Why investment style matters

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Participants in 401(k) plans rely on plan fiduciaries to prudently select the mutual funds made available to them to build a diversified retirement portfolio. As markets continue to fluctuate, advisors and plan sponsors need to be aware of how this affects their investments.

Executive summary

Participants in 401(k) plans rely on plan fiduciaries to prudently select the mutual funds made available to them to build a diversified retirement portfolio. Whether offering individual funds or multi-fund products, such as target-date portfolios, plan fiduciaries must understand and monitor the adherence to investment style of each fund to make sure the plan's investment menu continues to offer the opportunity for diversification.

Investment styles

An investment style is the method and philosophy a manager follows when selecting securities for a fund. The mutual fund industry has long relied on Morningstar's nine equity and nine fixed income style boxes to define investment factors.[1] Equity style boxes define investments according to market capitalization and growth/value factors, while fixed income boxes classify investments according to credit quality and sensitivity to changes in interest rates. These boxes provide a quick reference to help identify the investment style of a particular fund. While there are alternative asset classes that fall outside of the Morningstar style boxes, they are not typically utilized in retirement plans and tend to have low correlation to the traditional style boxes.

In addition to the traditional style methodologies, some managers also base their investments on environmental, social and governance ("ESG") factors, such as whether a fund invests in fossil fuel companies.

Style purity vs. Style drift

Funds must state an objective, and the investment style helps set general expectations for the risk and performance potential of a particular fund. Investment managers that adhere to their stated investment objectives are generally considered to be style pure. Ones that deviate may suffer from style drift.

Style drift can occur naturally or deliberately.[2] Natural drift typically occurs from the appreciation of one asset relative to others in a portfolio, such as when stocks in a small cap portfolio grow and become mid-cap. When “natural” drift occurs, a manager will typically rebalance the portfolio to bring it back in line with its stated objectives and intended optimal portfolio weights.

Deliberate drift happens when managers change their investment style. The typical reason for deliberate style drift is the search for higher return potential. While this strategy can produce short-term benefits, studies have shown that style drift tends to expose investors to unanticipated possible risk with no offset from potential above-average, long-term performance.[3]

Style drift is generally discouraged, which is why the Securities and Exchange Commission requires mutual funds and ETFs to invest at least 80% of their assets in investments suggested by the fund name, which means that a “Large Cap Value Fund” must invest at least 80% of its securities in large cap value stocks.[4] It is the remaining 20% over which fund managers have investment discretion that provides managers the leeway to occasionally drift from their stated benchmarks.

ESG investing

Style drifts can also occur in ESG focus investment portfolios, and can cause investors who want to construct an ESG-themed portfolio to be underexposed to the asset class.[5]

When constructing ESG-focused portfolios, investors should ask:

- Does the manager have some experience managing ESG portfolios?
- Does the manager use certain ESG criteria in its own business?
- Does the manager clearly communicate the processes it employs to identify ESG characteristic of securities selected for its portfolio.?

The importance of style purity

The Nobel Prize-winning economist Harry Markowitz developed modern portfolio theory in 1952, which is used to construct portfolios that minimize risk for a given level of expected return.[6]

As shown in the following chart, different asset classes perform better than others at different times, which is why creating a diversified portfolio can help smooth out returns over time.

Diversification helps offset exposure in any single position when individual sectors underperform. And minimizing

The Callan Periodic Table of Investment Returns

Annual returns for key indices ranked in order of performance (2001-2020)

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
U.S. Fixed Income 8.43%	Glbl ex-U.S. Fixed 22.37%	Emerging Market Equity 55.82%	Real Estate 37.96%	Emerging Market Equity 34.00%	Real Estate 42.12%	Emerging Market Equity 39.38%	U.S. Fixed Income 5.24%	Emerging Market Equity 78.51%	Small Cap Equity 26.85%
High Yield 5.28%	U.S. Fixed Income 10.26%	Small Cap Equity 47.25%	Emerging Market Equity 25.55%	Real Estate 15.35%	Emerging Market Equity 32.17%	Dev ex-U.S. Equity 12.44%	Glbl ex-U.S. Fixed 4.39%	High Yield 58.21%	Real Estate 19.63%
Cash Equivalent 4.42%	Real Estate 2.82%	Real Estate 40.69%	Dev ex-U.S. Equity 20.38%	Dev ex-U.S. Equity 14.47%	Dev ex-U.S. Equity 25.71%	Glbl ex-U.S. Fixed 11.03%	Cash Equivalent 2.06%	Real Estate 37.13%	Emerging Market Equity 18.88%
Small Cap Equity 2.49%	Cash Equivalent 1.78%	Dev ex-U.S. Equity 39.42%	Small Cap Equity 18.33%	Large Cap Equity 4.91%	Small Cap Equity 18.37%	U.S. Fixed Income 6.97%	High Yield -26.16%	Dev ex-U.S. Equity 33.67%	High Yield 15.12%
Emerging Market Equity -2.61%	High Yield -1.37%	High Yield 28.97%	Glbl ex-U.S. Fixed 12.54%	Small Cap Equity 4.55%	Large Cap Equity 15.79%	Large Cap Equity 5.49%	Small Cap Equity -33.79%	Small Cap Equity 27.17%	Large Cap Equity 15.06%
Glbl ex-U.S. Fixed -3.75%	Emerging Market Equity -6.16%	Large Cap Equity 28.68%	High Yield 11.13%	Cash Equivalent 3.07%	High Yield 11.85%	Cash Equivalent 5.00%	Large Cap Equity -37.00%	Large Cap Equity 26.47%	Dev ex-U.S. Equity 8.95%
Real Estate -3.81%	Dev ex-U.S. Equity -15.80%	Glbl ex-U.S. Fixed 19.36%	Large Cap Equity 10.88%	High Yield 2.74%	Glbl ex-U.S. Fixed 8.16%	High Yield 1.87%	Dev ex-U.S. Equity -43.56%	Glbl ex-U.S. Fixed 7.53%	U.S. Fixed Income 6.54%
Large Cap Equity -11.89%	Small Cap Equity -20.48%	U.S. Fixed Income 4.10%	U.S. Fixed Income 4.34%	U.S. Fixed Income 2.43%	Cash Equivalent 4.85%	Small Cap Equity -1.57%	Real Estate -48.21%	U.S. Fixed Income 5.93%	Glbl ex-U.S. Fixed 4.95%
	Large Cap Equity -22.10%	Cash Equivalent 1.15%	Cash Equivalent 1.33%	Glbl ex-U.S. Fixed -8.65%	U.S. Fixed Income 4.33%	Real Estate -7.39%	Emerging Market Equity -53.33%	Cash Equivalent 0.21%	Cash Equivalent 0.13%

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
U.S. Fixed Income 7.84%	Real Estate 27.73%	Small Cap Equity 38.82%	Real Estate 15.02%	Large Cap Equity 1.38%	Small Cap Equity 21.31%	Emerging Market Equity 37.28%	Cash Equivalent 1.87%	Large Cap Equity 31.49%	Small Cap Equity 19.96%
High Yield 4.98%	Emerging Market Equity 18.23%	Large Cap Equity 32.39%	Large Cap Equity 13.69%	U.S. Fixed Income 0.55%	High Yield 17.13%	Dev ex-U.S. Equity 24.21%	U.S. Fixed Income 0.01%	Small Cap Equity 25.52%	Large Cap Equity 18.40%
Glbl ex-U.S. Fixed 4.36%	Dev ex-U.S. Equity 16.41%	Dev ex-U.S. Equity 21.02%	U.S. Fixed Income 5.97%	Cash Equivalent 0.05%	Large Cap Equity 11.96%	Large Cap Equity 21.83%	High Yield -2.08%	Dev ex-U.S. Equity 22.49%	Emerging Market Equity 18.31%
Large Cap Equity 2.11%	Small Cap Equity 16.35%	High Yield 7.44%	Small Cap Equity 4.89%	Real Estate -0.79%	Emerging Market Equity 11.19%	Small Cap Equity 14.65%	Glbl ex-U.S. Fixed -2.15%	Real Estate 21.91%	Glbl ex-U.S. Fixed 10.11%
Cash Equivalent 0.10%	Large Cap Equity 16.00%	Real Estate 3.67%	High Yield 2.45%	Dev ex-U.S. Equity -3.04%	Real Estate 4.06%	Glbl ex-U.S. Fixed 10.51%	Large Cap Equity -4.38%	Emerging Market Equity 18.44%	Dev ex-U.S. Equity 7.59%
Small Cap Equity -4.18%	High Yield 15.81%	Cash Equivalent 0.07%	Cash Equivalent 0.03%	Small Cap Equity -4.41%	Dev ex-U.S. Equity 2.75%	Real Estate 10.36%	Real Estate -5.63%	High Yield 14.32%	U.S. Fixed Income 7.51%
Real Estate -6.46%	U.S. Fixed Income 4.21%	U.S. Fixed Income -2.02%	Emerging Market Equity -2.19%	High Yield -4.47%	U.S. Fixed Income 2.65%	High Yield 7.50%	Small Cap Equity -11.01%	U.S. Fixed Income 8.72%	High Yield 7.11%
Dev ex-U.S. Equity -12.21%	Glbl ex-U.S. Fixed 4.09%	Emerging Market Equity -2.60%	Glbl ex-U.S. Fixed -3.09%	Glbl ex-U.S. Fixed -6.02%	Glbl ex-U.S. Fixed 1.49%	U.S. Fixed Income 3.54%	Dev ex-U.S. Equity -14.09%	Glbl ex-U.S. Fixed 5.09%	Cash Equivalent 0.67%
Emerging Market Equity -18.42%	Cash Equivalent 0.11%	Glbl ex-U.S. Fixed -3.08%	Dev ex-U.S. Equity -4.32%	Emerging Market Equity -14.92%	Cash Equivalent 0.33%	Cash Equivalent 0.86%	Emerging Market Equity -14.57%	Cash Equivalent 2.28%	Real Estate -9.04%

The Callan Periodic Table of Investment Returns conveys the strong *case for diversification* across asset classes (stocks vs. bonds), capitalizations (large vs. small), and equity markets (U.S. vs. global ex-U.S.). The Table highlights the uncertainty inherent in all capital markets. Rankings change every year. Also noteworthy is the difference between absolute and relative performance, as returns for the top-performing asset class span a wide range over the past 20 years.

A printable copy of The Callan Periodic Table of Investment Returns is available on our website at callan.com.

The above Table is provided for illustrative purposes only. Past performance is no guarantee of future results. An Index is unmanaged and an investor can not invest in an index. Please refer to page 5 at the end for the various indexes definitions.

losses is a key to reaching retirement goals because it is mathematically easier to lose money than to make it. For example, a loss of 50% requires a gain of 100% to break even.

One of the keys to constructing a diversified portfolio is reducing fund overlap, which occurs when different mutual funds hold some of the same securities or move up and down similarly to market conditions. For example, if an investor's risk tolerance dictates that their allocation has 20% of the portfolio in large-cap growth and 20% in large-cap value, but the large-cap value manager believes the economy is heating up and shifts the allocation to more growth-oriented stocks, the investor's portfolio could see the allocation skew to 25% in large-cap growth and 15% in large-cap value stocks, which would not be in line with their stated asset allocation objectives.

That is why diversified mutual fund portfolios typically do not hold more than one fund in a style box category. However, style drift in one fund can inadvertently cause two seemingly different funds to react the same. For instance, if stocks in a mid-cap portfolio grow to be large-cap companies and the fund does not rebalance them out of the portfolio, and large cap goes out of favor, the mid-cap portfolio will trend downward with the large-cap holdings, even if the mid-cap sector is performing well. And many large-cap value and large-cap growth funds have overlapping top holdings, so it is important that a detailed analysis of funds' holdings be considered.

Addressing style drift in retirement plans

Style drift, regardless of the cause, can result in a portfolio having inadequate diversification and an investor being under- or overexposed to certain asset classes.

Rebalancing is the best method to eliminate fund overlap and maintain a diversified 401(k) line-up. Whether through Morningstar or another rating agency, investments should be monitored to ensure that they are staying style pure. If drift is detected, and the manager does not address the drift within a reasonable time period, consideration should be given as to whether the fund continues to be appropriate for the investor's need , or an alternative rebalancing of the assets would be appropriate.

Often, it is the reputation of a given fund manager that can generally be one of the best indicators that a fund will remain style pure. In addition, plan advisors and consultants have many tools to analyze funds and their holdings so utilizing professional guidance can better help participant build a truly diversified portfolio based on their need and specific situation. and not chase hot, potentially overlapping, funds.

Style drift in the top 20 active large cap growth funds for Defined Contribution Investment Only ("DCIO") plans

Large Cap Growth Fund	DC Plan Assets	Number of DC Plans	Average Number of DC Participants	Equity Style Large Growth % (Long Rescaled)	Equity Style Large Core % (Long Rescaled)	Equity Style Large Value % (Long Rescaled)	Equity Style Mid Growth % (Long Rescaled)	Equity Style Mid Core % (Long Rescaled)	Equity Style Mid Value % (Long Rescaled)
1	$63,196,719,094	6,979	1270	67.23	19.93	5.20	2.68	3.32	1.09
2	$30,597,480,022	8,932	763	73.61	17.64	4.28	2.51	1.68	0.28
3	$26,250,376,884	11,435	519	53.53	18.56	8.08	8.70	6.96	2.31
4	$15,564,993,305	2,313	1331	81.03	16.82	0.55	1.60	0.00	0.00
5	$15,215,823,066	4,131	734	68.81	18.73	3.89	4.73	3.55	0.29
6	$11,799,586,294	679	2751	66.11	22.22	4.88	3.44	2.93	0.43
7	$11,794,237,108	2,750	580	81.83	10.63	1.09	3.98	2.35	0.00
8	$9,298,975,089	1,841	1011	70.61	5.74	2.21	11.28	2.86	3.12
9	$7,962,940,532	2,238	780	63.51	15.24	6.46	5.09	7.88	1.53
10	$5,015,478,590	3,838	413	45.78	18.20	7.40	11.84	11.70	1.51
11	$4,743,840,973	2,329	570	74.57	16.94	0.37	2.73	5.21	0.18
12	$3,576,138,057	1,728	671	56.56	28.76	1.49	3.97	9.23	0.00
13	$3,036,113,949	2,108	438	67.26	19.02	2.07	5.33	5.72	0.48
14	$2,161,923,628	1,442	471	52.00	22.31	5.13	9.50	9.06	0.89
15	$2,097,215,214	1,553	560	62.49	22.87	0.00	10.42	4.22	0.00
16	$2,091,322,977	807	510	68.31	19.57	6.28	1.31	4.38	0.15
17	$2,047,720,796	531	1388	85.23	10.16	0.54	2.77	1.30	0.00
18	$1,840,735,852	1,136	538	41.63	41.66	2.18	2.23	12.30	0.00
19	$1,628,757,482	291	839	59.40	13.51	1.90	19.71	3.32	2.17
20	$1,584,846,565	880	703	58.61	26.42	2.27	5.75	4.12	2.84

Sources: Fund Size and Retirement Plan Information from www.brightscope.com, as of 10/7/21. Fund Style Data from Morningstar, as of 10/7/21.

Conclusion

A well-diversified investment portfolio helps provide investors an opportunity to reach their retirement goals with an acceptable level of risk-adjusted potential returns. Offering style pure mutual funds provides an opportunity for the anticipated risk and return expectations of a diversified portfolio to be maintained.

Footnotes and references

1. www.morningstar.com/InvGlossary/morningstar_style_box.aspx
2. See, www.investopedia.com/terms/s/styledrift.asp.
3. See, Cao, Iliev, and Velthuis, *Style Drift: Evidence from Small-Cap Mutual Funds,* Smeal College of Business, Pennsylvania State University (January 2017).
4. SEC, *Final Rule: Investment Company Names,* 17 CFR Part 270 (March 31, 2001).
5. See, Hay, *Breakingviews - Sustainable investing will wind up in the dock,* Reuters (12/31/2019).
6. Harry M. Markowitz, *Portfolio Selection: Efficient Diversification of Investments,* John Wiley & Sons (1959).

Definitions

Style purity referes to when investment has been made in accordance with stated investment objectives while **style drift** refer to when investment manager deviates from stated investmetn objective.

Large Cap Equity (S&P 500) measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-valueweighted index of 500 stocks. The weightings make each company's influence on the Index performance directly proportional to that company's market value.

Small Cap Equity (Russell 2000) measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index.

Developed ex-U.S. Equity (MSCI World ex USA) is an index that is designed to measure the performance of large and mid cap equities in developed markets in Europe, the Middle East, the Pacific region, and Canada.

Emerging Market Equity (MSCI Emerging Markets) is an index that is designed to measure the performance of equity markets in 26 emerging countries around the world.

U.S. Fixed Income (Bloomberg U.S. Aggregate Bond Index) includes U.S. government, corporate, and mortgage-backed securities with maturities of at least one year.

High Yield (Bloomberg High Yield Bond Index) measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

Global ex-U.S. Fixed Income (Bloomberg Global Aggregate ex U.S. Bond Index) is an unmanaged index that is comprised of several other Bloomberg Barclays indices that measure the fixed income performance of regions around the world, excluding the U.S.

Real Estate (FTSE EPRA Nareit Developed REIT Index) is designed to measure the stock performance of companies engaged in specific real estate activities in the North American, European, and Asian real estate markets.

Cash Equivalent (90-day T-bill) is a short-term debt obligation backed by the Treasury Department of the U.S. government.

Correlation shows the strength of a relationship between two variables and is expressed numerically by the correlation coefficient. The correlation coefficient's values range between -1.0 and 1.0. A perfect positive correlation means that the correlation coefficient is exactly 1.

Disclosure

No investment strategy, including diversification, can protect against any market loss, nor guarantee any investment gain.

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