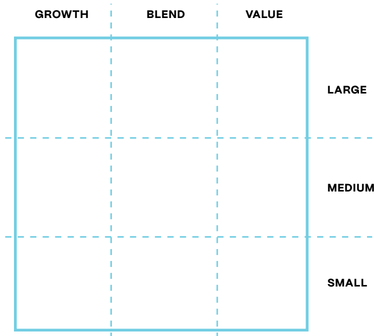
Release the Constraints

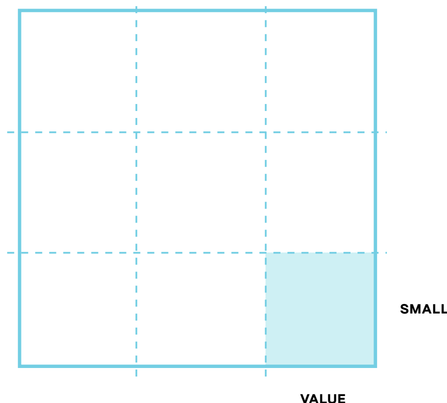
Traditional style boxes, like those created by Morningstar, limit investment potential by imposing unnecessary constraints. By focusing on risk and return rather than rigid categories, investors can achieve better, more efficient outcomes and maximize expected returns.



Created by Morningstar, the "style box" has been around for decades and used by professional and amateur investors alike to segment and diversify their investment portfolios. Large cap, small cap, value, and growth stocks all behave differently from one another and make up material portions of the stock market. Investors wanted to make sure they had ample diversification and thus looked for asset managers whose strategies fit neatly in those boxes.

To meet retail investor demand, asset managers created strategies that fit neatly in those style boxes. As a consequence, asset managers have been constrained by these style boxes, especially within evidence-based strategies. However, as the understanding of the key drivers of returns and efficiency of markets has grown, this antiquated way of thinking is holding investors back from better solutions. While it's possible that some investors have a very specific need to invest only in small cap companies below a very specific size ceiling, the astute investor doesn't much care about these constraints but, instead, cares about risk and return. Investors want a series of strategies that maximize return in the most efficient way possible for a given level of risk. By imposing artificial constraints on portfolios like size ceilings or value thresholds, investors sacrifice expected returns. Stated differently, no constrained system can be as good as one that is unconstrained.

Let's do the math.



Take a typical small value strategy that invests in the bottom 10% of size and the deepest 30% of value. This "box" approach that may fit neatly in a style box is suboptimal for investors hoping to maximize expected return.

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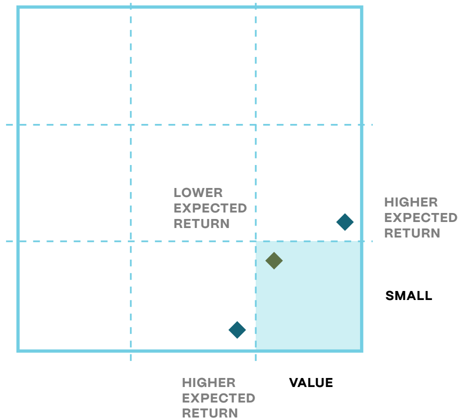

There are certainly mid cap companies right above the size ceiling that have great value metrics that will have higher expected returns than some of the companies right below the size ceiling that have only mediocre value metrics. Similarly, there are micro-cap companies just outside the value threshold with higher expected returns than larger small cap companies just inside the value threshold.

This approach also reduces the impact of trading costs and taxes investors face as one only trades when it is economically meaningful to do so. All trades have the goal of improving your expected return net of costs rather than rather than improving your style box allocation net of costs.

Therefore, by releasing these artificial constraints and focusing on expected returns, investors can achieve more efficient and cost-effective solutions.

Evidence-based investing focuses on the relationship between risk and return, free of constraints, so that you and your clients can feel confident that their money is being put to work in the most efficient way possible.

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