The New Definition of Investment Manager Success:
How to Tell Who's Winning

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I operate on the notion that self-evident truths should be self-evident. Paul McCulley PIMCO

- It's become self-evident recently that peer groups suffer from "loser bias" because the majority of active managers underperform their benchmark.
- Beating the losers is not a "win." Peer group comparisons simply don't work anymore.
- Beating the benchmark is a good beginning, especially when combined with a statistical test of significance called a "Success Score."

In the "good old days," investment managers had two shots at winning. They could beat their index or they could beat the median manager in their peer group. That peer group thing doesn't work anymore. Due to the popularity of passive ETFs and the emergence of Robo Advisors, there is only one pertinent yardstick – beating the benchmark. Unfortunately, less than 20% of active managers achieve this measure of success.

This active manager failure renders peer groups worse than useless. It is now well-understood that peer groups suffer from "loser bias," in addition to survivor and classification biases. Loser bias is the reality that more than 80% of the managers in a peer group are losers since they fail to beat their benchmarks. **Beating the losers is like winning the prize for best ballerina in Waco.**

So the new definition of "success" is beating the benchmark, but there's more to winning than this simple measure. We want to know that success is not just luck, that it is likely to repeat in the future. That's where statistics and "Success Scores" come in. We call it a "win" if the outperformance of the benchmark is statistically significant. Success Scores are the statistical significance of benchmark outperformance.

A facsimile of a peer groups is created by forming all the portfolios that could be formed from the stocks in the index. A ranking against these Success Scores in the top decile is significant at the 90% confidence level – we can be 90% sure that it wasn't just luck.

Success Scores are bias free and available a day or two after quarter end. It's not enough to beat the benchmark. An investment manager needs to beat his benchmark by a significant amount to be a true winner.

Success Scores are especially valuable for hedge funds since hedge fund peer groups are just plain silly.