Peer Groups Will Mess You Up
SPIVA Says 80% of Growth Managers Have Underperformed

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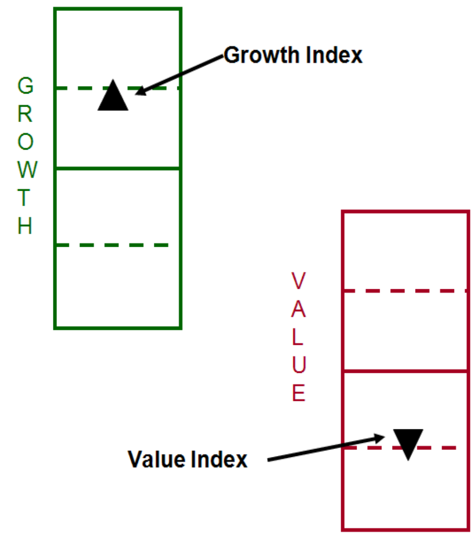
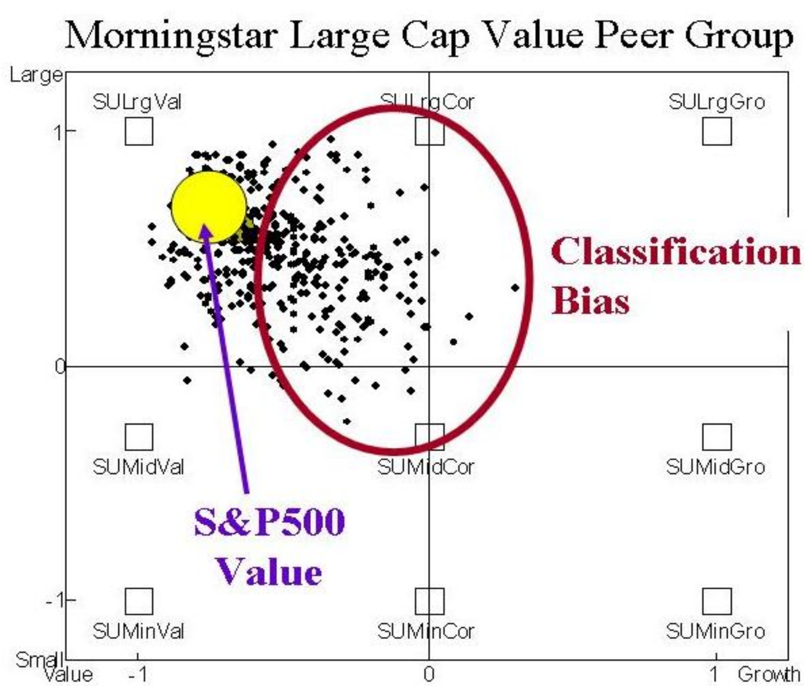
Don't let this happen to you: Peer groups will mess you up, & your clients too. There is a better way.

"80% of Growth Managers Have Underperformed Their Benchmark. So says Morningstar/ Lipper/ S&P."



Do you recognize this headline? It happens all the time, except sometimes its value managers and sometimes its growth – the pendulum swings, and I can predict when it happens. After you read this, you'll be able to predict it as well because it's a peer group problem, not an incompetence issue. Do you really believe that investment managers can alternate between brilliance and stupidity? Hero today, schmuck tomorrow? Of course not.

It's actually quite simple. When a style is out of favor, the majority of managers in that style peer group will outperform. When the style is in favor the majority will underperform. For the last 5 years the S&P 500 value index is down -3% per year while the growth index is up 3%. The current situation looks like the graph above.



Most importantly, peer groups will mess you up because they are loaded with biases, including one particularly insidious bias that most do not know or understand. It's called classification bias, and is described in detail at Classification Bias. In a nutshell, the majority of funds in a peer group, like large growth for example, do not belong in that peer group, so when that style is in favor, being out of that style is out of favor, hence the majority underperforms (please think about this). See the graphic on the right.

The situation gets shockingly worse with hedge fund peer groups because each fund in a hedge fund peer group is not like most of the other funds in that peer group.

As a result, funds rank well or poorly because they are misclassified rather than because they have succeeded or failed, but what's worse is that managers are hired and fired for the wrong reasons, so clients suffer, as do the unjustly terminated managers. Should you fire 80% of the growth managers?

The Contingency Table in Action

Classification bias creates a predictable relationship between manager performance and benchmark performance, as follows:

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

The "S&P Index Versus Active" Managers scorecard (SPIVA) for periods ending 2011 confirms this dependency:

Percent of Funds Underperforming Their Benchmark.

Exhibit 2: Five-Year League Tables (U.S. Equity Funds)

Category	Comparison Index	12/06-12/11	12/01-12/06
Large-Cap Growth Funds	S&P 500 Growth	80.20	57.18
Large-Cap Core Funds	S&P 500	67.93	75.43
Large-Cap Value Funds	S&P 500 Value	36.71	90.74

Performance	12/06-12/11	12/01-12/06
S&P 500 Growth	3%	3%
S&P 500 Value	-3%	9%

As you can see, growth managers have been the big losers in the current 5 years but value managers were the losers in the previous 5 years – it flipped. Note also that active managers appear to win when their style is out of favor. Some interpret this fact as active managers defending best when their style is out of favor – they shine when the going gets tough. This of course is not true. As you can see, the win-lose cycle has everything to do with classification bias, and nothing to do with skill.

A Better Way

But all is not lost. There is an alternative to peer groups that is totally unbiased so you and your clients make better decisions, and it's far less expensive than the universes you're currently paying for. Who wouldn't like to pay less for better information? Performance evaluation is a hypothesis test. You want to accept the hypothesis that performance is good. Crack open those stat books folks, where you'll find that hypotheses are tested by comparing the actual outcome to all of the possible outcomes. That's exactly what we've done to replace peer groups. Portfolio Opportunity Distributions (PODs) create all of the portfolios the manager could have held, selecting stocks at random from the manager's benchmark. You then compare what actually happened to all of the returns that could have happened, and you can be confident that your inferences are not contaminated by the host of biases in traditional peer groups.

The CFA Institute's benchmark committee report warns about the biases in peer groups, but acknowledges that the reader will probably ignore this warning. Some think they can "fix" peer groups, but that doesn't work. PODs work. Use them.

POD ranking software is available for free from Free Software. Universes may be purchased for a very low price. The razor is free and the blades are inexpensive.

(Hedge fund universes are not free, and are licensed.)