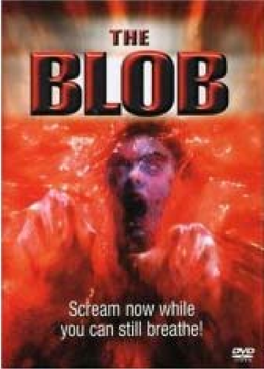



# The BLOB Attacks Investment Manager Due Diligence: Invasion of the Perilous Peer Group Bias

Ron Surz 949/488-8339 ron@ppca-inc.com

Tuesday, March 11, 2008

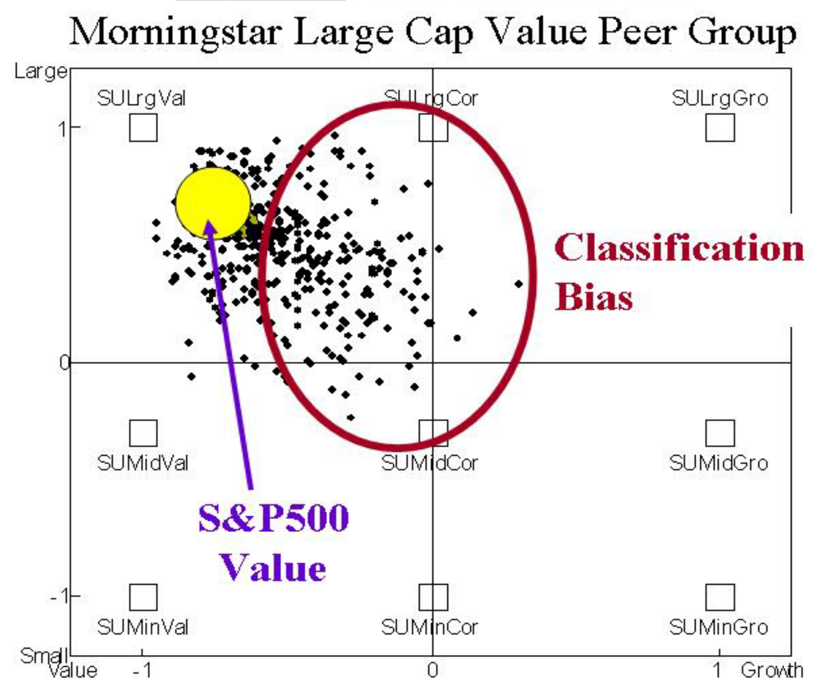
*Ignore this bias at your own peril.*

There are many biases in peer groups, some of which can be controlled. But one obscure bias just won't go away, and it's raising havoc with investment manager evaluations. It oozes out from compromises that all peer group providers must make, and invades evaluators' judgment, unbeknownst to its unwitting victims. This perilous perpetrator is called ***classification bias***. Note it well. Peer group providers establish rules for classifying managers as large or small, value or growth, etc. and then populate their peer groups with managers that meet these criteria. Classification bias feeds on the lack of similarity among the funds that meet these classification rules, enveloping manager evaluations with scary ratings. It is an amorphous bias that cannot be made to go away, try as we may. We need to think outside the box to rid ourselves of this blob.

Most are aware of survivor biases in peer groups and choose to ignore them. But only a few understand classification bias so the decision to ignore this perilous problem is unintentional. Classification bias distorts traditional peer group rankings and invalidates hedge fund peer groups. In the following I provide details on recent effects of classification bias in traditional peer groups, and then explain why it is a very serious problem for hedge funds.

## Classification bias in traditional peer groups

Value investing had been in favor prior to 2007, but value managers lagged their benchmarks woefully: more than 90% of the value managers in Morningstar's value peer groups underperformed their benchmarks in 2006. Had value managers gone brain dead? Fortunately value managers have redeemed themselves in 2007 with the majority of the funds in the Morningstar value peer groups now



outperforming their benchmarks. Brain transplants perhaps? We think not. The real problem that is being manifested here is ***classification bias,*** which unlike survivor bias is not well known or understood, but it is at least as insidious. The exhibit above shows how it works. The majority of funds in the Morningstar large cap value peer group are not large cap value at all – they're smaller company and more growth oriented, as shown by the red oval in the exhibit. As a consequence, the majority of these managers lagged their index in 2006 because their growth exposure disadvantaged them, but now that value is out of favor this growth orientation serves to their advantage, making them look good again. What goes around comes around.

Classification bias distorts studies of investment manager rankings. A 2007 study by Matthew Rice of Chicago-based DiMeo Schneider Associates declares that "about 90% of managers with top-quartile results for the 10 years through December 31, 2006 suffered through a below-median stretch of three years or more along the way." So we have another study in a growing list that purports to show instability in manager skill, apparently proving that skill is fleeting. But could it be that manager skill isn't actually changing much at all? The reality is that peer group universes are revolving around the mangers as opposed to the managers moving within their universes. Styles go in and out of favor but skill persists, although classification bias makes things appear otherwise. Classification bias is causing much of the change in rankings, rather than changes in skill, because this bias has different affects as styles go in and out of favor, as summarized in the following contingency table:

**Who wins and loses because of classification bias when styles are in or out of favor**

| When style is… | Pure Managers | Impure Managers |
|---|---|---|
| In Favor | Win | Lose |
| Out of Favor | Lose | Win |

**<u>Hedge Funds</u>**

Classification bias for hedge funds is far worse than it is for traditional managers because hedge funds have far more moving parts, including the following:

- Approach long: style, # of names, geography, derivatives, beta, etc.
- Approach short
- Amounts long and short (Direction)
- Leverage
- Fees

Most hedge fund managers differ from all the others in at least one of these moving parts. As a result funds in hedge fund peer groups don't behave like one another – they

are not correlated. Kat [2003] and others have documented this fact in tables like the following, which shows the average correlation both within and across hedge fund peer groups. Kat concludes from this table that you get roughly as much diversification by picking funds in the same peer group as you do by using managers in different peer groups.

Average Correlations Between Individual Hedge Funds 1994-2001

| | MA | DS | EMN | CA | GM | L/S | EM |
|---|---|---|---|---|---|---|---|
| Merger Arbitrage | **0.45** | 0.30 | -0.04 | 0.18 | 0.07 | 0.24 | 0.29 |
| Distressed Securities | 0.30 | **0.39** | 0.18 | 0.28 | 0.15 | 0.32 | 0.14 |
| Equity Mkt. Neutral | -0.04 | 0.18 | **0.23** | 0.09 | 0.03 | -0.02 | 0.05 |
| Convertible Arbitrage | 0.18 | 0.28 | 0.09 | **0.28** | 0.09 | 0.23 | 0.08 |
| Global Macro | 0.07 | 0.15 | 0.03 | 0.09 | **0.26** | 0.09 | 0.10 |
| Long/Short Equity | 0.24 | 0.32 | -0.02 | 0.23 | 0.09 | **0.24** | 0.27 |
| Emerging Markets | 0.29 | 0.14 | 0.05 | 0.08 | 0.10 | 0.27 | **0.52** |

Some say that these low correlations are exactly what you should expect for hedge funds, and that this is good because it makes for good diversification. This is true. But it does not make for good peer group comparisons. We can't have it both ways. Hedge fund peer groups make reasonable shopping malls for selecting hedge funds, but they are very poor backdrops for evaluating individual hedge fund performance. Shopping malls have shoe stores and pet shops and food courts, each of which may be good in their own rights but none of which are doing the same thing – they're not comparable.

## An Alternative

To properly evaluate both traditional and hedge fund managers we need to remove as many biases as we can, including classification bias. Attempts to cleanse traditional peer groups don't work because we can't make classification bias go away using traditional approaches. As Albert Einstein said: "***The significant problems we face today cannot be solved at the same level of thinking we were at when we created them***." Fortunately, there is a solution to the myriad problems with peer groups. Its Monte Carlo simulations of all the portfolios that a manager could have held, called Portfolio Opportunity Distributions (PODs). For further information on PODs see Surz[2006 and 2005].

**REFERENCES**

Kat, Harry M. "10 Things That Investors Should Know About Hedge Funds." *The Journal of Wealth Management, Vol 5, No. 4*, Spring 2003, pp 72-81.

Surz, Ronald J. "A Fresh Look at Investment Performance Evaluation: Unifying Best Practices to Improve Timeliness and Accuracy." *The Journal of Portfolio Management*, Summer 2006, pp 54-65.

___________. "Testing the Hypothesis "Hedge Fund Performance is Good"." *The Journal of Wealth Management,* Spring 2005, pp78-83.