also, classification bias in traditional peer groups is likely to be problematic in the ten months to date. For an entertaining and informative discussion of this little known bias please visit [<Classification Bias >](#).

The universes in this exhibit are created using an unbiased scientific approach called Portfolio Opportunity Distributions (PODs). They represent all of the possible portfolios that managers could have held when selecting stocks from their respective indexes. In essence, hypothetical monkeys expand an index into a peer group by simulating all the portfolios that could have been formed from stocks in that index. By contrast, traditional peer groups are very poor barometers of success or failure because of their myriad biases. Everyone knows that it's easy to find a peer group provider that makes you look good, but for some reason the industry tolerates, even condones, this deceptive practice. PODs are bias free and are therefore a much more reliable performance evaluation backdrop, plus POD universes were available on October 2, many weeks before the "real" biased peer groups. As John Stossel says on ABC TV News: "Give me a break." Please visit [< Virtual Peer Groups >](#) for more details on this important breakthrough.

Target Date Funds

Unlike the dozens of U.S. stock indexes, there are only three target date fund indexes. Dow Jones introduced their indexes first, in April 2005. Then my firm, Target Date Analytics (TDA), introduced our indexes in October 2007. And Standard and Poor's (S&P) just announced the creation of their new indexes. Plan Sponsor magazine adopted the TDA indexes in August of this year and re-branded them as the PLANSPONSOR On Target Indexes (OTI).

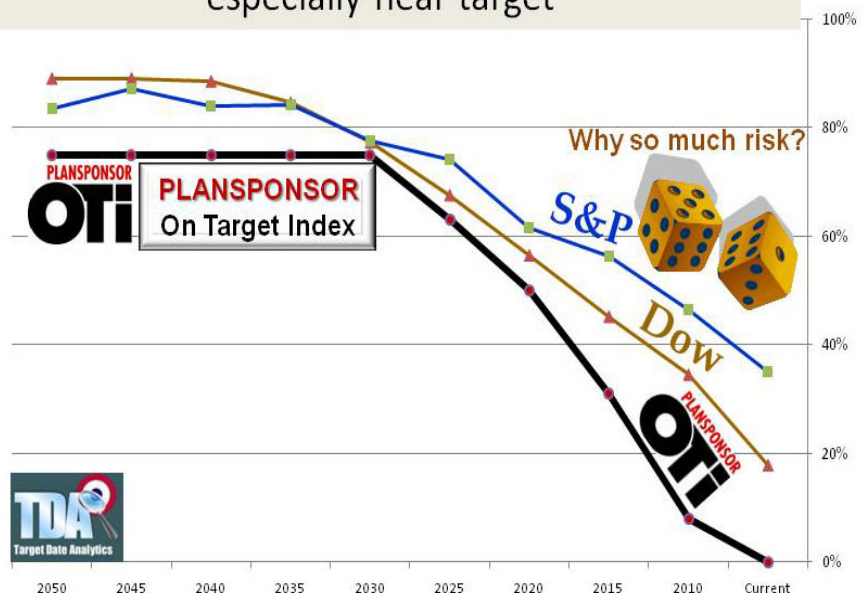
These three indexes differ substantially in composition and philosophy. Let's discuss philosophy first:

- The S&P indexes are industry averages, reflecting common practices among current target date fund offerings. S&P describes this construction as follows:

- “Each index is representative of the investment opportunity available to investors for the corresponding target date horizon, with asset class exposures driven by a survey of available target date funds for that horizon.”
- The Dow indexes have a stated objective to: “measure the performance of a lifecycle portfolio that seeks to grow and preserve real value over time.”

Glide Paths: Equity Allocations
PLANSPONSOR OTi is the most conservative, especially near target

- The PLANSPONSOR On Target Indexes have two objectives: “(1) Protect the purchasing power of contributions with a very high probability, and (2) Grow assets with a reasonably high probability, without jeopardizing the primary protection objective.”



- The major difference between the Dow and OTI objectives is priority. Dow places equal emphasis on preservation and growth whereas OTI emphasizes preservation over growth. In summary, the OTI and Dow indexes are standards – the way target date funds should be managed – and the S&P indexes are common practice aggregates. Unfortunately, we find common practice woefully lagging both the Dow and OTI standards. Target date funds are a great idea with awful execution, at least so far.

These differences in philosophy and objectives lead to materially different index compositions and results. The following exhibit summarizes composition differences at the broad equity allocation level. As you can see, as the target date approaches the S&P indexes are the most aggressive, followed by the Dow, and then the PLANSPONSOR OTi are the most defensive. All 3 indexes are quite similar in equity allocation at the more distant dates.

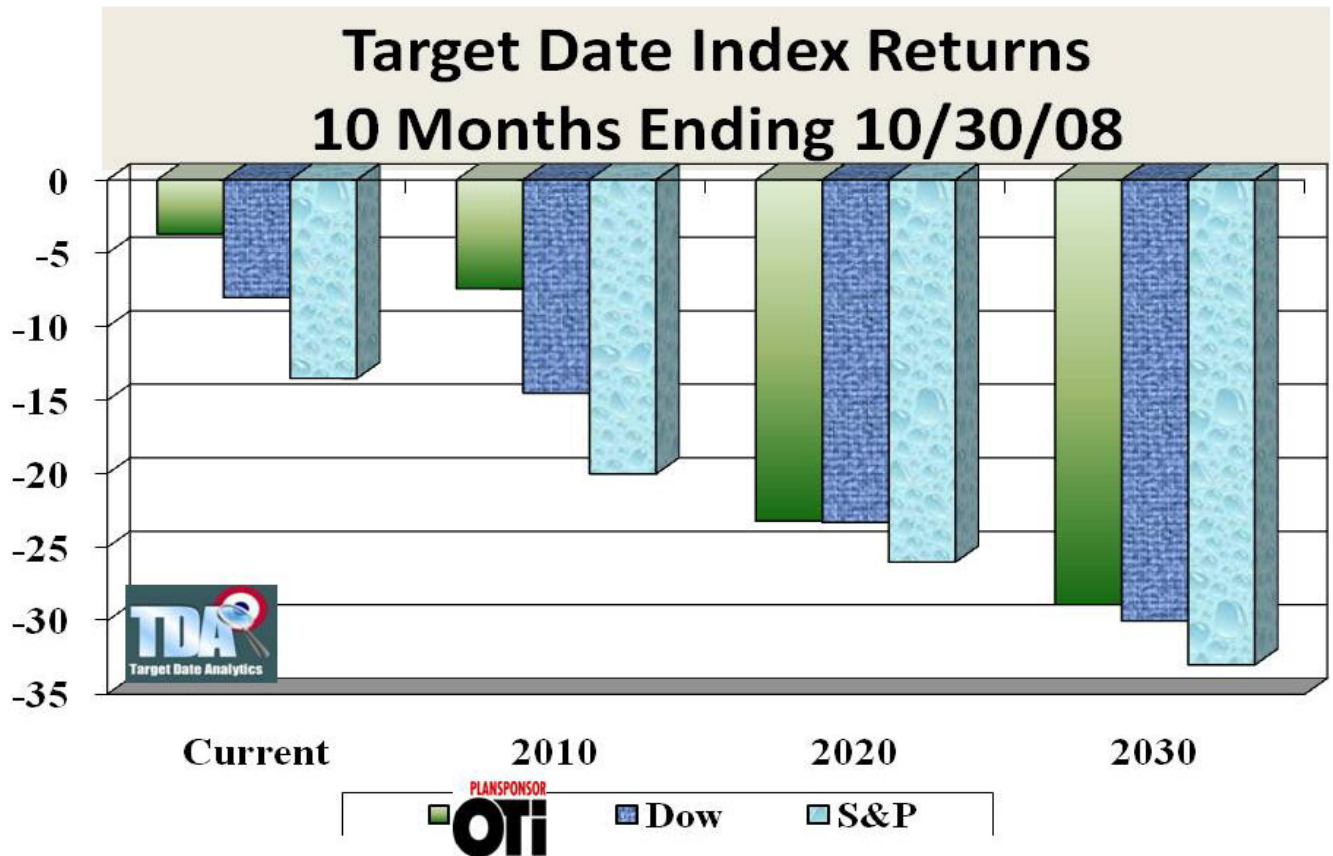


There is an ongoing debate raging in the target date industry regarding the purpose of target date funds. So far it's TDA versus the industry. We at TDA believe that target date funds should be limited to the accumulation phase of a participant's lifecycle, and that the distribution phase is best served by vehicles designed for this purpose, like annuities.

Vehicles designed to address longevity risk should be employed post-retirement because there is no glide path that can handle this life-long task.

Accordingly, we believe that target date funds should be entirely in safe non-risky assets at target date, waiting for the participant to move to the next phase, which they should be thinking about long before retirement. But the industry doesn't see it our way. The target date fund industry sees target date funds continuing beyond the target date. Some see accumulation funds morphing into distribution funds at target date and continuing on, in some cases to death. This is akin to viewing the target date as a small speed bump on the highway of life. Truth in advertising dictates that funds taking this extended view should be re-labeled so the investor knows their intended lifespan. For example, 2010 funds that are intended to serve the investor for 30 years beyond retirement date should be re-labeled 2010-to-2040 funds. But not all fund companies extend their glidepaths. Some fund companies roll their target date funds into "Income Funds", which have the objective of throwing off reliable income while preserving principal, rather than managing longevity risk. Both approaches extend the investor's participation beyond target date. What do you think the role of target date funds should be? Should they continue beyond target date?

These composition and philosophical differences have significantly impacted target date index performance in the year to date, as shown in the next exhibit. The recent meltdown has been a wake-up call for the target date industry and gives TDA an "I told you so" that we wish we didn't have. Our greatest concern is for investors in near-dated funds, who are at or near retirement, and have the most at stake both emotionally and monetarily. For the most part these 60-plus year old investors are in target date funds as a default option in their 401(K) plans, since target date funds are one of three qualified default investment alternatives (QDIAs). Do you suppose any of these folks were prepared for the kind of disastrous loss that has occurred in both the S&P and Dow indexes? Did they know the risks they were exposed to? That is, what is the better standard?



(S&P returns are approximate, and represented by TDA's peer group indexes.)

Your choice of index makes a big difference in your evaluation of target date fund results. **[Choose the index that is most in line with the plan participants' understanding of what target funds should be.](#)**

Conclusion

These have been trying times, and may be a harbinger of more to come. As long as we're paying the price, we might as well learn as much as we can from the lessons of these markets.

Here are a few lessons from this decrepit decade that can help us going forward:

1. Investors are entitled to be concerned about recent capital market behavior. It's been awful. "Staying the course" just hasn't cut it, and might not going forward. But there's a penalty for us all running to the door at the same time. The biggest risk we face is a panic-induced Pogo predicament: "We have met the enemy and they are us." These are very tough decisions.



2. Moving to certain styles, sectors or countries may help defend but hedging has worked best. Of course, investors can hedge on their own through the use of derivatives, or moving to cash.
3. This is a good time to stress test managers for skill. You know that stuff about what the tough do when the going gets tough. But it is absolutely critical that the benchmark is accurate. Some will get fired for the wrong reasons, and then their replacements will get hired for the wrong reasons too. Clients need to know what a "fair" loss should be, given what the manager does. Hint: off-the-shelf indexes only work on index huggers.
4. Selecting target date funds is currently problematic because this industry as a whole has entered into a performance race, and is exposing investors to too much risk, especially near target date. The timing for these moves to higher risk was bad, but it will be even worse if we don't learn from this lesson: target date funds should defend better near target date.

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