Volume 7, No. 7

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

The Large-Cap Gap: Are Your Clients Subject To It?

Michael Yaktus and Lawrence Tabak, Madison Investment Advisors

Conventional wisdom and academic theory often dictate the way consultants and investors construct equity portfolios. However, when actual outcomes are analyzed, the result doesn't always match the objective or the expectation. The objective that we examined in this case is the construction of a diversified large-cap portfolio. The expectation: added value and lowered volatility.

Two methods are often utilized when blending managers: (1) combining a large-cap value with a large-cap growth manager; or (2) using a core index fund, with satellite growth and value managers. In both cases, a *large-cap gap* may result, and it is only through holdings-based style analysis that we can expose this potentially serious oversight.

In constructing an overall equity portfolio, the normal starting point is developing a diversified large-cap portfolio. From here, mid-cap, small-cap, international, etc. can be added to expand coverage to various market opportunities and round out the portfolio. The two most common benchmarks used in the analysis of the large-cap space are the S&P 500 and the Russell 1000. For purposes of this report, we will use the Russell 1000. We selected the Russell perspective because it is one of the most widely accepted techniques of analyzing a stock's position on the growth-value continuum. It also provides valuable insight into a manager by allowing us to position the portfolio based on actual holdings and its components.

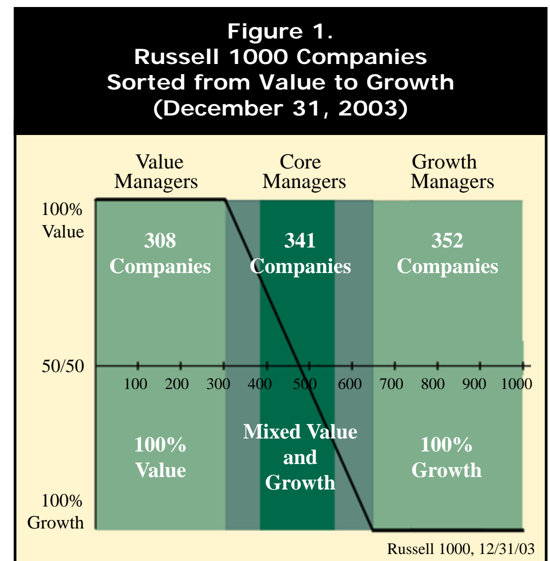
Here is a summary of Russell's approach. Russell's universe begins with the 3,000 largest domestic stocks. The large-cap index takes the 1,000 largest of these based on market capitalization. The growth and value splits are separated by looking at price/book, price/earning, dividend yields and forecasted growth rates. The large-cap index is separated by using a probability methodology initiated in 1995. Roughly 70% of companies are classified as either all growth or all value. The remaining stocks are assigned a probability rating and are shared by the two indices, in a proportion based on this probability rating. Consequently, approximately 30% of the large-cap stocks overlap both growth and value.

The Russell 1000 – Tilted Towards Growth

As a result, the Russell 1000 showed the following characteristics as of December 31, 2003. Of the 1,000 stocks considered, 308 were considered pure value, 352 of the stocks were considered pure growth, while 341 of the stocks were a mix of growth and value (Figure 1). However, 192 of the 341 "mixed" stocks are more growth than value, according to Russell. Consequently, of the 1,000 stocks in the Russell 1000, 544 (54%) were either 100% growth or more growth than value; while 456 (46%) were either all value or more value than growth. Although this tilt towards growth may seem minor, it can be important in comparisons, since a portfolio with a perfect value/growth balance would seem, in comparison to the benchmark, biased on the value side.

With this backdrop, and using the growth/value characteristics as defined by Russell, let's examine the two common approaches to constructing a large-cap portfolio using holdings-based analysis. The first and most frequently used approach is to use a large-cap growth manager, along with a large-cap value manager, in roughly equal percentages. Most pure style managers (the ones with whom a consultant will typically want) maintain a style consistency, with little or no

Figure 1. Russell 1000 Companies Sorted from Value to Growth (December 31, 2003)



style drift. With this in mind, and using the growth/value characteristics as defined by Russell, most value managers, on a holdings basis, would look something like what's depicted in Figure 2. Using the same assumptions, most growth managers would likely look similar to Figure 3. When you combine the two together, theory would tell you your desired objective is achieved. However, the actual result could create a different image: a *large-cap gap*.

This space represents stocks that are not pure growth or pure value. Instead, it represents stocks that demonstrate enough of each characteristic to potentially prevent their inclusion in either the growth or value managers' portfolios. Why does this happen? Because most "pure style" managers don't like to stray from tight style box constraints popularized by institutional consultants in the 1980s and 1990s. Since that time, however, many consultants have realized that strict adherence to style boxes can limit a manager's ability to add value relative to a benchmark. Additionally, consultants began to question manager blending techniques that inadvertently exclude a substantial component of the market where additional value may lie. Examples of stocks that could fall into that frequently excluded market component we refer to as the *large-cap gap* along with their corresponding growth/value characteristics are illustrated in the Table 1.

Although many of the companies listed above are the type of solid, proven companies that investors seek when building a portfolio, they may very well be under-represented by the typical pure growth/pure value manager blend that some consultants use when constructing a portfolio. The Large-Cap Gap is a void in many portfolios which can lead to underperformance and unexpected volatility in a client's total portfolio.

One of the common methods used to close this gap or void is the use of an index fund as the "core manager" along with satellite managers in the growth and value spaces. The belief here is that pure style managers can add alpha in their space, and the index fund can cover the space not provided by the two pure style managers.

Let's look at what the holdings-based style analysis says of that method. First, if you look

Figure 2.
Large-Cap Value Manager

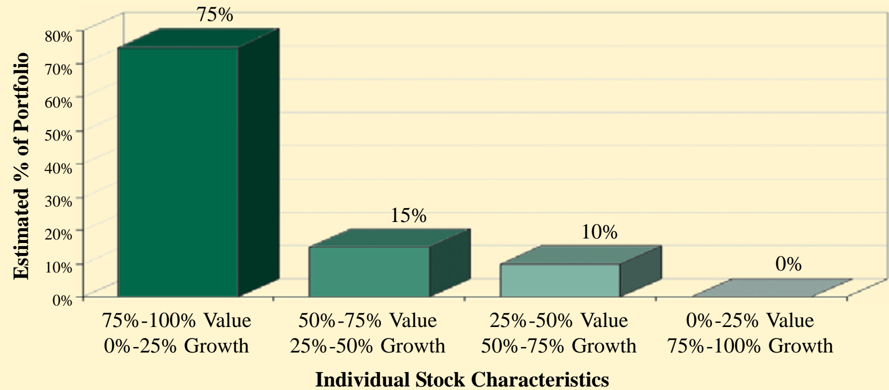


Figure 3.
Large-Cap Growth Manager

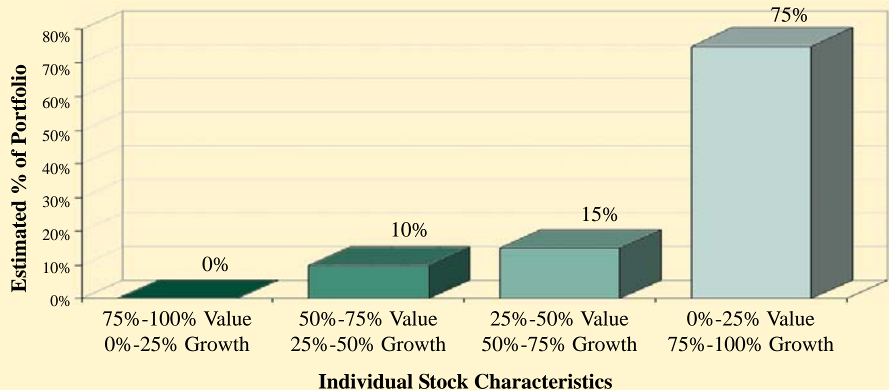
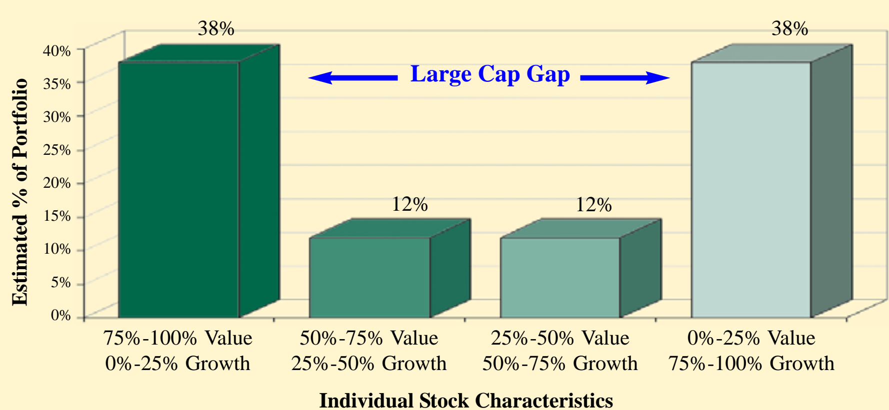


Figure 4.
Large-Cap Gap



© 1998-2004 PCT Publishing
Ph 804-643-1075 ■ Fax 804-643-1544

at the Russell 1000 and plotted the index by the characteristics on a growth/value basis, it would look roughly like Figure 5. If you added this portfolio in equal parts to the large-cap growth and large-cap value, and looked at the overall portfolio on a holdings basis and weighted average of those holdings, you may end up with a portfolio containing some exposure of those Large-Cap Gap stocks, yet is still primarily a portfolio overweighted on the ends of the growth-value continuum (Figure 5).

Many consultants have been substituting an active core manager with historical positive alpha for the index fund. It is important to note that the core manager used should be one who clearly seeks to add value through active security selection rather than a closet indexer who can only hope to add minimal value. Additionally, the core manager should remain invested primarily in the middle of the spectrum in order to avoid overweighting when blended with the other managers. Therefore, active core managers with both growth and value characteristics, while not drifting to extremes, would seem a plausible answer.

If we examine the holdings of a manager as described above, one would expect their holdings to look similar to that shown in Figure 6.

While such managers may have some stocks that demonstrate 100% growth or value characteristics, the majority of stocks have both growth and value characteristics. If one is to combine the core portfolio described earlier, with that of the pure growth or pure value manager, in equal percentages, the large-cap space would likely result in a scenario similar to Figure 7. As you can see, incorporating a manager that stays primarily in the center of the growth/ value spectrum, can lead to a more diversified large-cap portfolio, without placing substantially overweighted percentages in the extremes. The implication here is one of lower risk as well as superior market coverage.

Summary

In summary, conventional wisdom and theory provided starting points in the manager blending and portfolio construction processes, but holdings-based analysis demonstrates a common and important gap. By incorporating an active core manager with satellite managers in the growth and value space, an investor may achieve a more diversified portfolio, one that

Table 1.
Examples of Stock Falling Into Large-Cap Gap

Company	Characteristics
American International Group	49% Value / 51% Growth
Bristol Myers	50% Value / 50% Growth
Campbell Soup	55% Value / 45% Growth
Clorox	44% Value / 56% Growth
Comcast	56% Value / 44% Growth
Costco	61% Value / 38% Growth
General Mills	48% Value / 51% Growth
Hershey Foods	44% Value / 56% Growth
IBM	50% Value / 50% Growth
Merck	55% Value / 45% Growth
Storage Technology	59% Value / 41% Growth
Waste Management	45% Value / 55% Growth

Figure 5.
Russell 1000

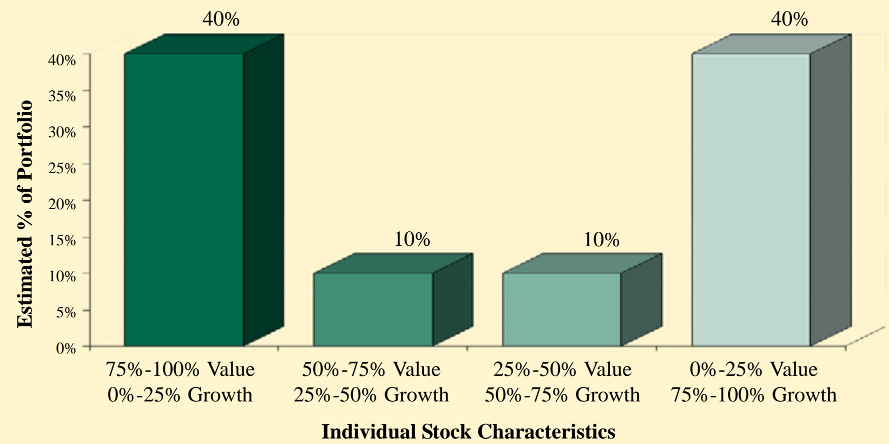
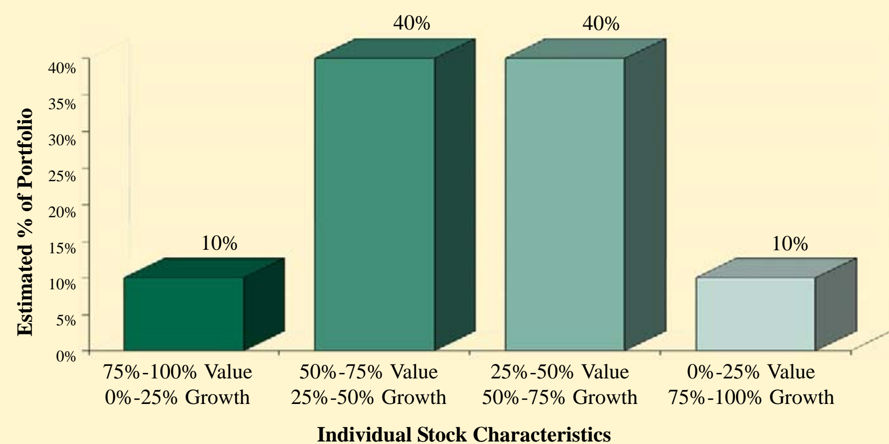
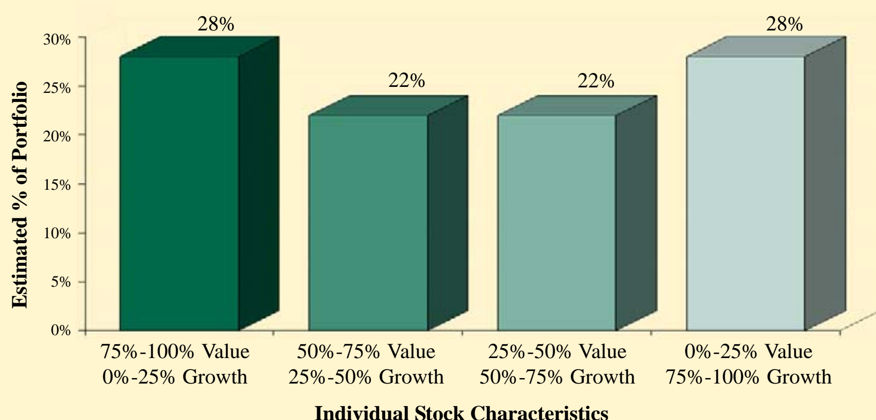


Figure 6.
Core Manager



© 1998-2004 PCT Publishing

Figure 7.
Core Manager Combined with Growth and Value Manageres



should lead to reduced volatility with minimal overweighting at the extremes. Only through holdings-based analysis can a consultant truly determine whether the total portfolio is achieving the desired objective; and only through the rigors of holdings-based analysis can you be assured of sufficient market coverage with reasonable balance between large-growth, large-value and core, aka the Large-Cap Gap. ■

About the Authors

Mike Yaktus is a Managing Director at Madison Investment Advisors and has primary responsibilities in the area of client development and service, overseeing Madison's institutional marketing team. Mike holds a BBA in Finance and Accounting from the University of Wisconsin. In addition, he has obtained both the CPA and CFP designation. Prior to joining Madison Investment Advisors, Mike was a financial consultant with Kemper Securities Corp., and a CPA. with Grant Thornton.

Larry Tabak is a Vice President at Madison Investment Advisors and has primary responsibilities in the marketing/communications area of Madison Investment Advisors and Mosaic Mutual Funds. He was educated at Northwestern University and the University of Iowa, from which he holds a Master's Degree in English. Prior to joining Madison Investment Advisors, Larry was a communications executive with American Century Mutual Funds and held senior positions with the United States Tennis Association. His feature writing has appeared in numerous national magazines, including the in-flights for American, United, TWA, Continental, Fast Company and The Atlantic Monthly.

For more information about Madison Investment Advisors, Inc. visit their web site, http://www.madisonadv.com.

Notes

SENIOR CONSULTANT

THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

JAMES P. OWEN
Co-Founder

STEPHEN C. WINKS
Co-Founder, Publisher & Editor-in-Chief

SYDNEY LEBLANC
Consulting Editor

MAMIE WOO MCNEAL
Production Editor

EDDIE BRYANT
Marketing Consultant

Advisory Board

JERRY BOTT
Bott Anderson

JOHN BROCK
Brock-Hazzard/Wachovia Securities

DICK CHARLTON
New England Pension Consultants

BOB CLUCK
Canterbury Capital

HAROLD EVENSKY
Evensky Brown & Katz

JEFF FRUM
Wells Fargo

RICH GLEASON
Smith Barney

KATHLEEN E. HEGENBART
Smith Barney

BRIAN HUNTER
Wachovia Securities

GREG HUNTER
Merrill Lynch

BILL JOHNSON
CapTrust

JOHN KELSEY
Smith Barney

KEITH PHILLIPS
Morgan Stanley

BOB ROWE
Morgan Stanley

DICK SMITH
Capital Advisory Group

JIM YANNI
Yanni Partners

SENIOR CONSULTANT
1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-643-1075 ■ Fax 804-643-1544
www.SrConsultant.com