Shining a Light on Indexes

How to Help Investors Better Achieve Their Goals

"What is the appropriate benchmark for your strategy?"

This is a question frequently posed to an investment manager. Before this question can be answered, it is necessary to gain a solid understanding of the strategy by examining the manager's investment philosophy and how it is applied in the investment process, and, more specifically, how it is expected to perform throughout a full business cycle.

At Confluence Investment Management, our investment philosophy for the domestic value equity strategies was adopted in mid-1994 at our predecessor firm and continues to be implemented more than 25 years later. The approach is focused on understanding and valuing individual businesses with the emphasis on owning competitively advantaged businesses at attractive prices. It is a fundamental approach that views risk as losing money, or more precisely, ***the probability of a permanent loss of capital***. Today, it is the foundation for all six of our domestic value equity strategies.

It is an approach borne from the belief that as investment managers we manage risk, not returns. Returns are the byproduct of an investment process and how well it is deployed. Our philosophy and process are centered around individual businesses with the intent of owning a collection of superior entities in a concentrated manner and then allowing them to compound over long periods.

Our energy has never been focused on managing to a benchmark or index as it is not additive to the investment process. Furthermore, we do not view tracking error as a measure of risk. Quite the contrary, ***active investors should welcome tracking error as it is the only way to outperform an index***. This is not to say that we are not mindful of the indexes; we are, and it is perfectly reasonable to compare us to an index. But it is equally important to understand how an index is constructed to better understand the applications and limitations when using that index as a benchmark to measure an investment manager.

The Evolution of Indexes

Stock market indexes date back to 1884 when Charles Dow sought to convey the wellbeing of the industrial economy by creating an index of 12 companies—10 of which were railroads—which was to become the Dow Jones Industrial Average (DJIA). Today, this index comprises 30 companies selected by a committee. When it was created, there was scant interest in the market by the general public, but the roaring 1920s brought plenty of attention to the equity markets and, consequently, the index. With this newfound interest, in 1926, the Standard Statistics Company created a weekly index of 233 businesses to serve as a more diversified proxy of the market. This was the predecessor to the Standard & Poor's 500 (S&P 500) Index, but it was not until 1957 that the S&P 500 took its current form.

The S&P 500

The S&P 500 Index is one of the most commonly used benchmarks. Its construction methodology is formulated by a committee which relies on eight primary criteria: market capitalization, liquidity, domicile, public float, sector classification, financial viability, length of time traded, and stock exchange. It is weighted by market capitalization and consists of 500 of the largest businesses that meet the criteria. Given that the S&P 500 index is market cap weighted, more valuable companies account for a larger proportion of the index. The methodology is subjective and can limit inclusion of large entities. For example, Berkshire Hathaway and UPS were excluded for a period due to concerns with their public float (shares held by outside parties relative to insiders).

The Russell Indexes: Investing with Style Emerges

While the DJIA and S&P 500 were created to measure the general wellbeing of the economy, the Frank Russell Company created a family of indexes to better track investment managers. In 1984, Russell launched three indexes that bifurcated the equity market by size using an objective and transparent process. The indexes are derived from market capitalization and focus on the largest U.S.-domiciled businesses. It is a straightforward application: the Russell 1000 Index comprises the largest 1,000 companies, the Russell 2000 Index comprises the next 2,000 companies, and the Russell 3000 Index includes all 3,000 companies. These three indexes are well regarded for their size proxy in the large, small, and all capitalization arenas.

A decade later, Russell developed style indexes by overlaying valuation into its methodology in order to better track the underlying style of investment managers, i.e., value versus growth. These style indexes were created by incorporating the book value and projected growth rates of the companies in order to split their existing indexes into two equally weighted ones: value and growth. Russell's process of classifying companies by style attempts to be inclusive; e.g., if it is determined that a company is 60% value and 40% growth, then its market capitalization will be included in both the value and growth indexes in proportion to the derived weighting. The Russell Value and Growth indexes are widely used gauges of style in the large and small capitalization arenas.

Index Limitations

One shortcoming of these popular indexes emanates from their passive nature and construction methodologies which raise impediments when benchmarking to investment strategies that apply fundamental and/or qualitative analysis. The main issue stems from the weighting methodology. By using market capitalization to determine weightings, larger companies represent a greater proportion of the index, distorting the index composition to reflect the performance of a handful of companies rather than broader market performance. During periods of extreme optimism or pessimism, the index is subject to undue influence of the largest companies. What was once a diversified index can become very skewed during these periods of intense investor sentiment as price momentum usurps fundamentals, causing abnormal exposures (high or low) in certain companies/sectors and altering the risk profile of the index. This occurs in the benchmark despite no change in the investor's risk profile. Examples of this scenario occurred in the Energy sector in the late 1970s/early 1980s during the oil crisis, the dot-com era in the late 1990s, and the Financials and Real Estate sectors in 2007-08. These conditions produce excessive volatility and tend to exacerbate underlying trends at the beginning and end of market cycles.

The Growth and Value styles indexes allow for the measurement of a defined risk factor—valuation—which is lacking in the broad-based market capitalization-weighted indexes, such as the S&P 500. The style methodologies seek to generate a more consistent risk profile over a full market cycle via the rebalancing mechanism which makes periodic adjustments based on valuations. Regrettably, the heavy influence of book value causes the Value style indexes to skew toward asset intensive industries (e.g., Financials, Materials, Energy, Utilities), resulting in less diversified indexes for both Growth and Value. This has become more pronounced over time as our economy has become more oriented toward technology and services, which are less asset intensive.

Application for Confluence Strategies

Given the number of available equity indexes, selecting a benchmark may appear rather straightforward, but there are several factors to consider.

The old joke of the drunkard searching for his keys illustrates the issue:

> *Late one night, a police officer observes a drunk man searching for his keys under a streetlight so they begin looking under the streetlight together. As time passes, the policeman asks if he is sure he lost the keys here, and the drunk replies, no, that he lost them in the park. The officer asks why he is looking here, and the drunk responds, "this is where the light is."*

This type of observational bias, known as the *streetlight effect*, occurs when people only search for something where it is easiest to look. Comparing an investment manager to an index may be easy, but is it constructive?

When comparing a Confluence strategy to a benchmark, it is important to also recognize the inherent biases and traits that emanate from our investment process; fortunately, we have a long history for investors to assess. Our focus is on individual businesses with the goal of owning entities with substantial competitive advantages—businesses that possess pricing power. We further focus on those businesses that generate more cash than they consume, even after maintenance capital expenditures, and have management teams that know how to allocate the excess cash flow in a manner that generates long-term shareholder value. Businesses that exhibit these attributes are often difficult to find in commodity-oriented or highly regulated industries in which pricing is contingent on factors outside management's control. This will result in our portfolios over/under-weighting certain areas of the market that either offer more attractive valuations or have superior underlying attributes. Subsequently, our performance in any given time frame will be affected by the market's perception of the value of these individual businesses compared to the broad market.

Our investment process also incorporates a distinct value discipline as we seek to acquire these businesses at a discount to our estimate of their intrinsic value. We, like most investors, want to own growing businesses but realize that in order to derive above-average returns we cannot pay too much for said companies. Therefore, we conduct extensive valuation analysis at the onset to determine the business's worth which is then used to apply an appropriate discount to arrive at an entry point, hence our value orientation. It is an approach that is best termed as Absolute Value as opposed to Deep Value or Relative Value. This process, combined with our low turnover, may result in our strategies drifting from the "Value" style to "Core" despite little or no change to the underlying portfolios as our measurement of value is not heavily weighted toward book value like the value style indexes. ("Core" is a style term that has evolved to describe an investment style that replicates an equal blend of Value and Growth styles.) The drift is also affected by market perception of the benchmark's underlying businesses relative to the select names we hold in our concentrated portfolios.

Since setting sail in 1994, we have stated that we are long-term investors that strive to beat the markets on average and over long periods but expect to vary from the market in any given period. The investment process was designed to maintain a consistent risk profile throughout the course of a market cycle. By doing so, we would expect our value equity strategies to perform well in tough markets by providing good downside protection, but we may lag in the later stages of a bull market when investor sentiment drives returns. Over the full cycle we would expect to achieve our long-term objectives and the results of past cycles tend to reflect that expectation.

How does Confluence use benchmarks?

At Confluence, we suggest investors consider utilizing both a broad-based index and a value index. Why two? The indexes discussed above have different attributes, and limitations, when using them as benchmarks for investment managers that incorporate fundamental and/or qualitative analysis, as Confluence does.

The broad-based indexes (S&P 500 or Russell 1000/3000) were intended to be used as representations of the domestic economy, and thus, they are fair proxies over a full market cycle. However, during shorter periods or intra-cycle, these broad indexes can be influenced by sentiment due to their market capitalization weighting methodology that can distort the risk profile at extremes when fundamentals are not a factor. This conflicts with our investment methodology which does include valuation as a key component. In fact, it is the primary reason we tend to lag the broad indexes in the later stages of a market cycle as momentum overwhelms fundamentals.

The value style indexes (Russell 1000/2000/3000 Value) introduce fundamental factors that are missing in broad-based indexes. Those factors aid in measuring a manager by putting performance in the proper context over shorter time frames when the broad markets are being heavily influenced by sentiment. Nevertheless, the methodology is not perfect as too much of the benchmark's emphasis is weighted on book value, which is not wholly consistent with our valuation methodology. This can result in wide industry weighting disparities. On the flip side, the value style indexes have historically been less volatile which is more comparable to our approach.

The Confluence domestic value equity strategies, with the exception of Equity Income, fit well within the framework outlined here as the primary objective of each is capital appreciation. Equity Income, by contrast, has an investment objective that is a balance of income and capital appreciation. The objective puts constraints, specifically dividend yield, on the available universe as Equity Income stocks are expected to have an above-average current yield in order to be included in the portfolio. If growth stocks (typically not oriented toward dividends) dominate returns in a particular index, then it would stand to reason our performance would lag in that time period, and therefore the strategy falls more squarely in the value universe.

The Bottom Line

There are no perfect benchmarks for measuring an actively managed strategy. The composition of a passive, market cap-weighted index and, more importantly, its risk profile, may be very different relative to an investment manager's strategy that incorporates fundamental and/or qualitative analysis. All indexes have construction methodologies, much as investment managers have investment philosophies, which will naturally lead to certain biases and limitations. It is essential to understand these characteristics when using a benchmark to measure an investment manager as focusing too much on the index can cause investors to lose sight of their risk profile and objectives. After all, the broad indexes were not created with an investor's objectives in mind; they were created to measure the general health of the economy.

Therefore, we believe it's important to evaluate investment managers with the following criteria in mind:

- Investment strategy has defined objectives that align with investor objectives
- Manager employs a disciplined investment process in order to achieve those objectives
- Manager adheres to their process throughout the market cycle despite market volatility and extreme changes in investor sentiment to produce a consistent risk profile

With a deeper understanding of the index constructs, along with the investment manager's philosophy, process, and risk profile, the question of the appropriate benchmark can lead to more meaningful discussions during the portfolio review process and allow investors to evaluate managers from a comprehensive perspective.

At Confluence, we incorporate the above methodology into our disciplined investment process, which enables us to stay aligned with investor objectives and risk tolerance. We have implemented this approach in our value equity strategies for more than 25 years and remain committed to maintaining our process as we look forward to the future.