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SOLUTIONS FOR EUROPEAN DISTRIBUTORS

STYLE INVESTING

BEST OF BOTH WORLDS: VALUE AND GROWTH

Style investment strategies, which revolve around the monitoring of distinct market segments, depend on quantitative analysis of the underlying stocks

The continuing recovery of European stock markets is increasing investors' appetite for equities, but a residual uncertainty is preventing a herd-like rush back into stocks. Style investment strategies, where managers swap from "value" to "growth" companies depending on market conditions, are gaining in popularity in line with this renewed interest towards stock markets.

Equity investing is beginning to pick up momentum as a result of low valuations, particularly in Europe, where the region's stock markets are valued at fair to favourable levels, compared with historical data. The re-entry of institutional investors into equities is also increasing, as bonds lose some of their appeal in a low interest rate environment.

'Value and growth – the "yin and yang" of the equity investment world – are the two most popular styles of investment'

Martin Schlatter, Bank Leu

ADVANTAGES

Trends in European economies and equity markets make investing 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.

In order to take advantage of the 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.

ANOMALIES

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 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

Key benefits

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

- **It should offer a compelling strategy for investors seeking attractive returns from an actively managed equity product;**
- **enable investors to benefit from the relative merits of either value or growth investing, by automatically changing the fund's overall bias in accordance with changing market conditions, and**
- **must be managed by an experienced portfolio management team that has a proven track record of success.**

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Key attributes of value and growth companies

Value companies

These are the characteristics that mark value companies:

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

Growth companies

So-called growth companies show the following characteristics:

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

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. 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 strategies typically look at stocks with the characteristics shown in Chart 1.

CONSTRUCTION

Growth stocks will typically have certain key characteristics in common, such as 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 companies are always exclusively growth or value stocks. Growth stocks could become value stocks over a period of time and vice versa. Equities can also be classified as both value and growth simultaneously, 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 product be constructed?

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

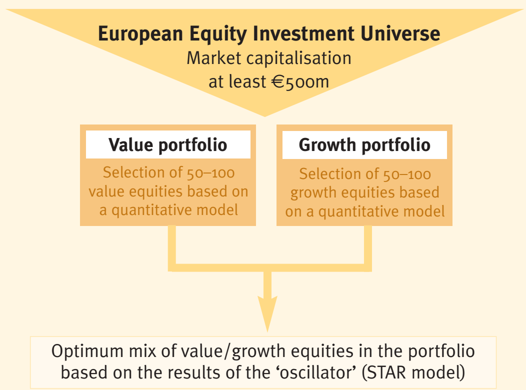
The second portfolio of 50–100 "value" stocks would be selected on the basis of high dividend yield, low price to book ratios and long-term price momentum. For a value portfolio, a rebalancing every six months is sufficient.

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.

2

How style investing can be used to create an optimal equity asset mix



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Outperformance of the Bank Leu 'style invest' equity product over the last three years

Source: Bank Leu AG

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 the 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.

PROVEN PROCESS

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 on which investment style they prefer at any one time, and when they should switch. These are left up to a proven investment process that can demonstrate positive results over recent years. (See Chart 3.)

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 to be achieved over all time periods.

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