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Style Boxes: Inevitably Misleading

BY MILTON EZRATI AND JOHN FIDACARO

During the past couple of years, investors have begun to question the narrow style boxes traditionally used to construct portfolios. And their doubts have good cause. Some of the distinctions between large, small, and mid capitalization equities have always had an arbitrary quality, as have the distinctions among value, growth, and core styles of management. Even more compelling, market behavior during the past 10-plus years has demonstrated that the correlations used to diversify a portfolio among such fine style-box distinctions are anything but stable. Now it has become apparent that even the most dedicated managers have trouble keeping their portfolios within narrow style-box limits, at least as they are customarily measured. Such movement is termed "style drift."

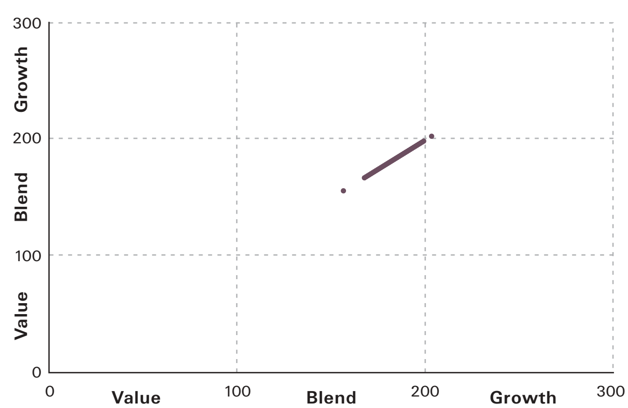
Our analysis of style drift relies on data from Morningstar, a mutual fund research service that offers one of the most widely used and carefully constructed tracking of style in the investment community. This service regularly analyzes portfolio characteristics to tag each portfolio with what it calls a "style score." It then uses the scores to group portfolios: those with scores between 0–100 are considered "value"; between 100–200 are considered blend or core; and scores above 200 are considered "growth." Though focused on mutual funds and perhaps a bit less sophisticated than some of the analytical structures used by institutional consultants, Morningstar's guidelines are almost surely as useful a guide as any, especially since many investment firms reasonably manage their mutual fund-style disciplines in much the same way as they do their separately managed and institutional portfolios.

The accompanying charts paint this picture of drift from three different perspectives. Each looks at groups of portfolios sampled from all styles and tracks their scoring monthly for each of the last 10 years. For ease of viewing, those scores are presented here on a plane instead of a line. Thus, each chart measures from value to growth in the same way on both the vertical and the horizontal axes so that a linear progression from value to growth would proceed from the lower left to the upper right, while stability in one style would appear on the chart as a concentrated cluster of points.

Chart 1 looks at the scoring and positioning of the entire Morningstar universe of portfolios, including all styles and capitalizations, almost 2,700 portfolios in all. Since this group contains growth, value, and blended-style portfolios, it is surely reasonable to assume that the average of all would stick consistently close to the center of the possible range. And as the chart

Chart 1. Style Scores for Morningstar Universe

(monthly observations, 1999–present)



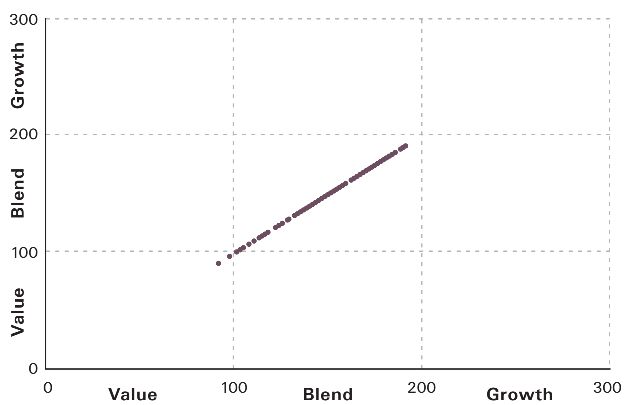
Source: Morningstar.

NOT FDIC INSURED—NO BANK GUARANTEE—MAY LOSE VALUE shows, the array of observations does hover, as it should, in that location. But it also shows that the positioning from one year to the next is far from stable. In fact, only one year truly hits the theoretically expected center point. For the rest, they stretch up at times into the range of growth scores. Doubtless, some of this drift reflects the strong outperformance of growth at times and the consequent shift of client funds from value and core styles to growth. But not every such observation coincides with such periods. The most extreme did, in fact, occur in February 2000 at the height of the technology boom. But the universe of portfolios averages near growth scores in 2003 as well, when conditions hardly favored the growth style. Clearly, some of this drift has a random element.

Chart 2 shows the results of a similar analysis, but with just the largest funds, those with assets of more than $5 billion. This effort tracks some 75 portfolios through time. Here, too, since the selected portfolios come from all investment styles, it is reasonable to expect their average score to center on the middle range of the blend designation. It does, but the deviations from one year to the next are even wider than those measured for the entire universe of funds. In some years, this average score almost gets into the growth designations, and in two years, it actually slips into the value designation. These two years, 2001 and 2002, have only a few market characteristics in common. The most growth-like average score occurred in 2007, a year that had only a mild market disposition toward the growth style. On balance, as with the overall aggregate, much of this style drift has a random element.

Chart 2. Style Scores for Morningstar Top 75 Portfolios

(monthly observations, 1999–present)

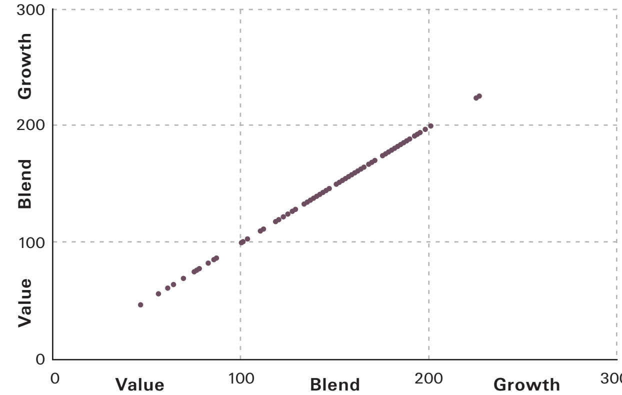


Source: Morningstar.

Chart 3 puts this question of style drift into the sharpest relief. It shows the results of the same sort of analysis, except with the average score of nine portfolios: three of the top value-oriented funds, three of the top growth-oriented funds, and three of the top blend- or core-oriented funds. As in the other analyses, theory would expect the average to tend toward the middle, blend score, which the results do indeed show. But they also show a huge deviation in the average score from one year to the next, ranging from the middle of the value group through all scores within the blend or core group, and well into the growth scoring. Similar to the other analyses, some of these moves are unsurprising, given the investment experience of a particular period. But, as in the other perspectives of the other exhibits, other shifts have more of a random quality.

Chart 3. Style Scores for Morningstar Top Nine Portfolios

(monthly observations, 1999–present)



Source: Morningstar.

None of this analysis necessarily suggests that managers fail to exercise style discipline. On the contrary, although some managers can become careless from time to time, most work very diligently to stick to their mandate. In all three approaches, the sample is large enough to rise above the effects of those few less-than-diligent managers. Rather than find fault or assign blame, this analysis aims to show that even with the greatest effort at style discipline, the vicissitudes of portfolio management, especially the behavior of clients as they shift from one style to the other, will alter a portfolio's score enough to make it seem to change style boxes. As the historical record shows from three perspectives, such shifts are simply unavoidable, even with the most diligent efforts.

The implications for practical portfolio management are also clear. Efforts at very fine style distinctions and, by implication, capitalization distinctions as well are bound to face frustrations and may not serve diversification goals as effectively as some might want. Since investors all live in a world of limited resources, these results would seem to argue against excessive attention to fine style and capitalization distinctions. ■

Milton Ezrati, Lord Abbett Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor, *and* Foreign Affairs, *on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.*

John Fidacaro, Director of Competitive Intelligence for Lord Abbett, assesses various aspects of the financial services industry, including market trend activities, product positioning, growth opportunities, and competitive analysis. Mr. Fidacaro has 14 years of industry experience. He joined Lord Abbett in 2002 as Manager, Mutual Fund Performance. Prior to joining Lord Abbett, he was Senior Performance Analyst at Morgan Stanley, and before that, an Analyst with Hamilton & Company. Mr. Fidacaro received an MBA in finance from Baruch College and a BS in finance from the University of Delaware. He also is a holder of Series 7 and Series 63 licenses.

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