

## CAPTRUST *IN FOCUS...*



*...Research Driven*

### Thinking Outside the (Style) Box

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We live in an age of opportunity. Thanks to technological innovation and global boundaries being torn down, the consumer has more options open to them than ever before. Not only have our opportunity sets for leisure, entertainment, personal education, and consumption expanded, but accessibility has improved. Twenty years ago if I wanted to rent a movie, I was at the mercy of the selection of my local rental store. But in today's age, I have the ability to access movies on-demand through a number of different providers all from the comfort of my own home or even the ease of a hand-held device. These advancements are apparent in the investment world as well where investment opportunities are broader and more accessible than ever before. Investors now have immediate access to the financial markets through personalized trading systems and a broader selection of investment vehicles such as individual stocks, mutual funds, or ETFs. So why, in a world with expanding horizons, are we confining ourselves to an investment approach emphasizing restriction? Why handcuff our investment managers with tight style restrictions and market capitalization constraints? The answer has always been "diversification." However, that answer suggests style-boxing is the only solution to diversification; a philosophy CapTrust believes to be too simplistic.

Many credit the concept of diversification, or at least the mathematical evidence for diversification, to the creation of Modern Portfolio Theory: a concept developed by Harry Markowitz in the 1950's. Modern Portfolio Theory assesses the tradeoff between risk and return and theorizes that investing in a collection of uncorrelated assets can enhance returns by smoothing the overall volatility of a portfolio. While there has been much theoretical and practical debate over the merits of Modern Portfolio Theory, we won't tackle those arguments in this piece. Instead we'll focus on the most common implementation of the concept: style-boxing.

Style-boxing has been the investment community's solution to diversification. By breaking out asset classes into a number of different buckets and hiring specialized investment strategies to meet each mandate, style-boxing helps ensure diversification. The question surrounding the approach isn't whether it meets the goal, but rather if the approach is necessary to reach the goal and more specifically, if investors are unnecessarily sacrificing opportunity by constraining their investment managers.

At CapTrust, we have always believed there are good value-oriented investors and good growth-oriented investors. But when it comes to the difference between market capitalizations, we've never subscribed to the theory that investment teams analyzing companies with market capitalizations over \$10 Billion had some unique specialization that prevented them from adequately assessing companies with market capitalizations under say \$5 Billion. CapTrust's approach has always been to find excellent stock-pickers with transparent and easily understood investment processes. We then allow them the flexibility to find good companies, regardless of capitalization. As a result, we've often preferred managers with more flexible mandates and placed less emphasis in our evaluation process on strict style consistency. While we understand there are diversification benefits to style-boxing, our focus has always been identifying skilled stock-pickers and then finding an appropriate bucket to put them in, rather than the other way around. We believe investing with a group of diversified investment managers who have broader scopes for style and market capitalization, ultimately provides better opportunity for out-performance without sacrificing diversification.

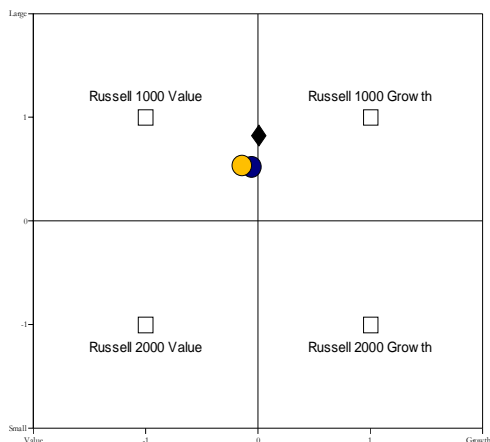
In order to test this theory, CapTrust compared the benefits of a broader mandate to the traditional style-box allocation. We used Domestic All Cap strategies as our test subject and compared their performance

to that of a blended group of style-boxed active managers. The allocation to market cap within the blended group of active managers was constructed in line with the primary benchmark for Domestic All Cap managers, the Russell 3000. As a result, our base for comparison was a blend of 70% Active Domestic Large Cap strategies, 20% Active Domestic Mid Cap strategies, and 10% Active Domestic Small Cap strategies. For each subset (Large Cap, Mid Cap, Small Cap, etc) an equal-weighted composite of the universe in Zephyr’s Separately Managed Accounts Database was created. We examined this analysis across styles, comparing Core, Value, and Growth mandates. If our theory proves correct, we’d expect to see more compelling performance from the managers afforded a broader opportunity set.

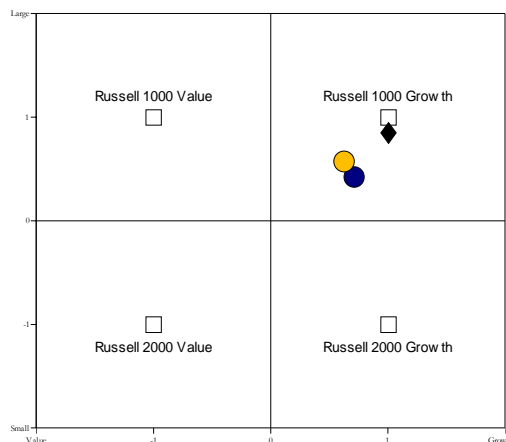
	1 Qtr	YTD	1 Year	3 Years	5 Years	7 Years	10 Years
Active All Cap Core Managers	5.99%	29.22%	29.22%	-2.73%	2.95%	8.85%	4.62%
Style-Boxed Core Managers	5.68%	29.00%	29.00%	-3.45%	2.37%	7.93%	3.66%
Russell 3000	5.90%	28.34%	28.34%	-5.42%	0.76%	6.20%	-0.20%
Active All Cap Growth Managers	6.34%	35.58%	35.58%	-1.28%	3.75%	10.22%	2.20%
Style-Boxed Growth Managers	6.82%	35.83%	35.83%	-1.73%	2.64%	7.98%	0.79%
Russell 3000 Growth	7.65%	37.01%	37.01%	-2.06%	1.58%	6.11%	-3.79%
Active All Cap Value Managers	5.25%	33.71%	33.71%	-3.08%	3.60%	10.13%	9.06%
Style-Boxed Value Managers	5.33%	29.10%	29.10%	-4.67%	2.34%	8.47%	6.13%
Russell 3000 Value	4.17%	19.76%	19.76%	-8.91%	-0.24%	6.11%	2.88%

As the performance table above indicates, there does appear to be some evidence suggesting managers with a broader mandate out-perform a more traditional style-boxed allocation. As you can see in the above exhibits, Active All Cap strategies consistently out-performed a blend of traditional style-boxed strategies over the trailing 3-, 5-, 7-, and 10-year periods (as of December 31, 2009). Of course performance alone does not always tell the entire story, so let’s examine some of the risk characteristics of the Active All Cap strategies compared to the style-boxed strategies.

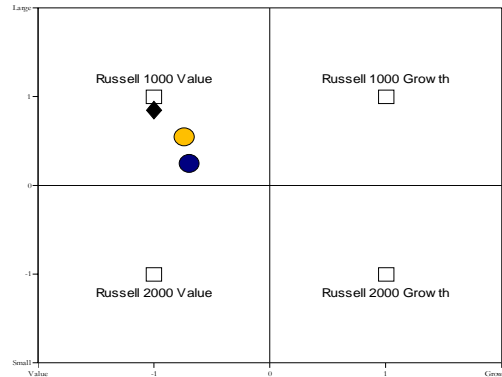
**All Cap Core**



**All Cap Growth**



*All Cap Value*



First let's take a look at the style orientations of each set of strategies. In each of these graphs, the yellow dot represents the "Style-boxed allocation", the blue dot represents the "All Cap allocation", and the black triangle represents the appropriate benchmark (Russell 3000, Russell 3000 Growth, Russell 3000 Value). You'll notice in the Core space, the market capitalizations for the Active All Cap managers and the blended Style-boxed managers are nearly identical; while in the Growth and Value spaces, the All Cap strategies tend to drift slightly down market capitalization as indicated by the blue dot drifting below the yellow dot. This represents an increased exposure to Small and Mid Capitalization companies which gives these portfolios slightly higher standard deviations over time in exchange for the potential added benefit of increased returns. The question for investors: Is the flexibility the All Cap manager employs going down market capitalization worth the slightly higher volatility?

In order to assess this question we'll take a look at a couple of different statistics. We'll start with *Sharpe Ratio* which is a statistic designed to measure the ratio of excess return per unit of risk.

<i>Sharpe Ratio</i>	3 Years	5 Years	7 Years	10 Years
Active All Cap Core Managers	-0.24%	0.00%	0.40%	0.11%
Style-Boxed Core Managers	-0.26%	-0.03%	0.33%	0.05%
Russell 3000	-0.33%	-0.12%	0.22%	-0.16%
Active All Cap Growth Managers	-0.14%	0.04%	0.42%	-0.03%
Style-Boxed Growth Managers	-0.17%	-0.01%	0.32%	-0.10%
Russell 3000 Growth	-0.19%	-0.07%	0.22%	-0.31%
Active All Cap Value Managers	-0.22%	0.04%	0.42%	0.35%
Style-Boxed Value Managers	-0.30%	-0.03%	0.34%	0.19%
Russell 3000 Value	-0.46%	-0.16%	0.20%	0.00%

Sharpe Ratio does have some limitations, specifically when generating negative results. Due to the construction of the formula used to calculate Sharpe Ratio, when the number is negative increasing risk actually results in a larger Sharpe Ratio. As a result, the focus of this data should be on the longer periods, specifically the trailing 7-year period where all results are positive and provide an adequate sample to assess. Within this data set each of the All Cap strategies, regardless of style, offer better Sharpe Ratios which indicates the increased opportunity set does indeed provide the investment managers with the flexibility to offer stronger risk-adjusted excess returns.

Since Sharpe Ratio has its limitations when negative, let's check with another risk-adjusted statistic to see if the All Cap managers continue to provide better risk-adjusted performance: **Alpha**. Alpha is a coefficient that measures risk-adjusted performance factoring in the risk due to the specific security (or manager), rather than the overall market.

<i>Alpha</i>	3 Years	5 Years	7 Years	10 Years
Active All Cap Core Managers	1.92%	1.87%	2.73%	4.31%
Style-Boxed Core Managers	1.64%	1.44%	1.75%	3.49%
Russell 3000	0.00%	0.00%	0.00%	0.00%
Active All Cap Growth Managers	1.35%	2.44%	3.80%	6.07%
Style-Boxed Growth Managers	0.54%	1.16%	1.75%	4.07%
Russell 3000 Growth	0.00%	0.00%	0.00%	0.00%
Active All Cap Value Managers	6.15%	3.76%	3.94%	6.02%
Style-Boxed Value Managers	3.88%	2.32%	2.38%	3.13%
Russell 3000 Value	0.00%	0.00%	0.00%	0.00%

A look at the Alpha statistics shows a more clear and consistent relationship to examine. As you can see the Active All Cap managers are able to generate more alpha than the traditional style-boxed allocation over all trailing periods and in most cases by rather wide margins.

### **Conclusion**

We believe style-boxing has and always will be an adequate way to help investors diversify. However, with rigid implementation of style constraints investors are more likely to receive constrained investment results. The comparison we've run suggests clients can benefit from identifying superior stock-pickers and loosening the constraints on those managers. This can be implemented either through broader mandates that allow investment managers a larger opportunity set, or more simply by placing less emphasis on style consistency in the evaluation process. By shifting investors focus from skill within a confined environment to just skill, investors ultimately increase the opportunity set and may open the door for better results.

## **Appendix 1**

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#### **References:**

All data was sourced from Zephyr's Style Advisor program, utilizing Zephyr's Separate Account Database, Index Databases and Universes.

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