

Investment Tutor

Style never goes out of Fashion

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Chris Wagstaff, head of investment training and development at Aviva Investors, considers the distinguishing characteristics of the main active equity investment styles and assesses the recent past and future of style investing

Active equity managers employ one of a number of distinct investment styles when attempting to outperform a predetermined benchmark. Although style investing can be traced back to the 1930s, having originated from the pioneering work of Benjamin Graham and David Dodds, it has only really gained prominence in the last decade or so as a means of developing and evaluating investment strategies and stock selection processes. Investment styles have emerged as a result of evidence that particular groups of stocks sharing one of a number of common characteristics, or style factors, exhibit a meaningful tendency to move together and experience long periods of out and under performance of the broader market.

Whilst investment styles are many and varied, the most popular are growth and value investing, each of which comprises a multitude of different approaches. For example, momentum investing, which focuses on those stocks whose price has been on a rising trend and continues to gather momentum in a self-perpetuating manner, is growth investing at its most aggressive. Appealing to investors' natural optimism, little attention is paid to the characteristically above-average market valuation of such shares. GARP, or Growth At a Reasonable Price investing, however, is a less aggressive and more research-oriented growth investment style, centred upon those companies that are perceived to offer above average earnings growth potential which has yet to be fully factored into the share price.

Value investing, meanwhile, seeks to identify those companies, usually cyclical in nature, that have either been ignored by the market or have suffered a setback but look poised to recover. Such stocks are defined by their characteristically low valuation and/or high dividend yield. Likened to a pawnbroker, the value investor attempts to buy stocks in distressed conditions in the belief that they will mean revert to their fundamental, or intrinsic, value. Just as markets overshoot their intrinsic value to the benefit of momentum investors, they also undershoot, or overreact to bad news, to the benefit of value oriented contrarian investors who position themselves against the market consensus.

Each investment style and style within a style, therefore, demands a different mind and skill set. In the same way that Gary Neville and Wayne Rooney could never perform at their best by swapping positions on the football pitch (apparently), most value and growth managers would find it difficult to successfully emulate their counterpart's attacking and defensive investment styles, respectively. That said, many fund managers argue that whilst growth and value investing have a different focus, they are not mutually exclusive, in that the majority of stocks exhibit, to varying degrees, both growth and value characteristics.



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Moreover, according to Warren Buffet, growth and value investing are joined at the hip in that investment styles and processes often overlap. For instance, not too many value managers would ignore a cheap stock simply because it looked to have strong growth prospects. In short, no two fund managers will approach any one investment style in exactly the same manner. Despite this, style matters. Indeed, Nobel Economist Bill Sharpe found that investment returns are more dependent on style factors than on the stock picking abilities of individual managers. In other words, a growth oriented stock picker would find it difficult to outperform in a value driven market.

So, notwithstanding the debate over the blurring of the distinction between growth and value investing, which of the two styles has been the most successful? Well, whilst it is well documented that value outperforms growth over a 50 to 100 year timeframe, this period extends far beyond the investment horizon of most pension funds. The shorter term record is not particularly helpful either as the evidence points to no one style outperforming in all market conditions; rather each periodically underperforms the market. Therefore, investment style, as well as being a key source of investment return, is also a major source of risk.

It would seem then that rather than stay loyal to one style, it pays to be pragmatic and alternate between styles as and when one style is about to take the baton from the other: for example when growth ceded to value at the end of the dot.com boom. Whilst this style rotation can, at least in theory, be successfully engineered by observing a multitude of economic and market indicators that collectively signal potential inflection points in the equity market, in practice style rotation has proved to be an elusive skill, not least because of poor modelling and forecasting. Consequently, a number of fund managers have adopted a style neutral approach to active equity management, such as running modular portfolios. Here, two or more sub-funds, each managed independently of the other(s) and with a style independent of its companion modules, are combined to form a single fund. When well-implemented, this approach, which lets growth, value and other style managers play to their natural strengths, should offer returns that are more consistent and less volatile than the returns of either sub-fund in isolation, given the diversification of manager and style risk.

These innovations, taken together with those such as the construction of style indices to better evaluate manager performance and the detailed attribution of manager performance to style factors, suggest that investment style, whether embraced or harnessed, looks set to continue as a permanent feature on the active equity management landscape. After all, it is said that style never goes out of fashion.

The opinions expressed are those of Aviva Investors as at 17 August 2008.