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DELIVERING
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IN THIS
ISSUE

Understanding
the use of
indexes
throughout the
investment
process.

MEASURING UP

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Benchmarking the Benchmarks *How do they measure up?*

As we welcome the New Year, Yanni Partners has turned its attention to indexes. Recent methodology changes to the S&P Style Indexes have led us to consider the revised index landscape and address key questions about the indexes that are used to gauge the performance of the overall stock market and of individual asset managers.

This edition of *Measuring Up* explains the differences between the indexes of several major providers and explains which of those providers constructs the best index for benchmarking active manager performance.

A solid understanding of how the indexes are constructed, including the strengths and weaknesses of each, leads to improvements in both evaluating prospective managers and monitoring current manager performance.

Benchmarking: Does The Choice Of Index Really Matter?

The answer to this question is unequivocally yes. There are four main providers of U.S. Equity Indexes, and each breaks its market coverage down by company size and style. These distinctions give rise to the large, mid, and small cap indexes as well as the growth and value subsets of each capitalization size. Since each provider claims to

track both the market as a whole and each sub-sector of the market, one would expect the performance characteristics of sub-sector indexes to be quite similar among the various index providers. Over longer time horizons this is the case. Short-term results, however, paint a different picture.

One eye-opening example is the difference between the S&P/Barra Growth and the Russell 1000 Growth returns in 2001. While both indexes represent the large cap growth sector, the S&P/Barra Index was down 12.7% on the year while the Russell posted a 20.4% loss. An active large cap growth manager could have had an annual return of -16.0% in 2001 and would have looked outstanding if benchmarked to the Russell Index (outperforming by over 4.0%), but may have looked like a candidate for replacement if benchmarked to the S&P/Barra (underperforming by over 3.0%). These are two decisively different appearances based on the same performance.

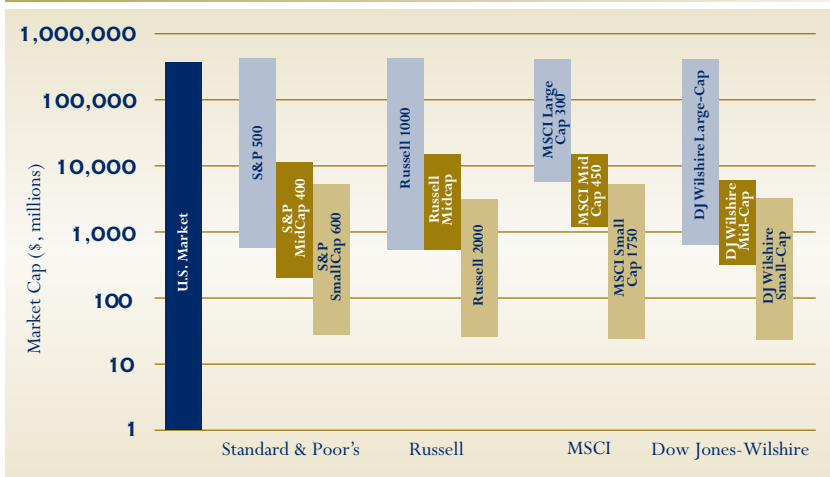


This example, while extreme, is far from a solitary event. In fact, as of the end of the third quarter 2005, the S&P/Barra Growth has outperformed the Russell 1000 Growth by 1.8% annually over a ten-year period.

The large cap growth example cited here illustrates benchmark return differences. While not as extreme as those in the large cap growth space, there are differences in index returns in each capitalization size and each style segment of the market. Performance variations are largely results of the differences in index construction among the major index providers.

While many of the criteria used to include companies in indexes are similar among providers, there are some differences. The first difference involves the procedure for including companies. Three of four providers (S&P is the exception) rank all domestic companies and then assign the companies ranked within a specific range to one of the cap indexes. *Figure One* shows the range for each provider's market cap indexes. Two of the providers (Russell and DJ-Wilshire) have mutually exclusive large and small cap indexes but construct the mid cap index as a subset of one or both the large and small caps.¹ The Russell Midcap Index consists of the smallest 800 companies in the large cap Russell 1000, and the DJ-Wilshire Mid-Cap combines the smallest 250 companies in the DJ-Wilshire Large-Cap with the largest 250 companies in the Small-Cap Index. S&P is the exception among providers and uses a Committee to select companies for their indexes rather than ranking companies by market cap, introducing a subjective element into the process. S&P also does not draw definitive lines between market cap segments, which results in significant market capitalization overlap despite the fact that no company is included in more than one index.

FIGURE ONE
Market Cap Comparison



Index Construction: How Do Providers Differ?

Currently there are four major providers of U.S. Equity Indexes: Standard and Poor's, Russell Investment Group, Morgan Stanley Capital International, and Dow Jones-Wilshire. The procedure for constructing each index differs by provider, but the overall scope of the indexes is the same. The indexes seek to represent all or part of the U.S. stock market while being investable with a well-defined and consistent methodology. This stipulation allows for a comparison of the methodologies of the various providers.

Style Indexes: Which Method Is Superior?

While there are differences in the method of assigning companies to market cap indexes, the biggest difference among providers is in the construction of style indexes. Each of the four main providers uses a unique method to separate companies into growth or value indexes. There are many steps involved in each provider's methodology, but the major differences are in the following factors: company characteristics used to determine the style, company overlap among indexes, and the use of forecast versus historical variables. *Figure Two* highlights the differences among index providers, while an explanation of each difference follows.

¹ After the rebalance date, there might be capitalization overlap between large and small cap indexes due to market drift.

The characteristics that an index provider uses to determine the style for a company vary widely. This was the most dramatic change to the newly released S&P Style Indexes, which use seven factors as opposed to a single factor used in the old S&P/Barra series. Each provider uses a different number of characteristics, and it is generally accepted that there is a positive correlation between the number of characteristics used and the accuracy of the style index. Providers consider fundamental financial characteristics like Price-to-Book ratio, Price-to-Earnings ratio, historical and forecast Earnings Growth, and Dividend Yield. Russell's use of two factors significantly lags its competitors in the depth of the information used to define growth and value.

A second consideration of style indexes is the treatment of companies that exhibit some growth characteristics and some value characteristics. An ideal methodology will result in some overlap of companies, meaning the company is represented in both the growth and value index, and some exclusion of companies. None of the four major providers follows this procedure exactly, but Dow Jones-Wilshire and MSCI are the closest. Russell and S&P both include roughly a third of the total market in both the growth and value indexes. In all cases where the provider includes a given company in both the growth and value index, the overall market cap of the company is divided between the two styles according to the relative strength of the style factors.

One last difference between the methodologies of the style indexes is the use of forecast variables. Forecast variables use predictions of future company earnings and growth rates to measure the expected characteristics of each company. Forecast variables allow new information to be quickly built-in to the style indexes rather than waiting for that information to flow through to the company's financial statements. S&P is the only provider that

FIGURE TWO

Comparison of U.S. Equity Style Index Providers

	S&P	RUSSELL	MSCI	DOW JONES-WILSHIRE
Number of Factors Used to Determine Style	7	2	8	6
Companies Included in both Growth and Value Indexes	Style: Yes Pure Style: No	Yes	Yes	No
Percentage of Companies Included in both Growth and Value Indexes	Style: 33% Pure Style: None	33%	11%	None
Forecast Variables	None	Expected Growth Rate	12 Mo. Forward E/P, Forward EPS Growth Rate	Projected P/E, Projected Earnings Growth

does not use forecast variables, citing concerns about accuracy and reliability.

The debate regarding index methodology ultimately turns to a single question. Which index is better? We believe that the provider that comes the closest to creating an ideal is MSCI. In constructing its U.S. Equity Indexes, MSCI has combined the best practices of its competitors with the best practices identified in academic studies. Despite this, the MSCI family of indexes has a limited following. In a survey of the Nelson Information MarketPlace Web database, which contains information about 4,089 U.S. Equity managers, 95% of the 1,000+ managers that use a style index as a benchmark use the Russell series of indexes. The MSCI Indexes may be the closest to the "ideal," but the Russell Style Indexes are the industry standard.

Client Portfolios: What Decisions Must Be Made?

A decision must be made whether the structure of one index presents a sufficient reason to change the benchmark for an investment manager. Once again, this is not a simple choice. Each investor must weigh the pros and cons of changing indexes, and in doing

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so each investor may reach a different conclusion based on its unique strategic diversification objectives.

One issue with changing indexes is the effect on active managers in the portfolio. Active managers may be indifferent to a change in the benchmark used to measure their performance. The manager might not consider the index in the portfolio management process, choosing instead to build the portfolio from the bottom up with attractive stocks regardless of the stock's weighting in (or absence from) an index. In these cases, changing to a superior index will have no effect on the way the manager builds the portfolio. Changing the benchmark may improve the evaluation of the manager's true value added (skill versus luck). On the other hand, an active manager may use the index constituents as a starting point for the investment universe or constrain sector weights in relation to those of the index. In those cases, a change in benchmark may drive a change in the holdings or increase tracking error.

Passive mandates pose serious issues as well.

A passive portfolio would be changed a great deal as a result of changing the index on which the approach is based, as none of the indexes classifies securities in the same way or into the same capitalization or style segments. As this newsletter has shown, the indexes of various providers that claim to represent the same sectors of the market perform quite differently over time.

Administrative and legal documents are also a consideration when determining the scope of effort to change the indexes that are used in client portfolios. Documents such as the Investment Policy Statement, Performance Reports, and Manager Evaluations would all have to be revised. These changes may not be as quick and easy as they first appear.

Conclusion

Yanni Partners will advise clients on an individual basis if there is a benefit to changing any of the indexes used in the portfolio. If a client's situation warrants a change in indexes, Yanni Partners will help make the transition as smooth as possible.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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