A MATTER OF OPINION

Investment style has been defined in many ways, but however you describe it, most successful investors have one that they consistently apply.

A Question of Style: Categorizing the Various Investment Approaches

By James B. Cloonan

Investment style is the combination of factors and mechanisms used by an investor over time to choose stocks for purchase. Most successful investors have a consistent style or combination of styles. Lack of consistency in approach is almost a sure-fire route to failure.

In future columns, I will examine different approaches to the market in more detail. For now, I want to list and summarize the different approaches.

Defining Style

Style has been defined in many ways, but the most popular methods tend to divide companies by two to three different capitalization sizes (number of shares outstanding times share price), and to divide companies by whether they are value or growth firms.

To accomplish the latter, usually a measure of value (price-to-book value; price-to-sales per share, etc.) is used to divide a stock universe into those with the lowest score (the "value" companies) and those with the highest score (the "growth" companies). However, a true value investor would not find more than 10% to 20% of all stocks as representing significant value. Likewise, a true growth investor would find only a limited number of growth stocks. So trying to categorize every stock as value or growth doesn't really make sense.

Other popular approaches to defining style include (see Table 1):

- Contrarians look for stocks that are currently out of favor, with the belief that "favor" is a cyclical phenomenon and that these stocks will become popular again. The very fact that some stocks are in favor indicates that at any one time, a large number of investors are emphasizing certain stocks.
- Top-down analysts feel that choosing the right market sector at the right time is more important than choosing the best stock in any sector. Thus, these investors, mostly institutional, feel that the most effective way to outperform the market is to analyze the overall economic climate, and from that determine the market sectors that will benefit from such an environment. Conversely, "bottom-up" investors emphasize the characteristics of the individual stock.
- Quantitative analysts use primarily quantitative data to analyze stocks. Basically, this is the information that is available on balance sheets and operating statements. Other approaches involve qualitative judgments. These might include the quality of assets, the competence of management, the good will of the corporation, the quality of copyrights and patents, brand loyalty, consumer tastes and taste changes, etc.

Other Influences on Style

Of course, other factors may enter into decisions, and style can be a matter of emphasis rather than exclusion. In addition to the above ways of differentiating approaches, there are other factors an investor can consider that will influence style (see Table 2).

These can be used to supplement the basic style approaches, and most of them are self-explanatory—market anomalies, such as the best time of the year or the best day of the week; market timing factors; technical analysis factors (such as short-term price patterns); and "stories."

A "story stock" is one where things may be happening that could make a dramatic change in the companies' listings. Generally, it is a new product or applica-

Table 1.
Popular Ways to Differentiate "Style"

Differentiating investment approaches based on:

- Small capitalization stock vs. large capitalization stock investing
- Value vs. growth stock investing
- Contrarian investing vs. investing in the "nifty" stocks
- Top-down analysis vs. bottom-up analysis
- Quantitative analysis vs. qualitative analysis

James B. Cloonan is chairman of AAII.

Table 2.
Other Factors Influencing "Style"

- Market anomalies—seasonal, day-of-the-week, day-of-the-month
- Market timing factors
- Technical analysis factors
- Story stocks

tion, but it could be changes in the market, in regulation or other factors.

Another View

I feel there are two other ways of looking at investment approaches (Table 3), one based on the practicality of the different approaches, and the other based on the central question implied by the various approaches that use ratios to evaluate stocks.

Table 3.
An Alternative Way to View "Style"

Differentiating investment approaches based on:
- Data needed for analysis
- Decision concerning which factor will cause stock to reach P/X average—P or X

The first view, looking at investment approaches in practical terms, categorizes them based on the information required to use them. The first category would include approaches that use only quantitative data about the company. This data is usually available on an annual or quarterly basis, which means decisions can only be made near the time that data is reported. It would seem that decisions could be made at other times because stock price changes will influence ratio criteria such as price-to-book value, price-to-earnings, price-to-sales, etc. If you think about it, however, the ratio is not determinable absent new corporate information. As an example, consider a stock with a price-earnings ratio of 10 (a share price of $10, divided by earnings per share of $1) at the time of the earnings report. Two months later, the price is $13. Is the price-earnings ratio now 13, or are earnings also heading up and actually at a rate of $1.30 even though no report is due? This type of analytic problem makes it better to make decisions only when new information is available and makes it reasonable to ignore the market on a day-to-day basis.

The second category includes approaches that are based on price and volume changes, which are available minute-by-minute. Technical analysis is the term for the approach that uses this information and decisions can be made at any time.

The third category consists of investment approaches that use qualitative factors, and these factors can change at any time. Thus, investors using a qualitative approach must devote more time to analysis, and must either do basic research themselves or screen a lot of other peoples' research.

My second suggested way of viewing investment "style" centers on the various ratios used to judge stocks. The most common measures used when viewing quantitative data are ratios, such as price-to-book value, price-to-sales, price-to-earnings, price-earnings relative to growth, etc. Now, think of some combination of these as being P/X. Using such an approach implies that we expect some long-term relationship to exist, and that this ratio will have an average value over time. What if we then find a stock that is far from this average value? Value investors would like stocks with a much lower value as measured by P/X, and growth or momentum investors might like a higher value as measured by P/X.

We can reconstitute this view by saying that different investors disagree on which of the two values is leading and which is lagging. In other words, some investors feel that the average will be reached by the price dropping, while others feel that the average will be reached by the "X" rising. The question is: When the model indicates an unreasonable value, which variable will change to bring the stock back into balance?

I personally believe that the answer is different for different stocks and different times in the business cycle.

This is my overview of the ways to view "style," and future columns will look at each of these in more detail.