

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## In Determining Whether a Manager is Skillful or Lucky, Why Isn't Everyone Using Style-Based Attribution Analysis?

*Dan Thatcher, MBA, CFP, CIMA*

It amazes me that every senior investment management consultant or technical analyst or due diligence department that supports the consultant is not using StokTrib. If one is evaluating whether a money manager is adding value, they must be able to determine if this manager is adding value as a stock picker, a sector selector or a trader. To accomplish this delineation, they must use holdings-based attribution analysis, and then they must back out the effects of style. There are only two products on the market which perform this analysis - FactSet and StokTrib. StokTrib is substantially less expensive and provides better graphics. So, why isn't everyone analyzing at this level of detail?

Unfortunately, for both the consultant and the investor, this level of detailed data is not being considered, and managers are often selected because their style is in favor or because of their marketing skill, or both. To alleviate this circumstance, Ron Surz of PPCA, Inc. developed StokTrib about three years ago. He accomplished two major breakthroughs – a blended index for each manager who is evaluated and a methodology for accurately identifying a money manager's value-added in terms of stock picking, sector selection and trading activity.

If you examine a single off-the-shelf style index, you will find that it contains stocks that appear in other style indexes as well; so the index is not mutually exclusive. Also, a family of generic indexes does not include every traded stock so the family of indexes is not collectively exhaustive. Recognizing these facts, Ron selected the Compustat database of stocks and has established rules for creating nine indexes of large, mid- and small-cap stocks within growth, core and value styles. This process creates indexes, which are

mutually exclusive and collectively exhaustive, allowing StokTrib to customize a benchmark for each manager.

Ron also developed a simple methodology for evaluating skill, not style. First, StokTrib calculates the return expected from the passive implementation of the manager's style. Second, StokTrib subtracts this return from the actual return. The difference is the value added by skill. Third, StokTrib separates out the sources of skill: sector allocation and stock selection. And, finally, StokTrib looks for persistence as a confirmation of skill, rather than luck.

So why isn't StokTrib used by everyone? It is a holdings-based system, and everyone likes the ease of using returns-based analysis. But like every product that is simple to operate, the results of returns-based analysis do not identify the critical value added capabilities of the manager – essentially, whether they are a good stock picker, good at sector selection, or good at trading stock.

Returns-based style analysis regresses a manager's returns against a family of style indexes to determine the

combination of indexes that best tracks the manager's performance. It requires patience because it is reactive to the detection of style changes. Holdings-based style analysis is mathematically simple and detects style changes immediately. Returns-based style analysis helps us identify each manager's style. But then style must be backed out of the equation to identify if that manager is indeed adding value. And it is important to determine very specifically what percentage s/he is adding to stockpicking, sector selection and trading activity. The only way to identify these value-added's is with holding-based attribution that properly separates out style from skill. Returns-based simply won't do the job.

**STOKTRIB PROVIDES A BLENDED INDEX FOR EACH MANAGER WHO IS EVALUATED AND A METHODOLOGY FOR ACCURATELY IDENTIFYING A MONEY MANAGER'S VALUE-ADDED IN TERMS OF STOCK-PICKING, SECTOR SELECTION AND TRADING ACTIVITY**

Returns-based analysis can only go so far in the search for skill. It's like a litmus test – if the paper doesn't turn the right color, we've probably got a loser. StokTrib goes the next step by determining the reasons the litmus paper turns "winner" color: What did the manager do right and were they consistent? This is critically important because we want to invest with managers who are likely to succeed in the future, which is definitely not the same as succeeding in the past. We can't buy past performance and shouldn't rely on it as the sole indicator of future performance.

Ron recently introduced StokTrib 3.5. This new version does an even better job of identifying manager skill, rather than luck or style. It also evaluates the effects of manager trading and provides performance rankings against the manager's custom style, in addition to comprehensive composite analysis, superior graphics, executive summaries, persistence analysis and timeliness. Ron is able to provide his users with updates within a few days of the end of each quarter, and his scope is very broad – U.S., non-U.S. and global.

Why should we use StokTrib? Will it put money in our pockets? You bet. You succeed when your clients succeed. StokTrib will

certainly allow you to analyze the money managers you use with greater specificity. And it provides you with a clear understanding of what capital markets have done each quarter. Whereas you might not want to use the graphics with many of your high net worth clients, you would certainly use the graphics with your institutional clients. StokTrib serves as an educational tool, which improves your capital market expertise, your manager evaluation skills, and your competence. These characteristics allow you to differentiate yourself in a commoditized market. Would you agree that these characteristics are also important to your existing and future clients? You bet they are. ■

### About the Author

**Dan Thatcher**, a Certified Financial Planner since 1987 and CIMA designee since 1991, received his MBA in Finance from Harvard Business School. With more than 18 years in the financial services industry, he has taken leadership roles in the areas of corporate finance, investment product development, marketing and training. His focus is on practice management, coaching and consulting with financial advisors.

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