**A Challenge to Traditional Thinking: Performance Contest Shows That Better Managers are Found with Tools That Replace Indexes and Peer Groups**

In a February 11, 2011 Webinar I mentioned a performance competition that I describe here. The Webinar was entitled "The History of Manager Due Diligence and Where it Went Wrong" and is available for replay at Replay . A few years ago I criticized Don Trone, founder of the Center for Fiduciary Studies and Fiduciary 360, for his due diligence criteria because they rely heavily on peer group rankings. Peer groups are loaded with biases that make them more likely to mislead than to inform. Don responded with a "If you're so smart" challenge. We would both construct multi-manager portfolios using the tools we like best – me with my best practices and Don with his common practice peer group screens. Managers selected using best practices won this performance contest, and the story is being told here publicly for the first time.

Here's a quick synopsis of the contest rules and its purpose.

I initiated the conversation with an e-mail to Lynn O'Shaughnessey, who had written a glowing review of Don's criteria in ***Bloomberg Wealth Manager***.

> Surz: ***The Trone list works from a procedural prudence perspective because everyone does it, but it doesn't work for discovering talent, the purpose of due diligence. I believe we discussed this during our interviews Lynn.***
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> To which Don Trone replied:
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> ***Ah, Ron, what are you doing? Jousting with windmills, I see, protecting a damsel in the press.***
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> ***Our due diligence criteria is designed for one purpose: to define the minimum due diligence process that should be applied by an investment fiduciary - it is not intended to be an industry best practice - that space is reserved for you!!. We expect people to layer on additional screens depending on their level of sophistication. One of our primary objectives is to define a process that can be applied to readily available information and data bases. To that end, our process is constrained to***

*the vagrancies of the various data base providers - garbage in, recycled compost out.*

*Now, even though we are defining a minimum due diligence process, it has produced, as a collateral benefit, good solid performance. In fact, now that you've thrown the gauntlet, would you like to joust with our two systems? Here's what I propose:*

*We each build a mutual fund portfolio for a $100,000 client using six asset classes:*

*15% Large cap growth*
*15% Large cap value*
*10% Mid cap*
*10% Small cap*
*15% International large cap equity*
*35% Intermediate fixed*

*We select one fund for each asset class. At the end of the quarter (June 30, 2005), we're each allowed to replace one fund. At the end of the second quarter (Sept 30, 2005) we calculate the performance (ending market value) of the total portfolio and determine the winner. We'll appoint Lynn as the referee.*

I accepted the challenge:

*Sure, I'll be Don Quixote to your evil enchanter. It's an opportunity to demonstrate that my views are not only idealistic, but practical. Cervantes might approve. I'll match your 2 systems with my 2 Sancho Panzas, clients who are using my tools.*

So the contest was on, and Don would come to regret his closing volley;

*You're going to need all the help you can get if you even hope to stay within 200 bp of our performance.*

The contest actually started mid July, 2005. Six months later the results were in: Surz 8.6%, Trone 6.4%. I won!!

So what can we learn from this contest? Investors have no qualms about spending serious money on their investment managers, who would be considered good if they added 100 basis points in a year. Please note that this contest was won by 220 basis points in just six months. Shouldn't investors and their advisors be willing to invest in better due diligence; the payoff could be much greater than the meager reward typically delivered by active managers who have been selected using the old tools. These improved due diligence tools include custom benchmarks built from better indexes and a replacement for peer groups that applies portfolio simulations to test the hypothesis "performance is good." Better living through science. To learn more, please view the replay of last week's Webinar. It'll be the best hour you've ever invested.