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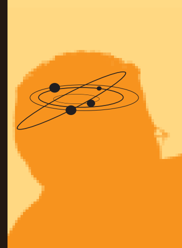
PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS



STYLE INVESTING

STRATEGIES THAT TOGGLE BETWEEN VALUE AND GROWTH

In uncertain market conditions, fund managers may go for a product that produces gains from two completely different investment styles

The year 2003 proved to be a roller-coaster one for European equities. The early months were dominated by headlines such as the war in Iraq, terrorist fears and the Sars virus. In the period to 12 March 2003, the MSCI Europe index gave up nearly 20 per cent of its value. What many saw as an initial bear market rally has since blossomed into a more robust bull market, with the index rising by 60 per cent as at end February 2004.

As a result, those equity investors who not surprisingly adopted a cautious approach during 2003 have missed out on many of the gains seen in European stock markets. Some lost out by retaining positions in more defensively orientated stocks, instead of switching into higher beta companies. Today, others may have missed out on the potential for future stock market rises in 2004 by taking profits from equity gains and re-allocating into other asset classes. This uncertainty over the pattern of future equity market advances, plus the dilemma of "identifying the winners and avoiding the losers" offers no answers to the question: "What should investors do right now?".

POPULARITY

Solutions do exist and one such example is a "style investing" strategy. This involves fund managers swapping from "value" to "growth" companies depending on market conditions, and they are gaining in popularity due to investor uncertainty about future trends. Many investors are actively using strategies that offer the potential to benefit from either of these investment styles, in-line with prevailing market momentum.

Trends in European economies and equity markets make long-term investment in European stocks increasingly attractive. Favourable macro-economic factors such as widespread structural reform of institutions and the job market, coupled with the creation of private pension plans in the European Union, are underpinning stock market gains. In terms of market capitalisation, the European equity market is the second biggest in the world, giving investors a broad investment universe by region and sector. Europe's low equity ratio, compared with the US, is also advantageous to equity investing in the region.

To benefit from these current upbeat trends in European stock markets, products that take advantage of style investing could provide a useful way into the market at this point of the cycle where uncertainty is still present. It is important for banks and other distributors to understand how these products work and how useful they can potentially be for their clients' portfolios.

'Such a product takes the pain out of investor decisions as to which investment style they prefer at any one time, and when they should switch'
Martin Schlatter, Bank Leu

SUB-MARKETS

A wide range of academic research suggests that distinct segments or sub-markets exist within the overall equity market. Furthermore, companies from different segments have different characteristics and appear to generate different risk-adjusted average returns for extended

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periods of time. In response to this research, investment professionals have devised strategies designed to exploit these so-called market anomalies. The implementation of such strategies has become known as style investing and is currently a major focus of interest amongst asset managers and investors.

Style investment strategies took off in the 1990s largely as a result of the work of William Sharpe, a Nobel Prize winner, who put forward the view that up to 90 per cent of performance in a US equity fund could be due to the style investment approach of the manager. Today, investors recognise two primary styles: value and growth. Some also believe that momentum is a distinct style, but others consider it a sub-style of value and growth.

YIN AND YANG

For argument's sake, value and growth – the yin and yang of the equity investment world – are the two most popular styles of investment.

Value and growth investing typically look at stocks with the characteristics shown in Chart 1.

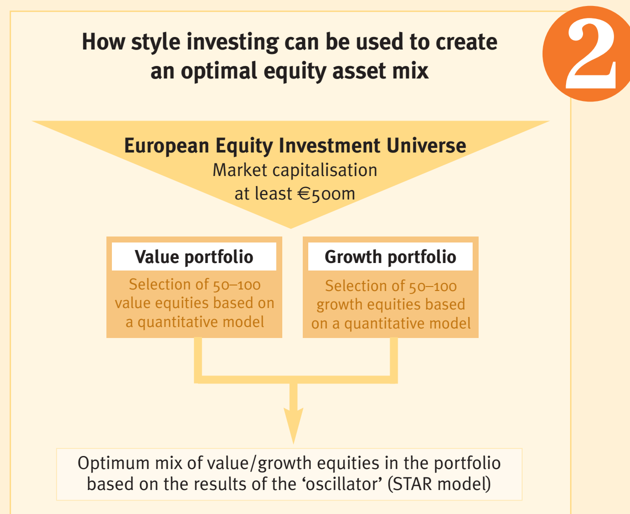
Growth stocks will typically have certain key characteristics in common. These include high revenue and earnings growth, high price/earnings ratios and high price/book ratios.

By contrast, value securities will have low revenue and earnings growth, low price/earning ratios and low price/book ratios.

However, no stock is always either a growth or value stock. Growth stocks could become value stocks over a period of time and vice versa. Stocks can also be simultaneously classified as both value and growth companies, depending on the sector and position in the life-cycle of the company, allowing for characteristics to be differently pronounced.

The creation of a product that takes advantage of upside performance in both value and growth stocks should, if rigorously managed, have the potential to outperform an index over all periods. So, how can such a vehicle be constructed?

The first step is to create two portfolios, one of growth



1 Key attributes of value and growth companies

Characteristics of value companies

- an established business model;
- stable operational cash flows;
- high level of earnings stability; and
- company valuation in line with generated returns.

Characteristics of growth companies

- a market with strong growth potential, but not yet established;
- prospect of rapidly growing operational cash flows;
- degree of earnings uncertainty with respect to forecasts; and
- company is valued based on expectations of future earnings.

Key benefits

The following benefits feature in a product specialising in style investing:

- **offers a compelling strategy for investors seeking attractive returns from an actively managed equity product;**
- **enables investors to benefit from the relative merits of either value or growth investing; and**
- **the portfolio's overall bias is automatically adjusted by professional asset managers according to prevailing market conditions.**

stocks and the other of value stocks. In Europe, each model style portfolio would be looking to pick stocks from European companies with a market capitalisation of at least €500m.

The growth portfolio would comprise 50–100 growth stocks selected using strict quantitative criteria such as industry sector, long-term price momentum and high earnings growth over recent years. The portfolio would be rebalanced every three months, with stocks added and discarded depending on their adherence to the growth style.

The second portfolio of 50–100 value stocks would be selected on the basis of high dividend yield, low price to book ratios and long-term price momentum. For a value portfolio, a rebalancing every six months is sufficient.

The next step is to determine the balance between growth and value portfolios within the product. By using a quantitative model, the STAR (style allocation rotation) oscillator model, it is possible to adjust the relative weighting so as to reflect the different risk preferences of investors.

This oscillator model is a function of expected economic growth, market sentiment (risk appetite) and the momentum of spreads between the return of value and growth stocks. The advantages of a quantitative investment strategy in such a style-based approach to investing are that it allows for:

- systematic detection and appraisal of market anomalies;
- structured and disciplined investment process with integrated risk management;
- evaluation of a large investment universe;
- rapid shifts of focus as well as the immediate exploitation of opportunities; and
- independence from human emotions, with no bias towards sell-side research recommendations.

'The downside of style investing is when a portfolio manager does not apply the strategy in a disciplined fashion... This results in style drift'

WEIGHTING

The weighting of either portfolio can be zero, one-third or two-thirds. A neutral weighting is not permitted so as to ensure the portfolio always has an active bias towards either one of the two styles. This disciplined investment process is shown in Chart 2.

Investors likely to be interested in a value/growth style fund in European equities will be seeking diversified investment in European equities with an active investment strategy. Such a product would provide active portfolio management that enables significant divergence from benchmark returns to be achieved.

Typically, such a product takes the pain out of investor decisions as to which investment style they prefer at any one time, and when they should switch, and leaves that up to a proven investment process that can demonstrate positive results over recent years.

DISCIPLINE

The downside of style investing is when a portfolio manager does not apply this strategy in a disciplined fashion. Historically, some managers may not have been as rigorous with their investment style as they needed to be. This results in style drift, with managers either moving away from their primary focus or becoming heavily biased towards it.

In a value/growth fund, the importance of applying rigorous quantitative methods is key to successful investing. A robust application of these methods provides the potential for significant outperformance of an index over all time periods.

Martin Schlatter, portfolio manager, Credit Suisse Equity Fund (Lux) Style Invest Europe

CORPORATE STATEMENT

Credit Suisse Asset Management (CSAM) is a leading global asset manager focusing on institutional, mutual fund and private client investors, providing investment products and portfolio advice in three regions (Americas, Asia-Pacific and Europe) around the world. CSAM has $318bn of global assets under management and employs 1963 people worldwide as of 31 December 2003. CSAM is part of Credit Suisse First Boston, a leading global investment bank serving institutional, corporate, government and individual clients.

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