



# Succumbing to Peer Group Pressure

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*Peer group comparisons in performance measurement and manager selection are so widespread that they have attained an almost unspoken air of legitimacy. This comes in spite of a significant body of research detailing the serious flaws inherent in the construction of manager universes and their application. Compass Advisors takes the position that peer group analytics are, at best, inadequate benchmarks of active manager performance and, at worst, have the potential to elicit investment decisions damaging to long-term performance.*



## Introduction

Peer group, or manager universe, comparisons are a standard element in almost every institutional investment performance reporting package available on the market today. This universal acceptance has bestowed on peer group analysis the presumption that it is an effective and unbiased tool for measuring the performance of investment managers. While this perception has not gone unchallenged by investment researchers, the vast majority of institutional investment consultants have shown little interest in addressing the significant concerns surrounding the use of peer groups in performance measurement and manager selection. This paper will summarize the well documented flaws inherent in peer group analysis, and the rationale behind Compass Advisors exclusion of these peer group analytics from its recommended performance reporting package.

## The Appeal of Peer Groups

Bailey [1992] proposes the following explanation for the popularity of peer group analysis:

***Why are manager universe comparisons such popular performance evaluation tools? We suggest two reasons: convenience and naïve appeal.***

***From the standpoint of convenience, manager universe data are widely available at relatively low cost. For consultants and bank trust departments, who are the primary vendors of performance evaluation reports, compiling manager universe data has been a natural outgrowth of their performance reporting business. Thus, they can easily offer such data as a standard product. Their clients, in turn, take the availability of the data for granted.***

***Manager universes also have a certain naïve appeal. On the face of it, the contention that a superior manager should generate above-average performance over a three- to five-year time interval has a compelling ring. Such logic appeals to the horse race mentality inherent in***

## ***active investment management.***

The concept of measuring a manager or portfolio against a group of its peers seems quite natural. As students we are usually graded on “the curve” ranking our performance relative to other students. As employees we compete against our peers for raises and promotions. Sports teams are not required to score a certain number of points to win, but merely to score more points than the opposing team. In order to understand whether grading investment managers on “the curve” is a good idea, we need to better understand investment benchmarking.

## Effective Investment Benchmarks

Setting appropriate benchmarks for an investment has always involved the concept of risk. Investors place their assets at risk in order to achieve a return in excess of the “risk-free” rate.<sup>1</sup> Thus, the minimum benchmark for any investment in risky assets is the risk-free rate of return. The decision to invest in an asset class, or sub-class, flows from the subjective evaluation of risk and the expected return available to investors. This decision is facilitated by identifying a benchmark that is representative of the performance of the asset class.

The natural candidate for this benchmark is a portfolio of all the securities in the asset class weighted by market-capitalization. From Arbitrage Pricing Theory, we understand that the price of each security, and thus its weighting in the benchmark, is determined by the consensus return expectations of investors and their willingness to hold the security. The extent to which the security weightings of an active manager’s portfolio differ from this benchmark therefore reflects the degree to which the manager’s expectations of risk and return differ from that of the consensus.

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<sup>1</sup> Although there is no investment that is totally devoid of risk, most practitioners turn to the 90-Day US Treasury Bill as a proxy for this “risk-free” instrument.

This benchmark portfolio, or index, embodies several fundamentally sound characteristics that make up an effective benchmark as put forth by Bailey [1992].

- **Unambiguous:** The names and weights of securities constituting the benchmark are clearly delineated.
- **Investable:** The option is available to forgo active management and simply hold the benchmark.
- **Measurable:** The benchmark’s return can be calculated on a reasonably frequent and timely basis.
- **Appropriate:** The benchmark is consistent with the manager’s area of expertise and process.
- **A Priori:** The benchmark is constructed prior to the start of an evaluation period.

These criteria provide a clear and fair gauge of manager performance as well as facilitating an ex ante communication of investor expectations to the manager being evaluated. With the exception of measurability, however, peer group analysis fails to satisfy these criteria. Peer groups are:

- **Ambiguous:** Universe construction is highly subjective and differs widely among practitioners.
- **Un-Investable:** Manager quartiles are not

investable since the underlying portfolios are only known after the fact.

- **Inappropriate:** The vagaries of universe construction create a high probability that significant portions of the peer group are not an appropriate measure of a specific manager’s mandate.
- **Only Available Ex-Post:** Universes are not constructed in advance and are therefore unfair to managers. They do not serve to convey the expectations of the client except in hindsight. In addition, the nature of the universe construction process severely impairs the timeliness of performance reporting.

### Survivorship Bias

Peer group analysis involves the calculation of annualized returns for managers in a universe over time. Because new managers are added to databases continuously and many existing managers cease to report, peer groups tend to morph and change over time. This works to change the rankings of managers as new managers begin reporting and back-filling the database with return histories, and many poor performing managers cease to report and thus fall out of peer groups. The impact this has on peer group percentiles is known as “survivorship bias” and is a well documented

Figure 1 - Survivorship Bias for Small Capitalization Growth Equity Manager Universe

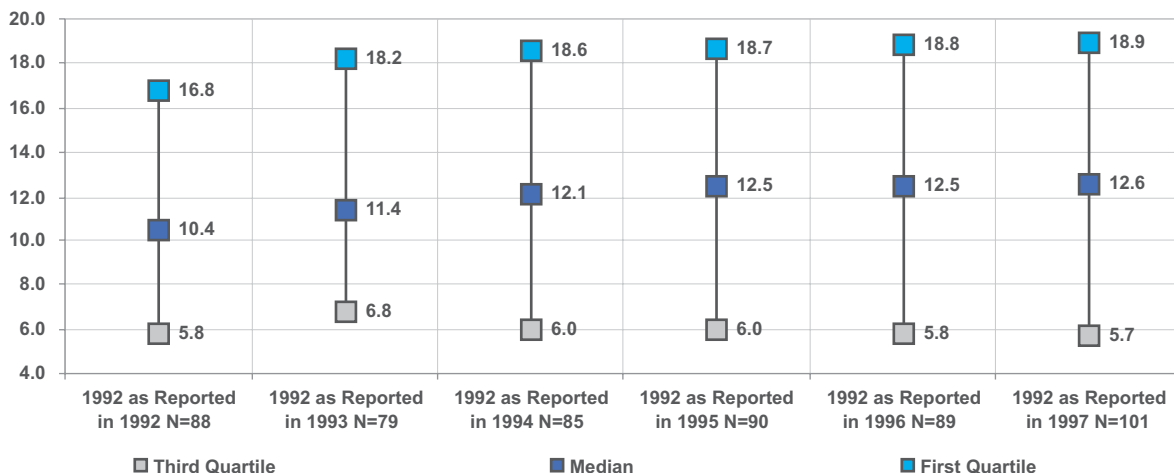
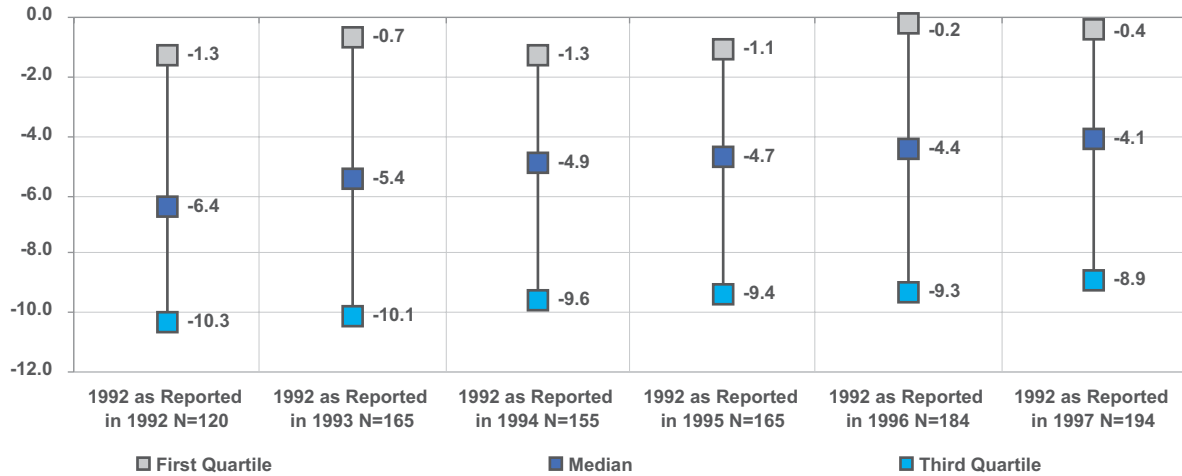


Figure 2 - Survivorship Bias for International Equity Manager Universe



problem. Bleiberg [1986] found survivorship bias to be 150bps annually over 5 years and 240bps over 10 years. Bailey [1992] found survivorship bias of 150bps annually over 16 years. Malkiel [1995] found survivorship bias of 140bps annually over 10 years. Swensen [2000] provides several graphical representations of the survivorship bias effect, three of which have been reproduced here in Figures 1-3. Of note in Figure 3 is the explosion in the number of managers in the universe from 1992 to 1997.

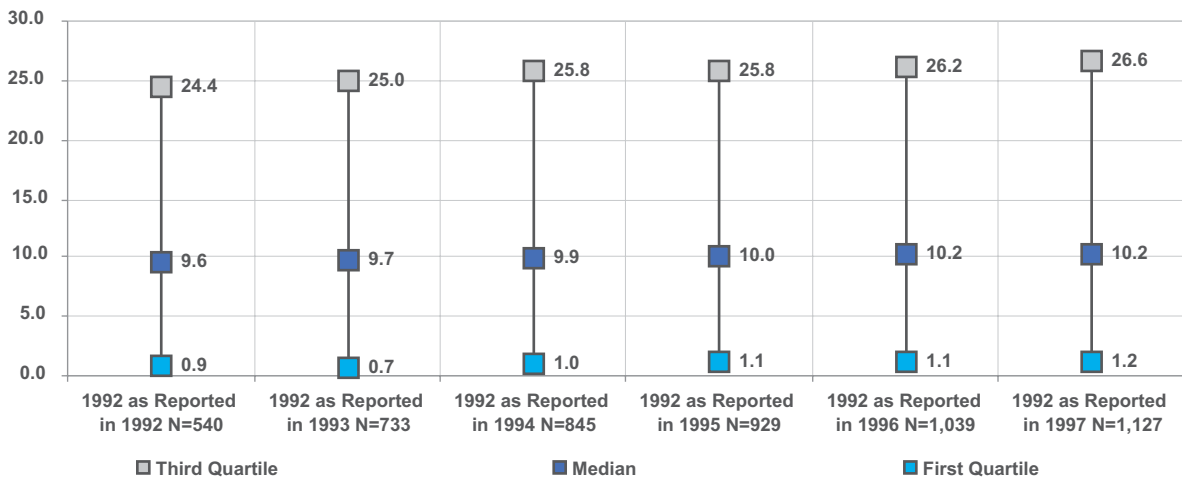
Clearly survivorship bias cannot be ignored. Its presence and magnitude adds considerable weight to the assertion that peer group analysis is ambiguous. Indeed survivorship bias calls into question whether peer group percentiles can even be

deemed reliably measurable.

### Performance Persistence

Investment literature is crowded with studies that document the migration over time of investment managers between the percentiles of their respective universes. The focus of these migration studies has generally been the promotion of passive investing, however these studies are also relevant to the discussion of peer group analysis. Table 1 shows the quartile migration of large capitalization domestic equity managers in the Plan Sponsor Network database between quartiles in consecutive 5 year periods. The data show that prior period manager rank is only significant with respect to whether or not

Figure 3- Survivorship Bias for Large Capitalization Domestic Equity Manager Universe



**Table 1—Quartile Migration of Large Cap US Equity Managers**

1992-1996 Quartile	1997-2001 Quartile					Total
	1	2	3	4	N/A	
1	47	50	40	45	55	237
2	36	51	53	49	49	238
3	37	41	45	42	72	237
4	24	29	28	47	110	238
Total	144	171	166	183	286	950
	Extant and Departed			Extant Only		
$\chi^2$	54.76			10.52		
p-value	0.00%			30.98%		

a manager survives the subsequent period, but has no relation to subsequent period ranking. This result corresponds well with the industry focus on peer group rank since we would expect managers with poor rankings to not be long for this world. This is in spite of the fact that a poorly ranked manager is just as likely to rank well in the subsequent period as not.

Tables 2 and 3 repeat the same analysis for small cap and mid cap domestic equity managers and show no relationship between prior ranking and either survival or subsequent period rank. Although there is nothing here that would give one confidence to use peer group rank as a tool for the selection or retention of investment managers, this process appears to be routinely employed by investment consultants and fiduciaries as a performance measurement tool.

**Table 2—Quartile Migration of Small Cap US Equity Managers**

1992-1996 Quartile	1997-2001 Quartile					Total
	1	2	3	4	N/A	
1	13	11	10	19	15	68
2	7	9	18	20	14	68
3	7	13	20	14	14	68
4	10	12	11	12	24	69
Average	37	45	59	65	67	273
	Extant and Departed			Extant Only		
$\chi^2$	15.47			10.02		
p-value	21.68%			34.90%		

**Table 3—Quartile Migration of Mid Cap US Equity Managers**

1992-1996 Quartile	1997-2001 Quartile					Total
	1	2	3	4	N/A	
1	8	9	12	6	14	49
2	10	2	10	9	18	49
3	8	6	7	10	18	49
4	6	4	8	10	21	49
Average	32	21	37	35	71	196
	Extant and Departed			Extant Only		
$\chi^2$	10.31			7.83		
p-value	58.85%			55.15%		

## Conclusions

The explosion of data and computing power over the past few decades has had a commoditizing effect on performance reporting services. Yet performance reporting plays a crucial role in focusing the energies of investment committees and fiduciaries with limited time and resources on those singular variables relevant to successful investing. At Compass Advisors we have recognized this by investing considerable resources in developing and maintaining our proprietary performance reporting systems.

Active investment management is an endeavor that is fraught with emotions and distractions that can prove detrimental to the attainment of investor goals. Responsible performance reporting services should be more than an exercise in statistical voyeurism. Instead, it should serve to remove distractions and focus investor attention through unambiguous, appropriate, measurable, a priori benchmarks.

Peer group analysis does not meet the criteria of an effective investment benchmark and can easily contribute to poor investment decision-making. Only when other benchmarks are available, such as is often the case with hedge funds, private equity, and venture capital investments, should peer group analytics be considered as a less-than-desirable alternative.

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## About the Author

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Randall Doser joined Compass Advisors, LLC as Vice President in March of 2001. A Fellow of the Society of Actuaries, an Enrolled Actuary (inactive) and a Member of the American Academy of Actuaries, he has a strong background in the mathematics of finance and extensive experience in the legal and accounting aspects of benefit plan liabilities and assets. Most recently, he was the Manager of Benefit Investments for Freightliner LLC, overseeing the company's \$900 million portfolio of pension, 401 (k) and retiree medical assets since 1998. Before that he spent three years with the consulting firm Watson Wyatt Worldwide in their Portland and Minneapolis offices doing retiree medical and defined benefit retirement plan valuation and design for employers ranging in size from 12 to 60,000+ employees. Prior to 1995 he was an associate consultant with Howard Johnson & Company in Portland, Oregon doing defined contribution and defined benefit retirement plan design, administration and valuation for small to mid size companies. Randall graduated in 1990 Magna Cum Laude from Oregon State University with a B.S. in Mathematical Sciences.

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