

Understanding the Importance of Investment Style

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When it comes to constructing a well-diversified portfolio, investment style is often one of the most overlooked factors. And yet, it is one of the most critical components of a portfolio's ability to increase potential returns, while mitigating risk.

Investment style is defined as the way in which a money manager selects securities for a portfolio. In general, equity managers fall into two broad categories of investment style - value and growth. Value managers look for quality companies that are undervalued or out of favour. These are companies that tend to have low Price-to-Earnings, Price-to-Book and Price-to-Cash Flow ratios. Growth managers, on the other hand, tend to focus on companies that are growing earnings, reinvesting in capital expenditure, and have high returns on equity. They also tend to have high Price-to-Equity, Price-to-Book and Price-to-Cash Flow ratios.

In addition to value and growth, equity managers can also be categorized according to the size of the companies they invest in. Young up and coming companies often have few investors and are not well capitalized. These are referred to as small capitalization (small-cap) companies. They have appealing growth prospects, but represent a greater investment risk than larger, more established firms with a broader investor base (large-cap companies).

The important thing to understand is that equities frequently behave differently based on their style attributes with very distinct cycles of outperformance and underperformance versus the broad market. In fact, at any given point in time, the markets tend to reward one set of attributes over the other as investors' appetite for risk changes based on a myriad of economic, fundamental, external, and psychological factors.

In short - style leadership is fickle, unpredictable and prone to sudden change.

Given this situation, how can investors increase potential returns, while mitigating risk when it comes to investment style? For the Pinnacle Program, it's all about the process. In fact, one of the founding principles of the Program is that a good investment process is just as important as good stock picking. To make money picking stocks, you must not only be able to select good stocks, but also determine which style will outperform. After all, there is no gain from owning the best stock in the worst performing investment style category. Unfortunately most of us are terrible at forecasting style.

Lest you think that last year was unusually difficult to forecast, prior year forecasts were no more accurate. All long-term investors have experienced inexplicable market run-ups and tumbles. Market behaviour is often driven by non-market events that are impossible to forecast from market fundamentals or trends. This is especially true of style leadership. Even if we could guess which style will outperform, the duration and magnitude of that outperformance is unknown.

The impact of style on a stock portfolio is so significant that not even multi-manager portfolios are immune. A portfolio composed of several money managers, for example, may have a strong style bias if the managers that run the underlying funds have a style bias.



Leveraging our vast resources and expertise, we provide you and your advisor with unbiased information on each manager to help you better manage the investment style of your multi-manager Pinnacle portfolio and, just as importantly, to recognize any potential style biases.

Through our extensive research, we have found that all money managers have a style bias to the extent that their portfolio differs from an index fund. Understanding and identifying these style biases is crucial to building a successful multi-manager portfolio, especially when the style labels used by money management firms are frequently misleading (there is no legal criteria for labeling a growth or value fund and some fund labels are remarkably inaccurate).

Given the important impact that investment style has on performance, using a managed asset program, such as the Pinnacle Program, can make a lot of sense. Each of the managers that have been selected for Pinnacle have been independently and objectively analyzed by our firm, Northern Trust Global Advisors, for style bias.

Given the difficulty of forecasting style leadership, we generally recommend style neutrality. This removes a lot of unnecessary short term volatility from a portfolio by eliminating periods when your portfolio underperforms the market because of a style bias. Having said this, there can be some good reasons for an investor to take on a slight style bias.

Investors who need income from their portfolio, for example, may need to own stocks that pay high dividends. These are normally value stocks and will, subsequently, tend to result in a portfolio with a value bias. On the opposite end of the continuum, there are those investors who choose a growth and/or small-cap bias. These are the individuals who happily accept extra style volatility in order to invest in fast growing industries or small up and coming companies. They are willing to take on more style risk in order to capture growth opportunities.

The benefit of the Pinnacle Program is that you and your advisor can tailor the style characteristics of your portfolio to your specific needs and preferences, whether you are a conservative investor or an aggressive investor, so that style becomes an explicit decision for you, not an unmanaged bet leading to unforeseen and frustrating consequences.

To find out more about investment style or the value and growth managers who have been selected for the Pinnacle Program, please contact your advisor.

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