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

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"You must unlearn what you have learned."

Peer groups are NOT reliable.

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

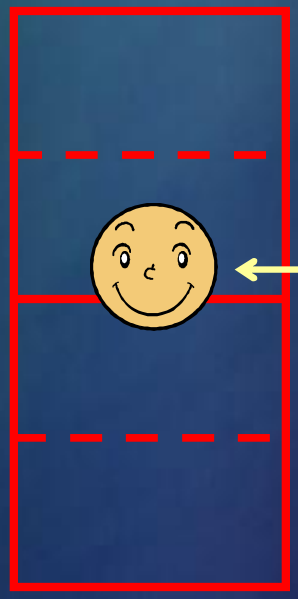
- Ankrim, Ernest M. "Peer-Relative Active Portfolio Performance: It's Even Worse Than We Thought." *The Journal of Performance Measurement*, Summer 1998, pp 6-11
- Bailey, Jeffrey V. "Are Manager Universes Acceptable Performance Benchmarks?" *Journal of Portfolio Management*, Spring 1992, pp 9-13
- Bleiberg,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

CFA Institute (AIMR) Web Page on Peer Groups

http://www.cfainstitute.org/standards/pps/benchmark.html

- "They are not available real time, resulting in a time lag for comparison
- There is no established oversight process for determining universe participants and whether the universe accurately represents the entire asset class or style of management
- Survivor bias will develop over time as some managers are deleted from the universe
- They are not replicable or investible
- They do not permit the manager to move to a known neutral position"

The Problems with Peer Groups



My Return

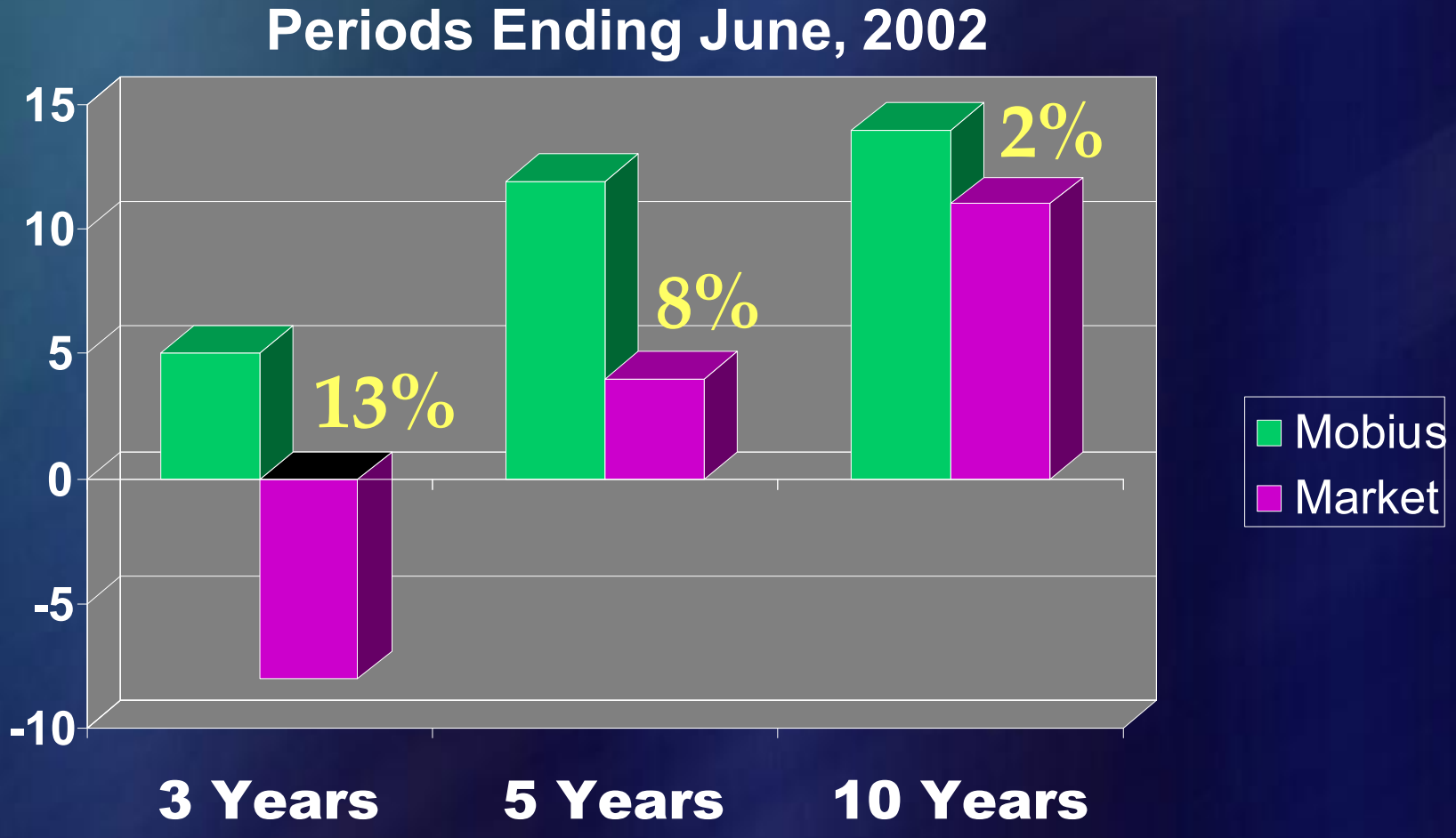
Peer Group Biases

- 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)



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

Pensions & Investments

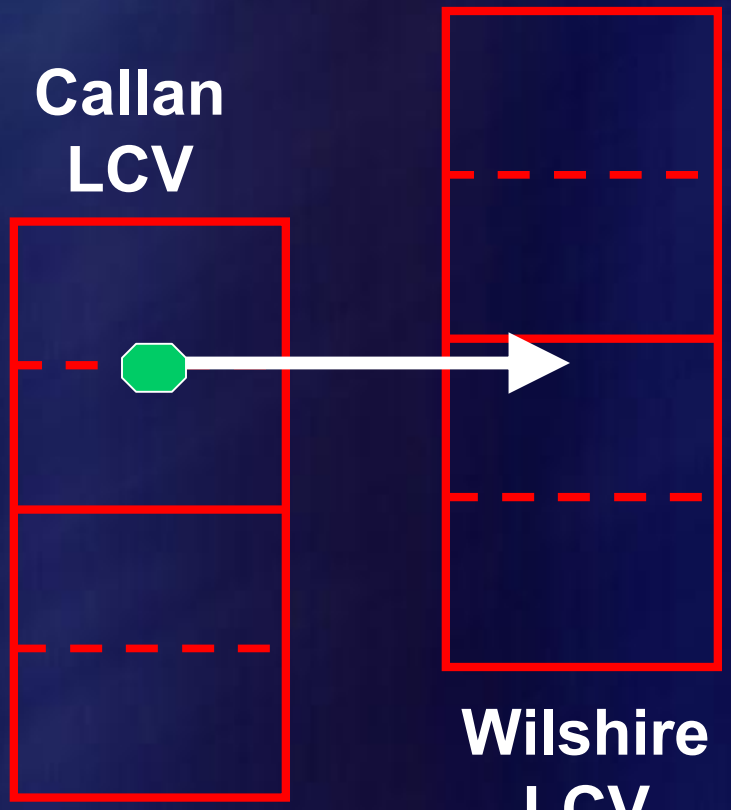
Issue Date: September 6, 2004, Page 12

"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?

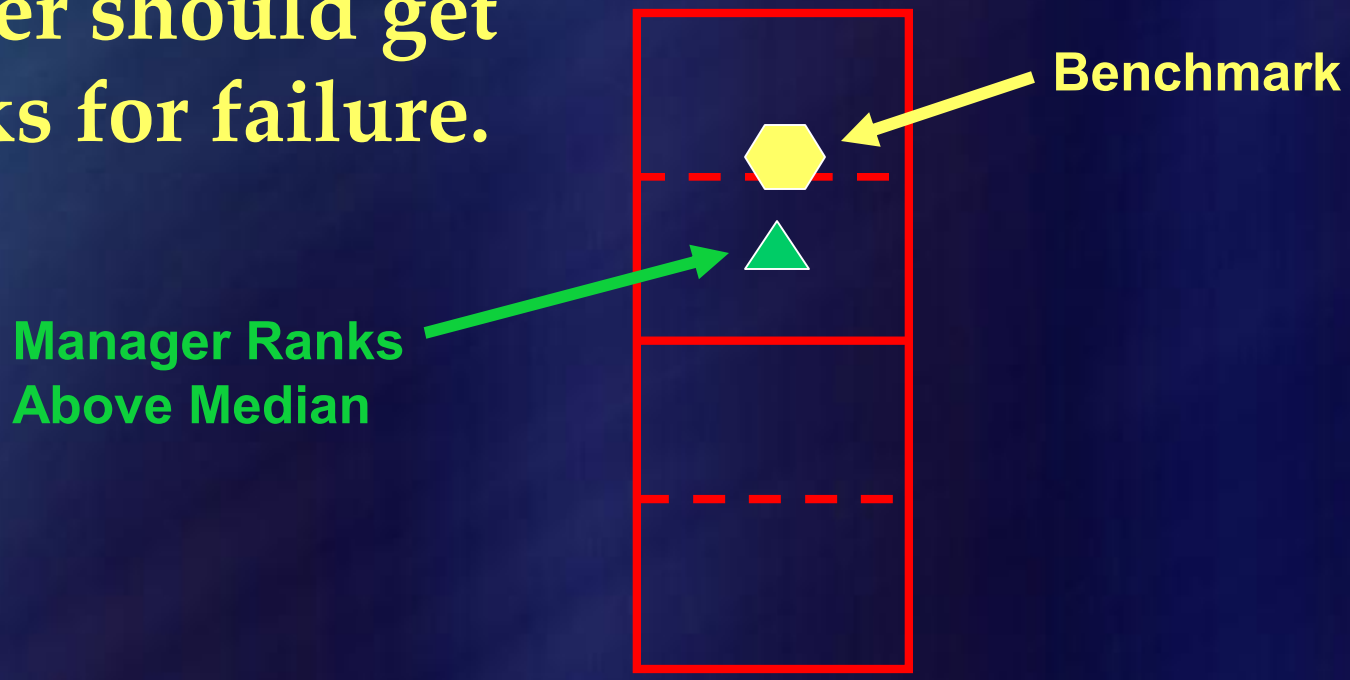


3 years ending 6/04

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.



“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.

The Problems with Benchmarks

- **Defining**: Benchmarks can be customized as blends of indexes (style analysis) or as blends of stocks (normal portfolios). Both choices are complex. Choosing an index as a benchmark is a mistake that invariably confuses style with skill.

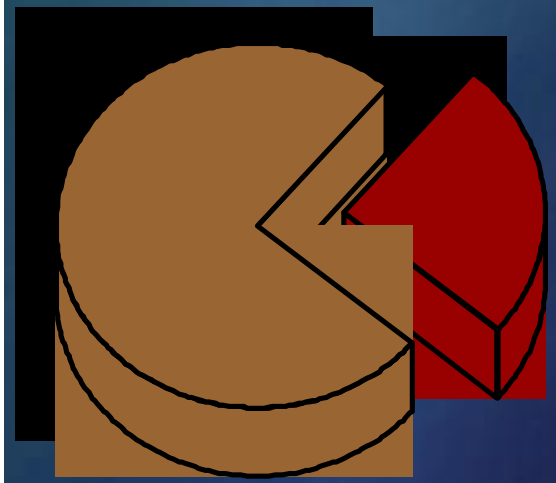
- **Waiting**: It takes decades to accomplish statistical significance with benchmarks. Accordingly, inferences are drawn on faith rather than confidence.

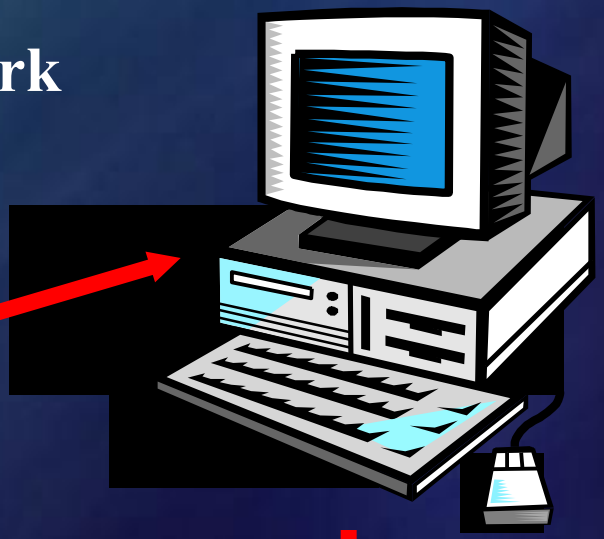
A Breakthrough

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

Portfolio Opportunity Distributions (POD's)

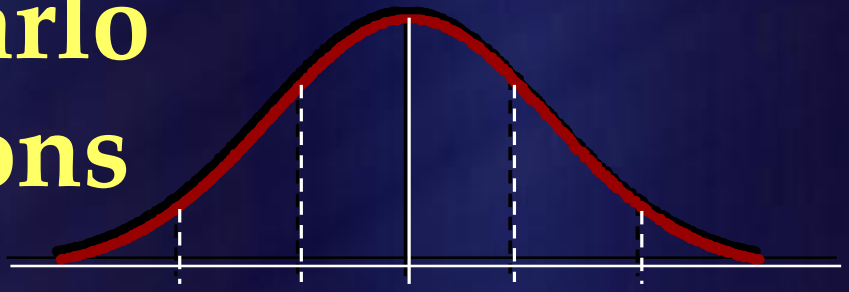
Benchmark





Portfolio Construction RULES

Monte Carlo Simulations



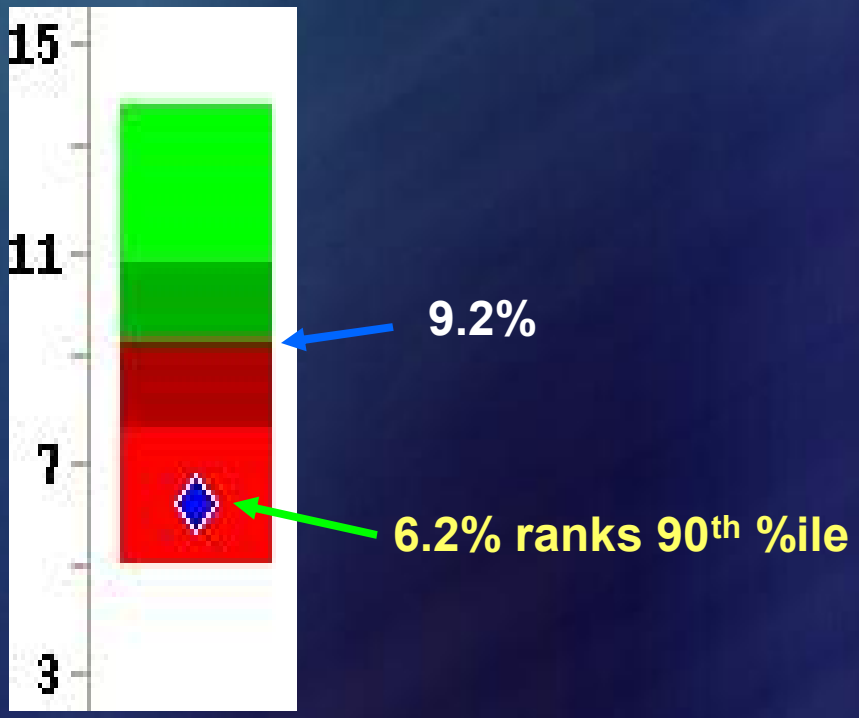
Portfolio Opportunities

PODs Combine Benchmarks With Peer Groups to

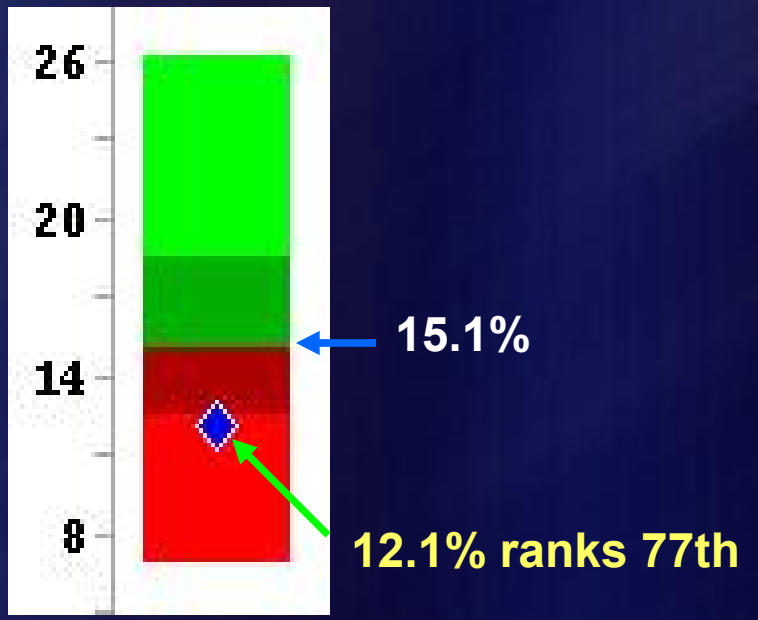
- Reduce biases
- Shorten the wait for statistical significance

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

Statistically significant versus the S&P500

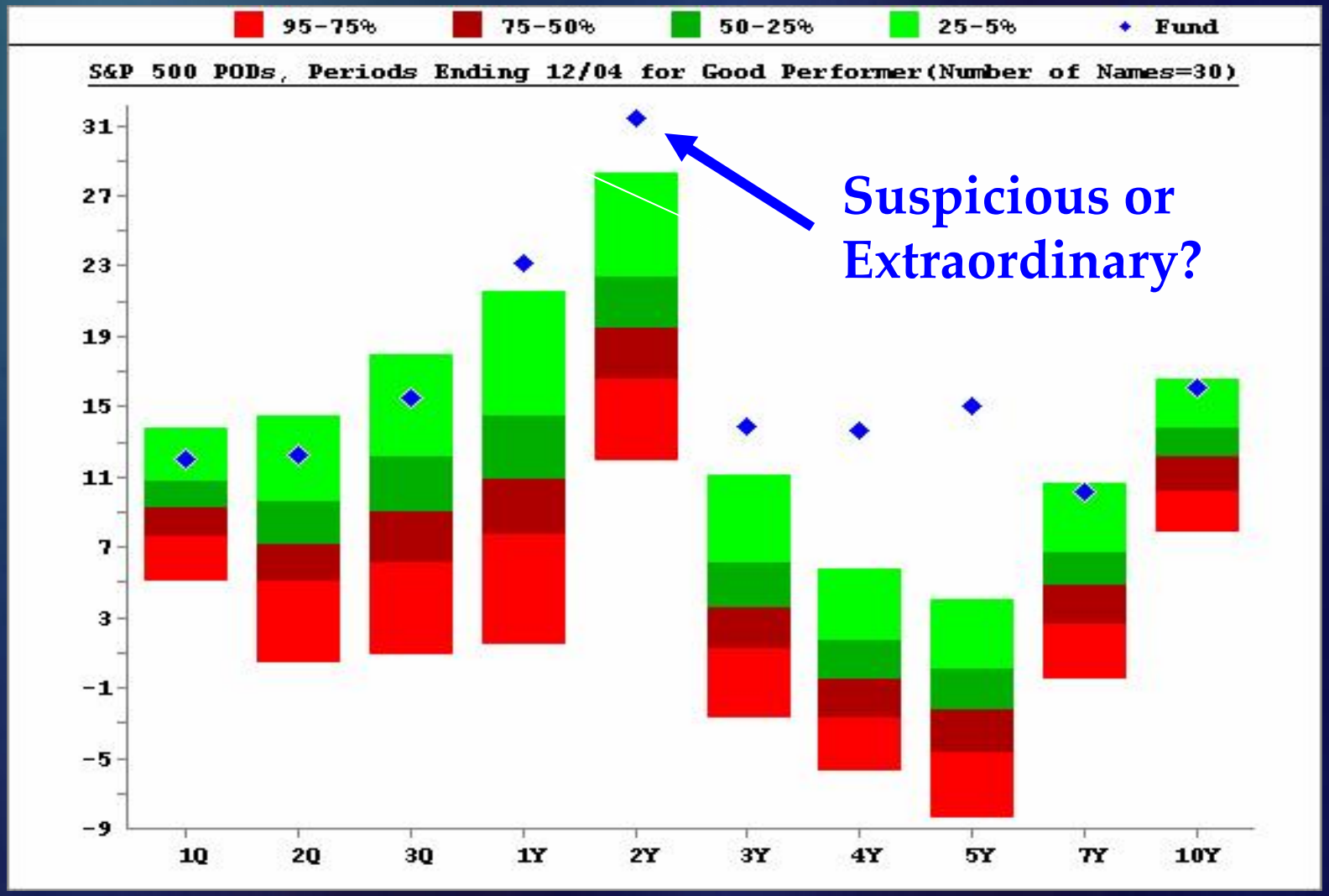


A non-event versus the Russell 2000 Growth

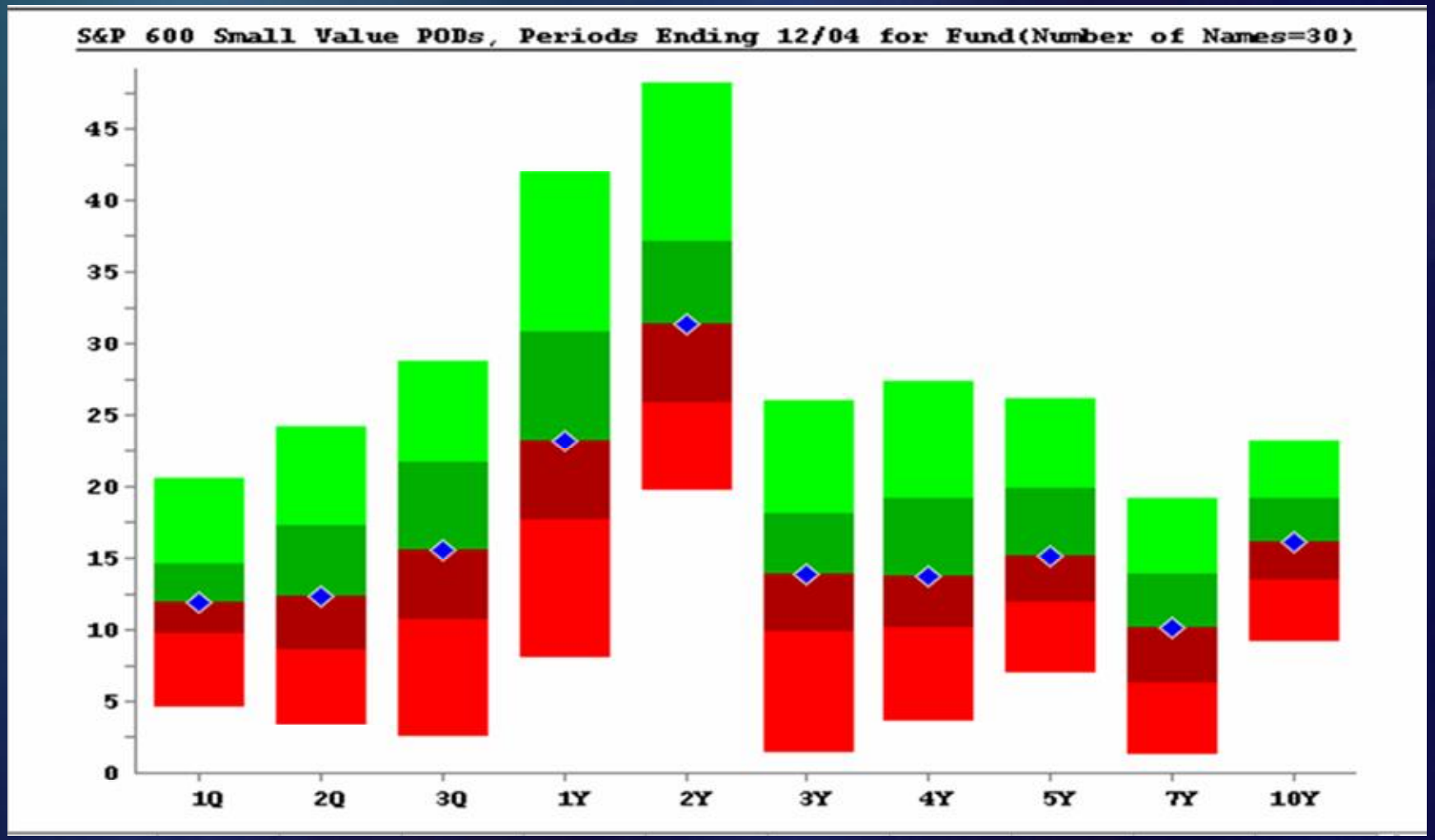


A Reasonableness Test

Rankings versus S&P500

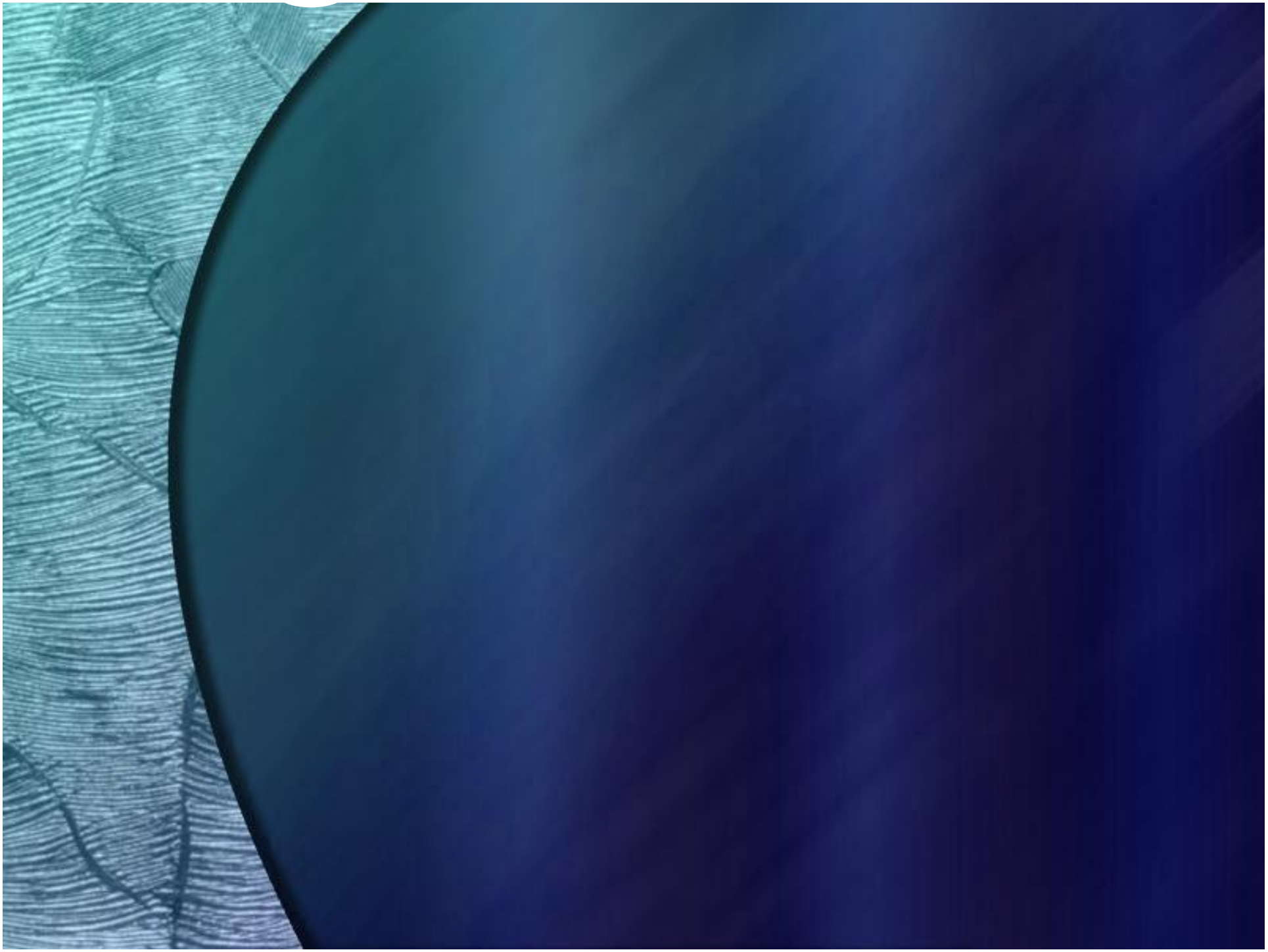


Same Fund Ranked Against Small Value



The Other Waiting

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



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

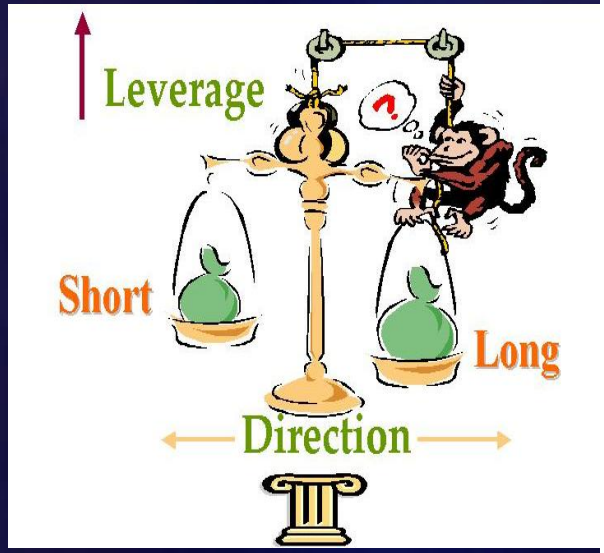
Portfolio Opportunity Distributions (POD's) for Long-Short Hedge Funds

Benchmarks

Long

Short

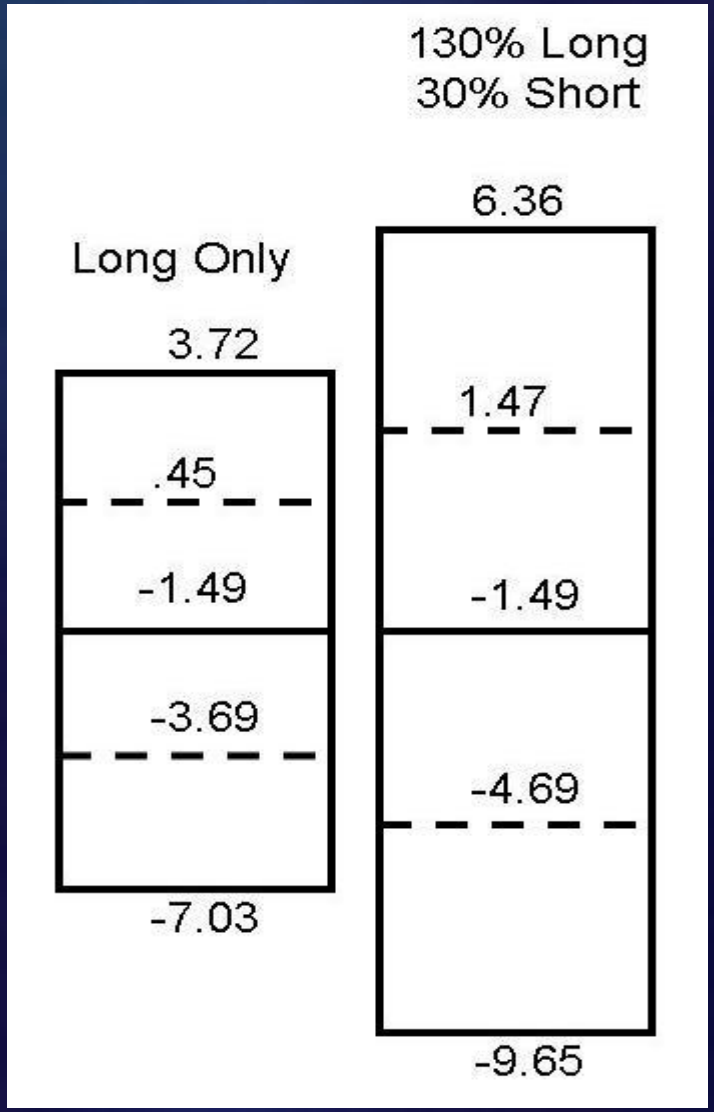
Portfolio Construction RULES



Portfolio Opportunities

Implementation Risk

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



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.

Recent Articles

- "A Fresh Look at Investment Performance Evaluation: Unifying Best Practices to Improve Timeliness and Reliability"
  Journal of Portfolio Management, Summer 2006

- "Shame on the Sham:
  The Due Diligence Dreg in the Hedge Pledge"
  Journal of Indexes, May/June 2006

- "Testing the Hypothesis "Hedge Fund Performance is Good""
  Journal of Wealth Management, Spring 2005