

Is Your Manager a Chimp, Chump or Champ?

Portfolio Opportunity Distributions (PODs) Tell the Difference





Contemporary Investment Performance Evaluation: Unifying Best Practices to Create Superior Diagnostics

Ron Surz

PPCA, Inc

949/488-8339

Ron@PPCA-Inc.com

“Unlearn you must what learned you have.”



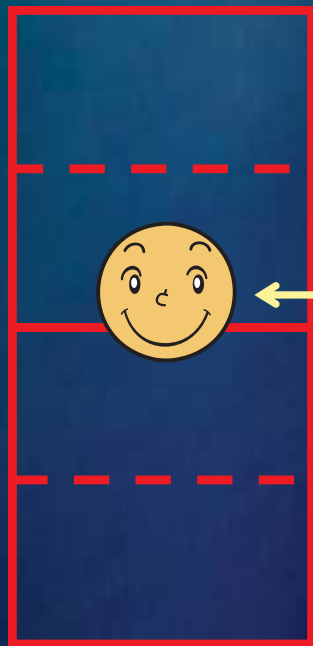
Yoda

Peer groups
are NOT
reliable.

Examples of CFA Institute (AIMR) Documentation of Peer Group Deficiencies

- **Ankrim, Ernest M. “Peer-Relative Active Portfolio Performance: It’s Even Worse Than We Thought.” *The Journal of Performance Measurement*, Summer 1998, pp 6-11**
- **Bailey, Jeffrey V. “Are Manager Universes Acceptable Performance Benchmarks?” *Journal of Portfolio Management*, Spring 1992, pp 9-13**
- **Bleiberg, Steve. “The Nature of the Universe.” *Financial Analysts Journal*, March/April 1986, pp 13-14**

The Problems with Peer Groups



My Return

Peer Group Biases

- Survivor ↑
- Classification ? ↑↓
- Composition ? ↑↓

Survivor bias raises the bar.

Classification and Composition biases can go either way.

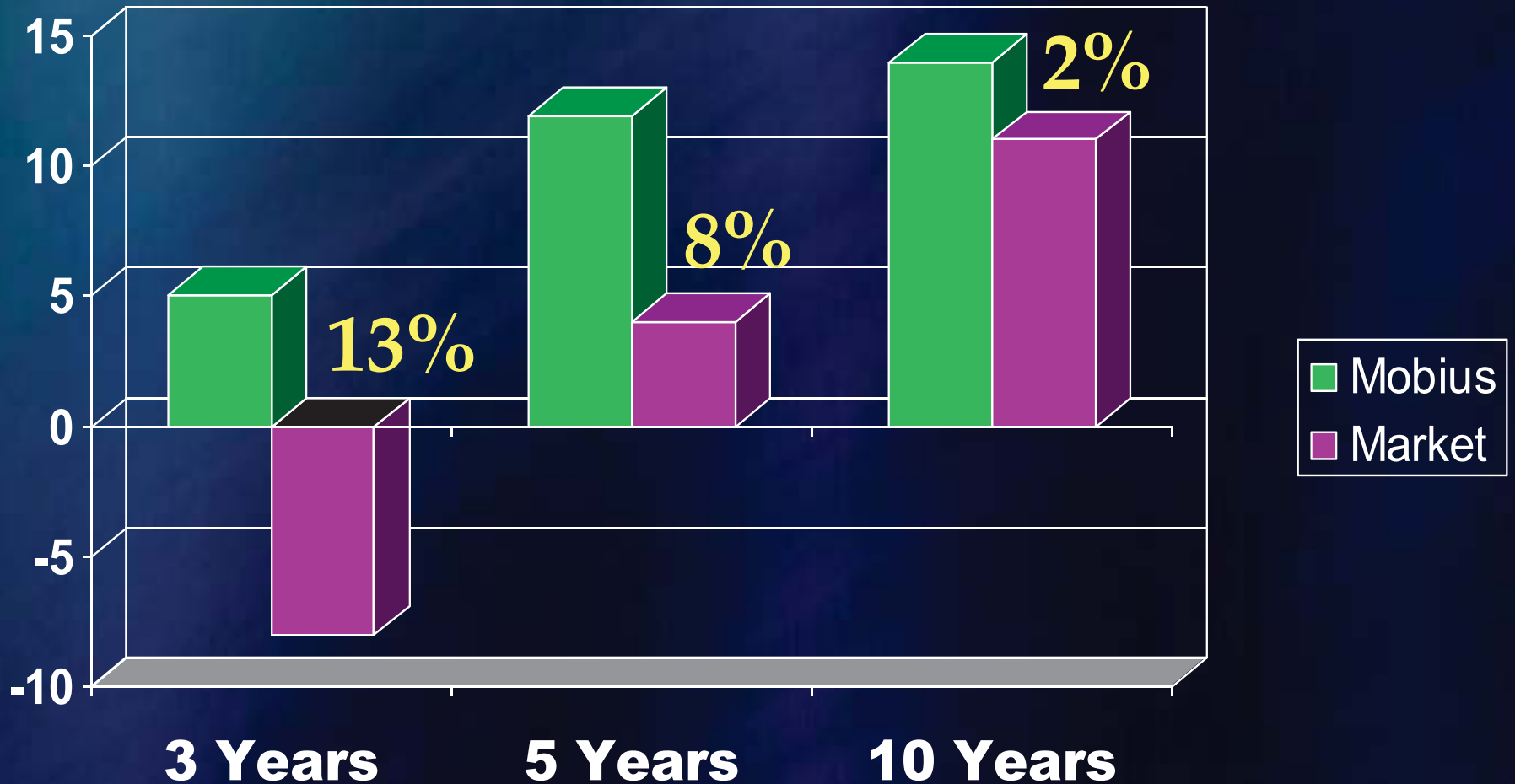
Classification biases arise from differing style definitions.

Composition biases are the result of differing database memberships.

Survivor & Back-fill Bias Example

(Yellow #s are amount of overstatement per Year)

Periods Ending June, 2002



Rob Fletcher, Madison Investments,
presentation to IMCA in September 2002

Peer Groups Don't Work

Classification & Composition Biases

It makes no sense to have a good rank against one peer group and a poor rank against a comparable peer group of another provider, which frequently happens.

**A manager should either
succeed or fail,
not both.**

Classification & Composition Bias Example

“Database Dysfunction”

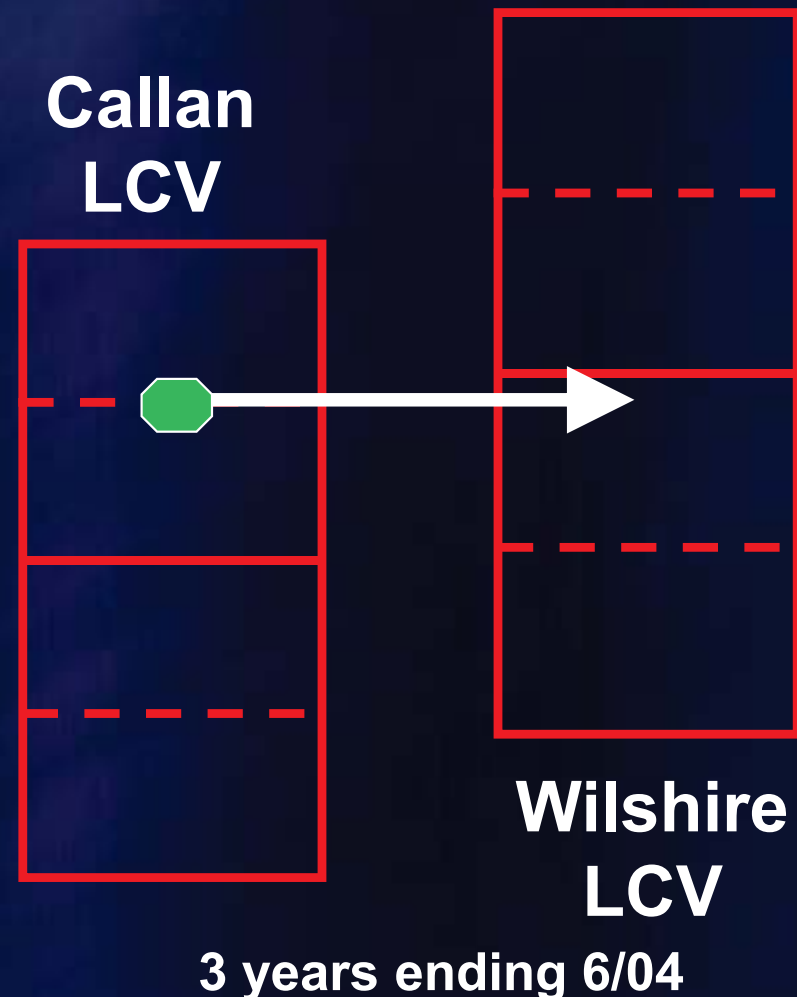
By
Randall R. Eley
President
The Edgar Lomax Company

The same fund ranks top quartile
in the Callan universe but below
median in Wilshire.

What is the
**CORRECT
RANK?**

Pensions&Investments

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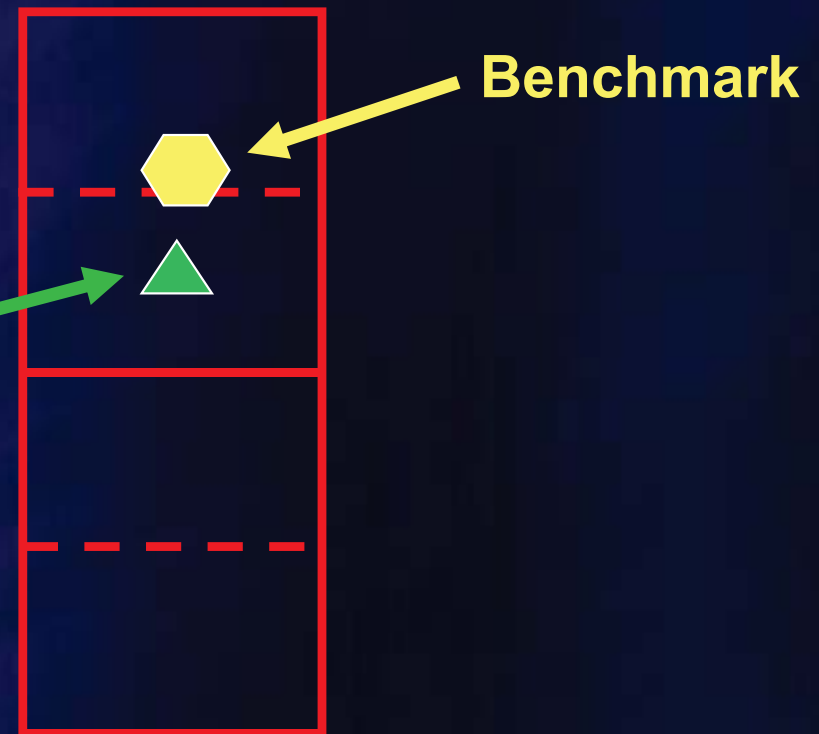


Peer Groups Don't Work

It doesn't make sense to rank well while underperforming the benchmark, as frequently occurs with traditional peer groups.

A manager should get bad marks for failure.

**Manager Ranks
Above Median**



“I can pick a GOOD peer group”

Peer groups are inherently flawed.
You can no more pick a “good”
peer group than you can pick a
puppy that won’t pee on the floor.



You can NOT make peer group biases go away, try as you may.

Importance

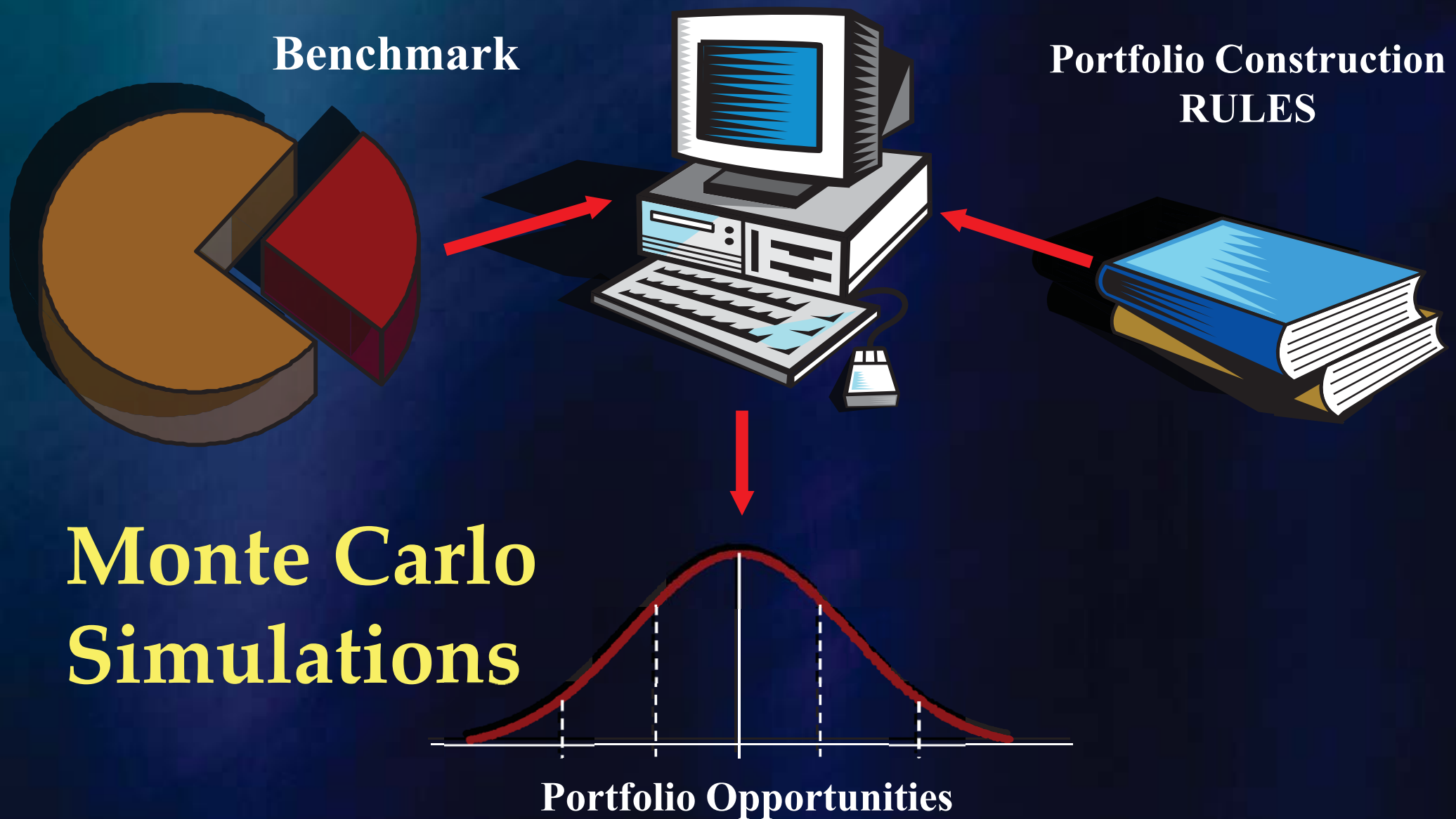
Performance does not win or lose accounts.
Success or failure relative to peers is what matters.

Faulty peer groups lead to faulty decisions,
hiring unsuccessful managers,
and firing successful ones.

A Breakthrough

**Combining best practices
(indexes and peer groups)
to create superior insights**

Portfolio Opportunity Distributions (POD's)

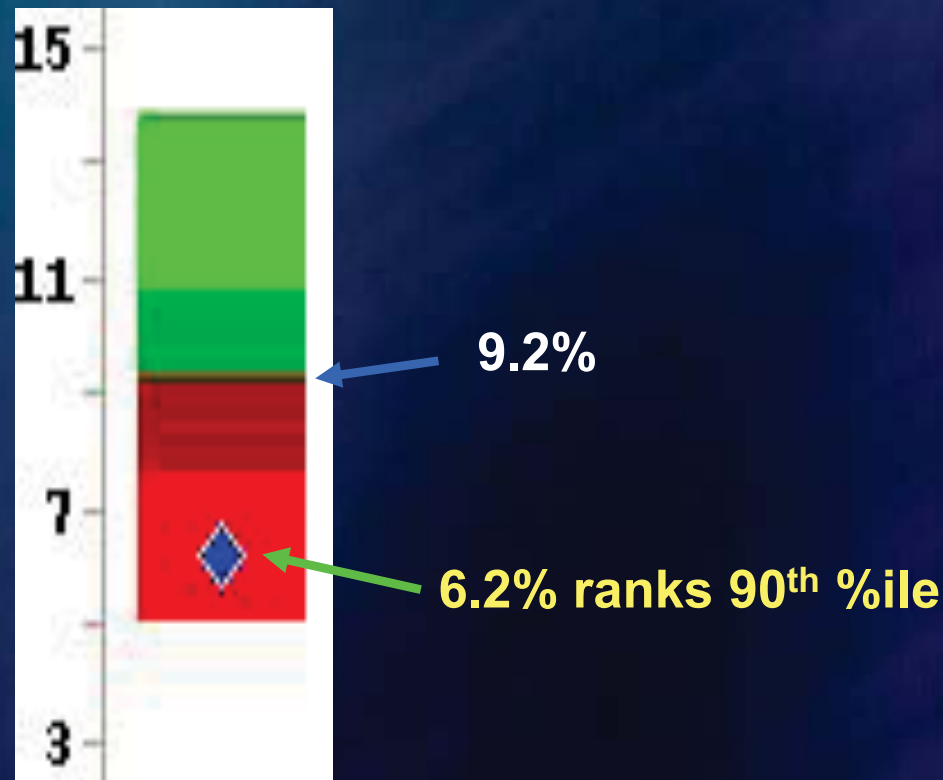


PODs Combine Benchmarks With Peer Groups to

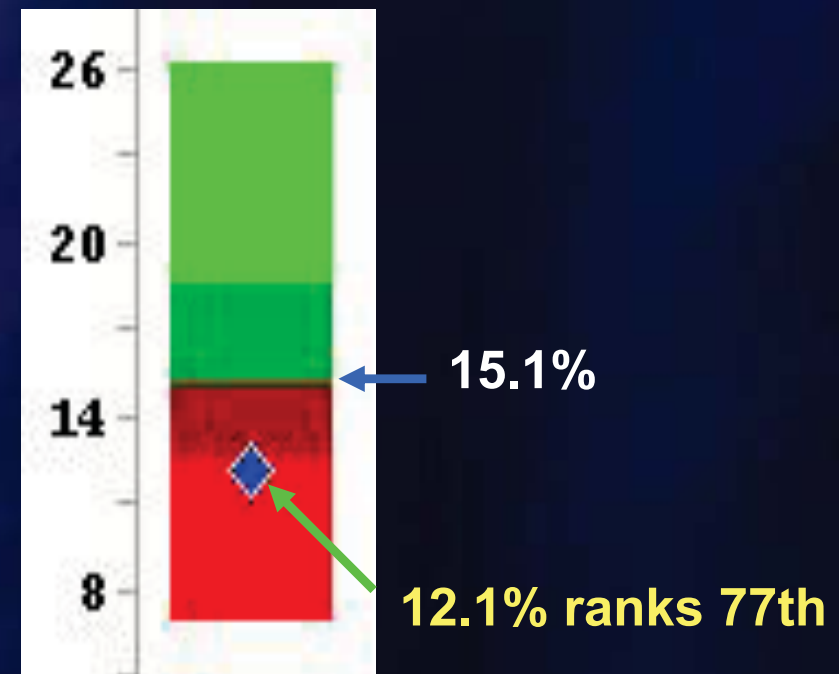
- Reduce biases
- Shorten the wait for statistical significance

How bad was missing the benchmark by 3% in the 4th Quarter of 2004?

Statistically significant
versus the S&P500

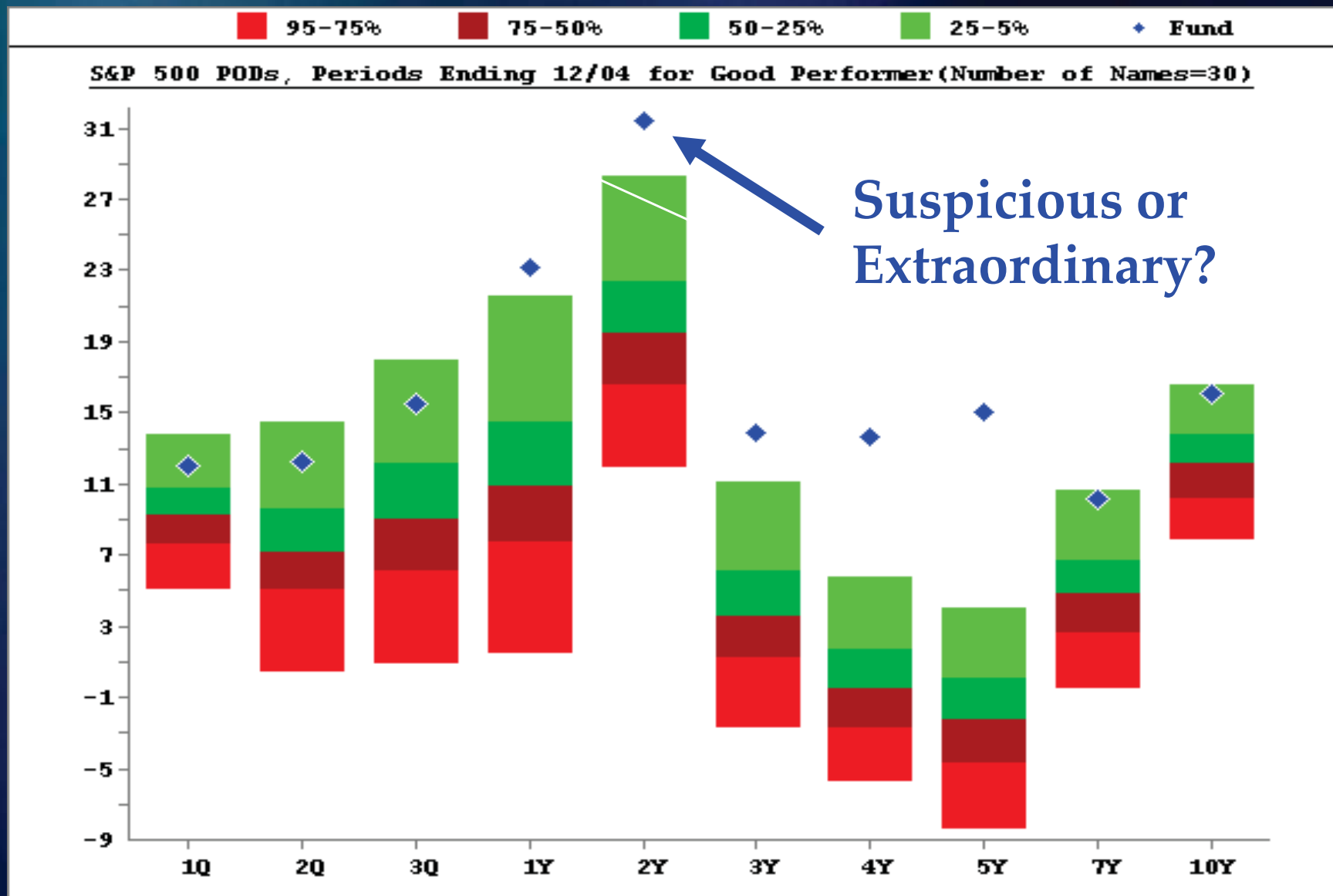


A non-event versus the
Russell 2000 Growth



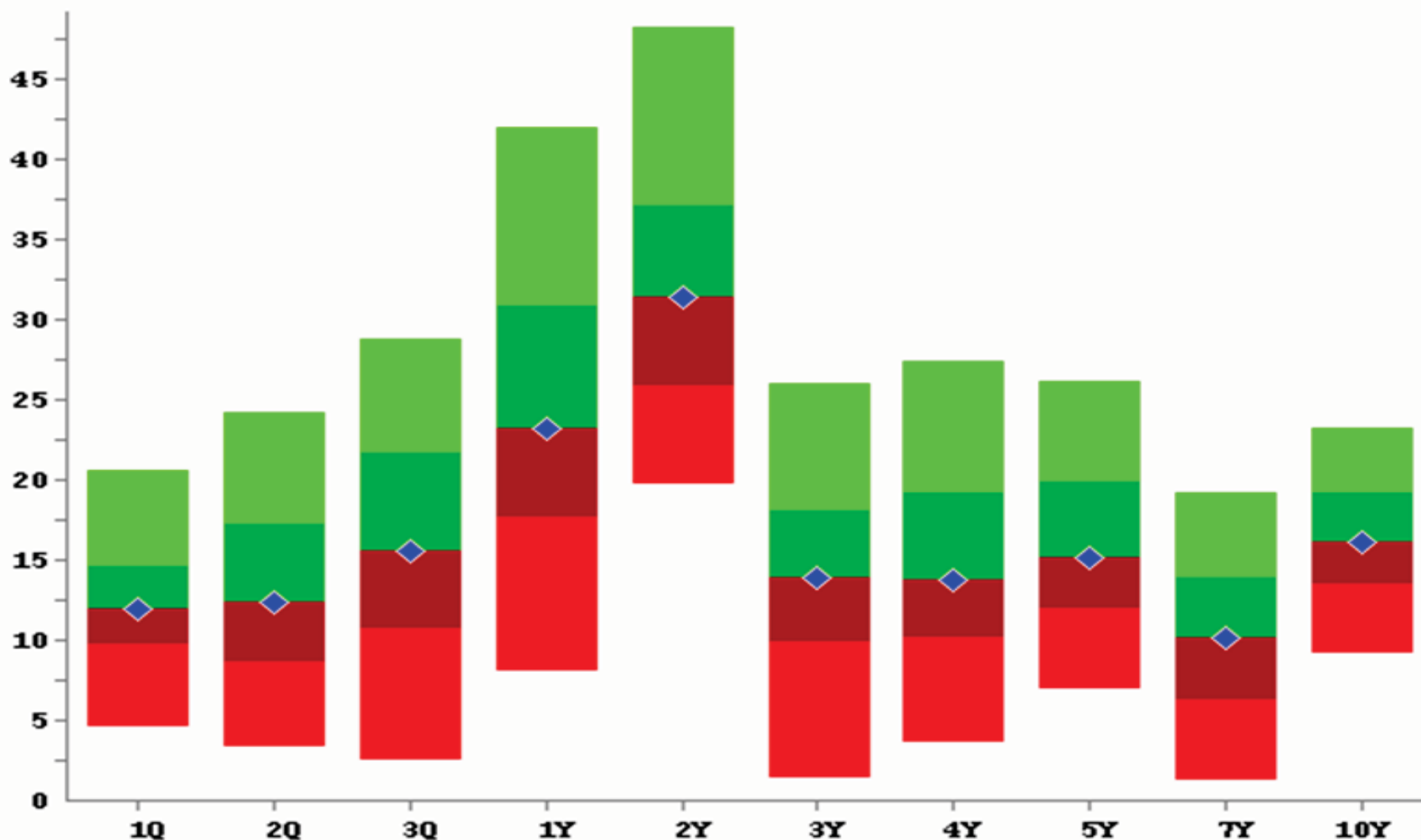
A Reasonableness Test

Rankings versus S&P500



Same Fund Ranked Against Small Value

S&P 600 Small Value PODs, Periods Ending 12/04 for Fund(Number of Names=30)



The Other Waiting

Portfolio Opportunity Distributions are available monthly a couple of days after month's end, many weeks ahead of traditional peer groups.



Hedge Funds



Peer Groups & Indexes Don't Work

Hedge Funds Are Unique

- ✓ Style
- ✓ Capitalization
- ✓ Direction
- ✓ Leverage

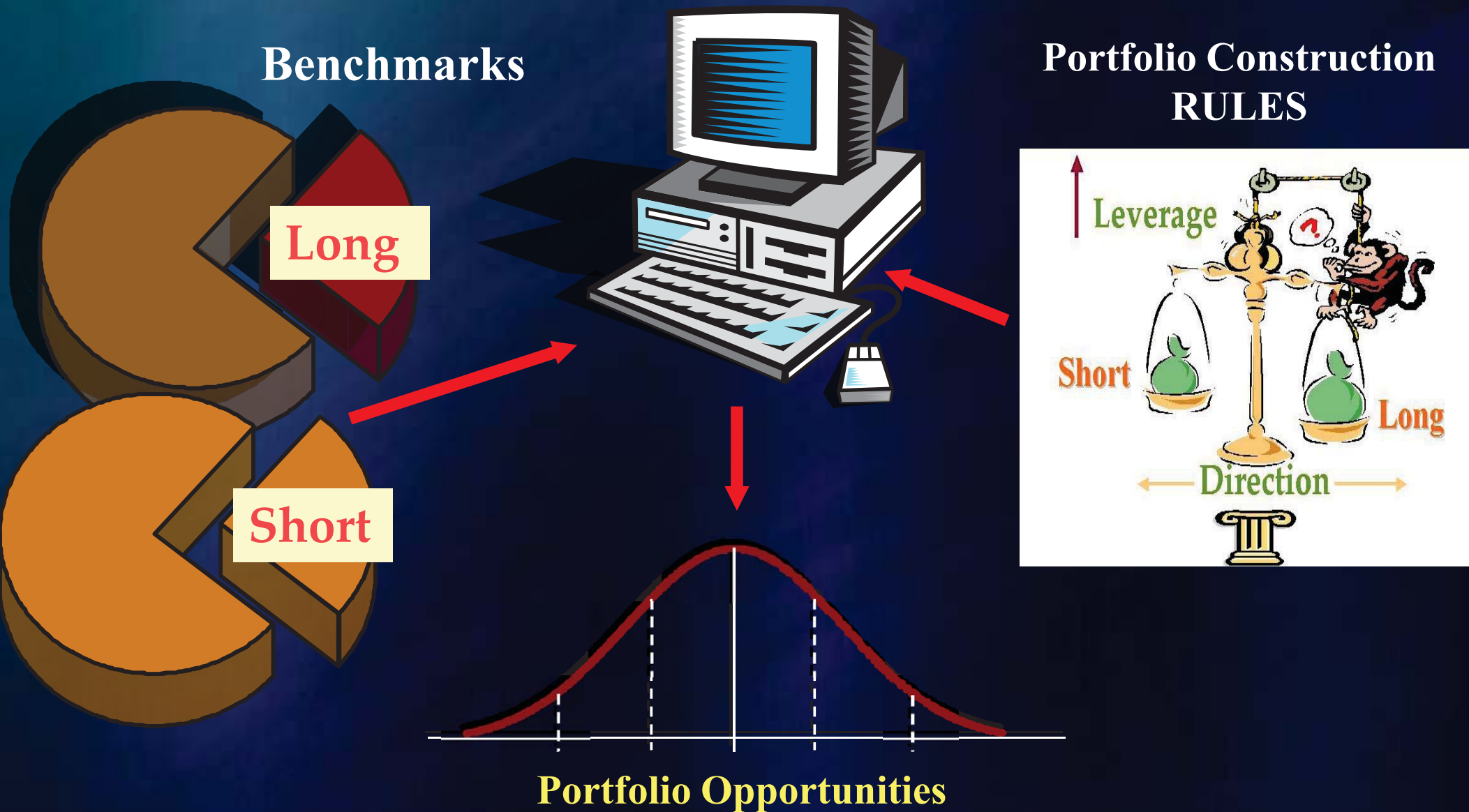
Average Correlations Among Individual Hedge Funds in the Same Peer Group 1994-2001.

These funds are not homogeneous.

Strategy	Correlation (r)
Merger Arbitrage	.45
Equity Market Neutral	.23
Distressed	.39
Convertible Arbitrage	.28
Global Macro	.26
Long/Short Equity	.24
Emerging Markets	.52

“10 Things That Investors Should Know About Hedge Funds”,
Dr. Harry M. Kat, *Journal of Wealth Management*, Spring 2003

Portfolio Opportunity Distributions (POD's) for Long-Short Hedge Funds



An Example: Market Neutral

Dollar, Beta, Sector, Style, ...

Our Experiment:

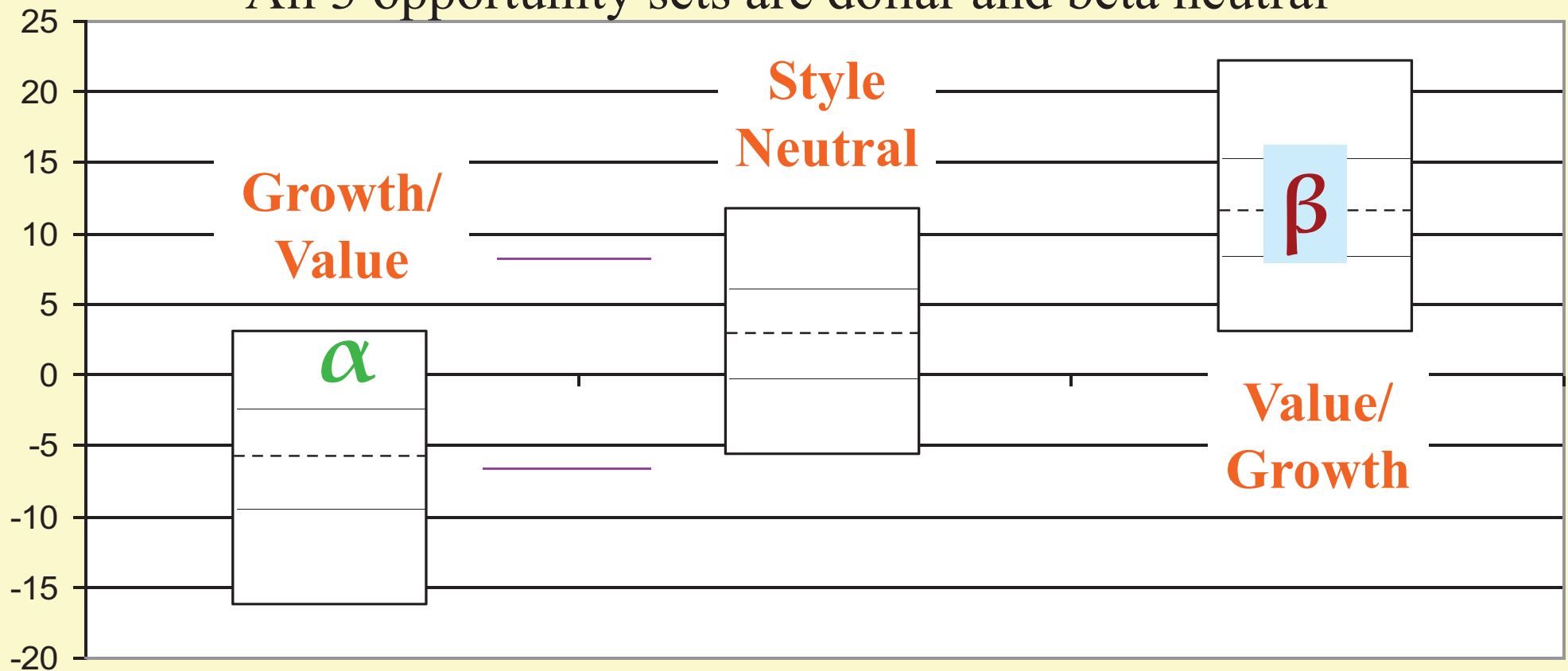
Three Dollar & Beta Neutral
Approaches

- Long Growth, Short Value
- Style Neutral
- Long Value, Short Growth

Market Neutral

Portfolio Opportunity Distributions
for Select "Market Neutral" Strategies
5 Years Ending 6/30/04

All 3 opportunity sets are dollar and beta neutral

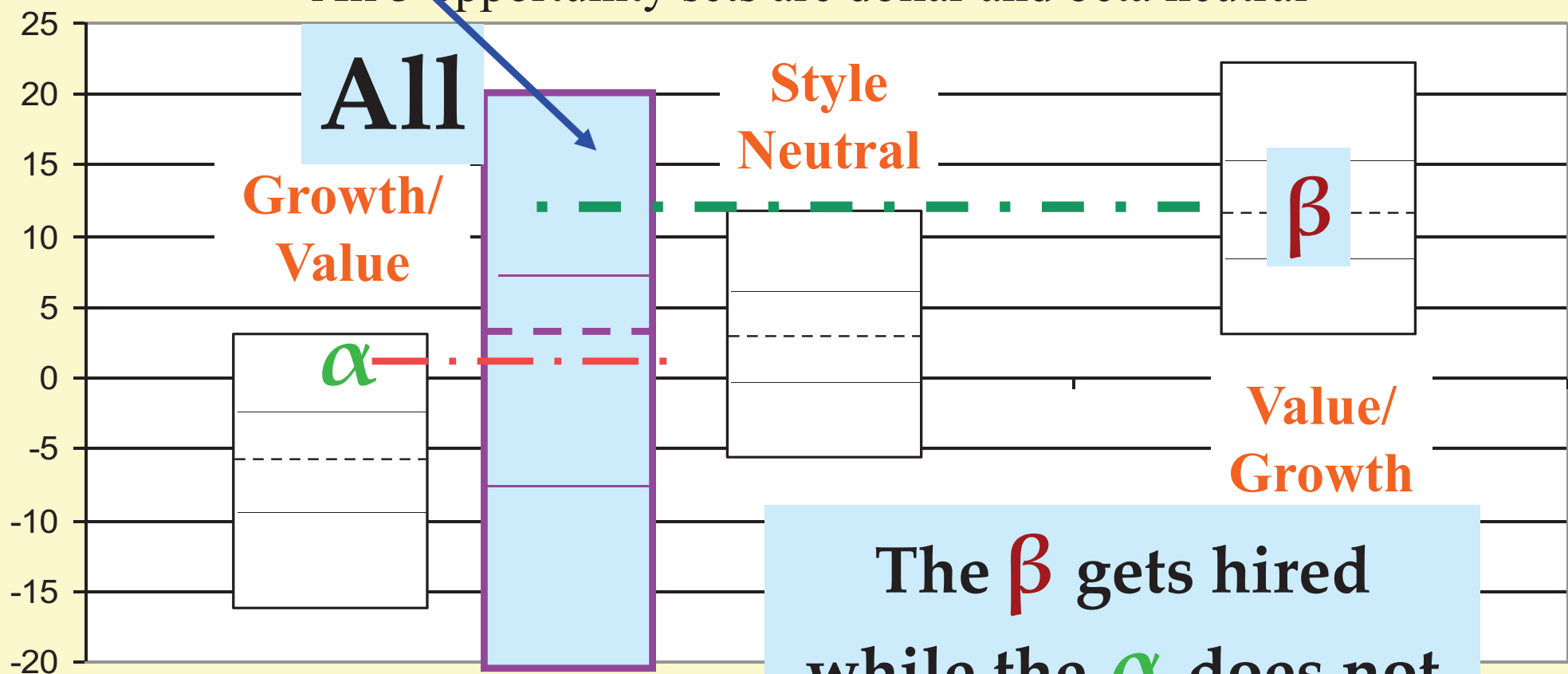


Market Neutral

Portfolio Opportunity Distributions
for Select "Market Neutral" Strategies
5 Years Ending 6/30/04

Traditional peer
groups can't
differentiate.

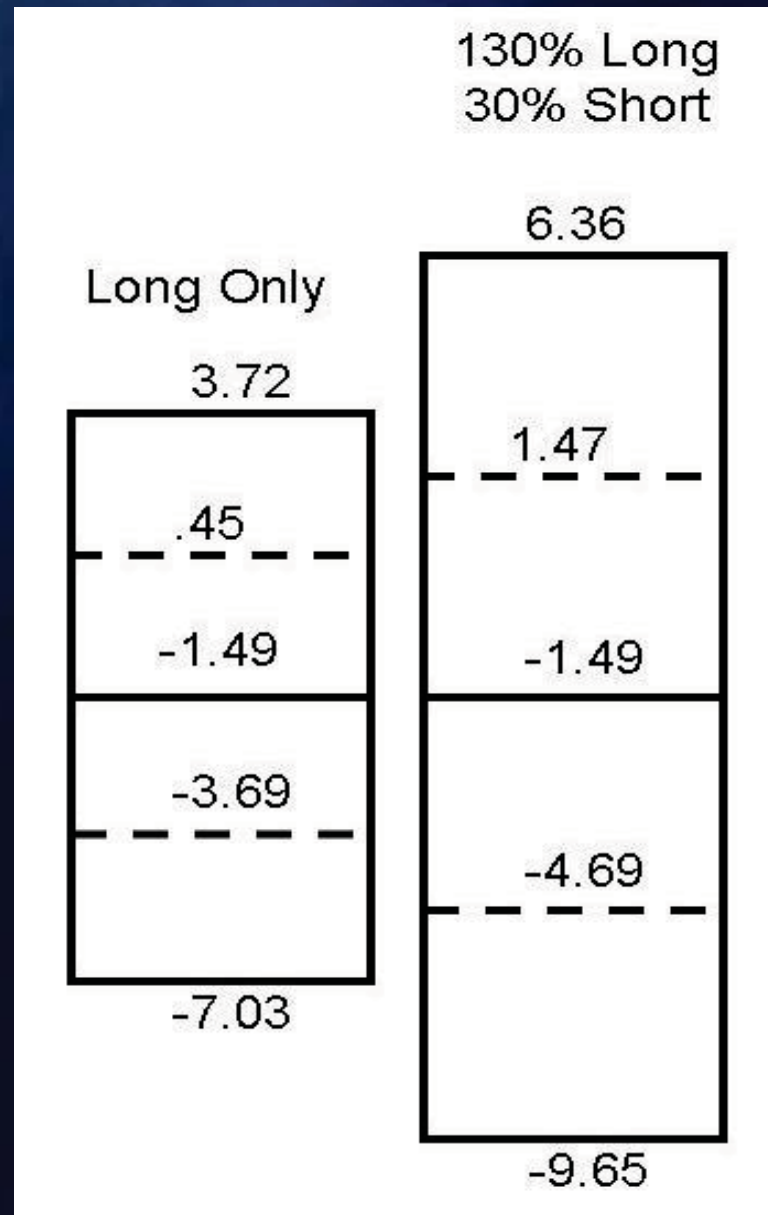
All 3 opportunity sets are dollar and beta neutral



The β gets hired
while the α does not

Implementation Risk

Maintaining the same net long position does not preserve risk, but it requires PODs to measure the increase in **Implementation Risk**.



Concerns

Let's discuss
common reservations

There are Good Answers to Common Concerns

- **Prefer real horse race**
- **Unrealistic portfolios**
- **Similar investors,
like unions or foundations**

Ask PPCA

“Everyone Uses Peer Groups”



Everyone Used to
SMOKE

Humphrey Bogart in “The Maltese Falcon”

Behavioral Science Explains Reluctance to Accept

- **Attachment bias:** Holding onto an approach for emotional reasons, such as “we’ve always done it this way”
- **Cognitive dissonance:** The challenge of reconciling two opposing beliefs
- **Confirmation bias:** The natural tendency to accept any information that confirms our preconceived position and to disregard any information that doesn’t support this position
- **Overconfidence:** Works with confirmation bias to place too much emphasis on one’s own abilities.
- **Status quo bias:** The tendency to do nothing even when action is in order.

Proof of the Pudding

- **PODs are virtually identical to large unbiased total equity universes for periods of up to about two years, and then survivor biases set in.**
- **Style-specific universes are harder to compare, but PODs are the only way to tie rankings back to benchmarks – the benchmark is the middle. See Sharpe's "The Arithmetic of Active Management"**

“It escapes me why so many wait for biased and inaccurate, or at least misleading, universe data when they can get unbiased data almost immediately following any calendar quarter or month.”

**- David Loeper, President
FinanceWare**

Who Cares?

- Investment managers.
- Everyone who employs investment managers.