



The Investment Manager Performance Horserace is Rigged Don't Bet on the Winners

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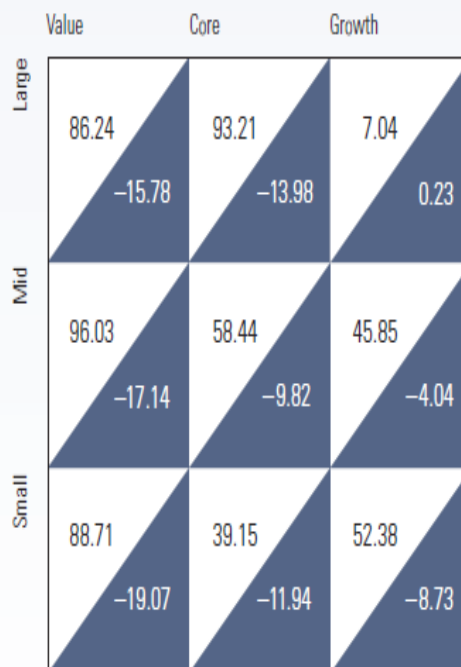
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Looking at Morningstar's chart below, you would easily conclude that value managers beat their benchmarks in the first quarter of 2009, while their large-cap growth counterparts failed miserably.

Fund Categories and Benchmarks

In six out of nine style categories, the majority of actively managed funds in a style category exceeded the return of the relevant Morningstar style index. The benchmarks with the biggest losses usually are the easiest to beat, and the value indexes all turned in losses in the mid-teens. Active managers added value by avoiding the biggest losing sectors in the index, such as energy and utilities.

Active vs. Passive



☑ Actively managed mutual funds outperforming their respective benchmark (%)¹

▲ Index Returns (%), Q1.

¹Includes the oldest share class for all U.S. diversified mutual funds with at least a one-year history. As of March 31, 2009 there were 2,492 eligible funds. Morningstar classifies funds into style categories based on the average style score (using the same 10-factor methodology as underlying benchmarks) of all available portfolio holdings over a three-year period.

And you would be wrong. This horserace is rigged, as are all peer group rankings.

The white triangles in the chart above show the percentage of managers who outperformed their benchmark. For example, 96.03% of mid cap value managers



outperformed the Morningstar mid cap value index, while only 7.04% of large cap growth managers outperformed their index. Morningstar is saying that active value managers added alpha and active growth managers subtracted alpha. But this is an erroneous inference.

In a recently published [article](#), I explain the fallacy of peer group methodologies. 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. Some peer group providers use manager categorizations of themselves while others apply criteria like correlation to an index or holdings-based profiles.

Regardless of the methodology, a little known bias creeps in, called “classification bias.” As I say in the article: *“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.”* It’s like staging a race for brown horses only.

I urge you to heed this sobering alarm about the distortions that are caused by classification bias. It’s a bias that most don’t understand but its harm cannot be ignored. There’s enough suffering going on in this environment without compounding it with faulty decisions: Winners will be fired and losers will be hired.

Moreover, this is not just a Morningstar problem. As peer group providers release their performance numbers in the next few weeks, this same anomaly will appear in all peer group comparisons. Here is my prediction for those peer groups: value indexes will show up toward the bottom of the floating bars, ranking bottom quartile against active managers, but large cap growth indexes will rank in the top quartile of active growth managers. Next quarter, Q2/09, the reverse could be true.

The pattern above will change – the pendulum will swing back and growth managers will look like heroes again. This is not styles going in and out of favor, but rather active management alternating between success and failure. We see this pendulum swing over and over again, to the extent that this phenomenon has been given the name “alpha cycles” by F-Squared Investments. Do you really believe that entire groups of managers can be geniuses one day and then idiots the next? That fast ponies today tend to cramp up tomorrow? I don’t. *There are no “alpha cycles,” just peer group bias cycles, which are certainly not “buy cycles.”*

The winners circle in Q1/09 is the result of flawed analysis rather than an insight into industry performance or manager behavior.



Is it important to use better comparisons? Only if you really want to know who is winning and who is losing. The scorecard above is very misleading, as are all peer group comparisons. This is not a conspiracy; it's simply a mistake. The handicappers of this horserace rarely pick winners, although they sincerely try.

To do better we need to take to heart a quote by Albert Einstein: "*The problems we face today cannot be solved at the same level of thinking that created them.*" We need to think outside the box.

To run a much fairer and unbiased race, begin by customizing the benchmark rather than jamming every manager into a style box. Style boxes work fine for index huggers, but we need something better and unique for liberated managers. Style analyses -- both returns-based and holdings-based -- work well for this purpose. Then test the hypothesis "performance is good" by using accepted and well-established statistical procedures. Create all of the portfolios the manager might have created when selecting stocks from the custom benchmark, and compare the manager's performance to this custom scientific backdrop, or "virtual peer group." If the manager outperforms 90% of this scientifically constructed universe, he has delivered a statistically significant success. Skill is another issue, although consistent success may be a good clue.

Most importantly, every manager enters this race with the expectation of ranking near the median. In a statistical sense, managers on average will match their custom benchmarks, less fees and expenses. As opposed to the table above, this more advanced approach has a custom cell for each liberated manager. There are a lot of cells, and the rankings within each cell are roughly normally distributed. Half the managers rank above the 50th percentile and half rank below. In other words, the typical "triangle" in an advanced scientific comparison has a number close to 50 in it, and outliers represent real success or failure rather than a bias. This statistical profile does not change through time because there are no alpha cycles.

This newer alternative to peer group rankings creates a special two-horse race for each manager. The competing horse is passive implementation of the manager's custom style, and all of its permutations. It's a race against the benchmark clones. (After all, everyone loves a clone.) The manager's performance is compared to all of the possible portfolios he might have selected, including the one he actually holds. The custom index is the return at the median, and the manager's custom ranking is his statistical distance away from the benchmark return. Call this better living through science, or an unbiased way to evaluate active manager performance.

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