



Follow-up to the Folly of Peer Group Analysis

April 6, 2010

The following is in response to a commentary from Research Affiliates, [The Folly of Peer Group Analysis](#), posted on March 19:

Dear Editor,

Rob Arnott never ceases to pique my interest. I have just done a comparable study to that described by Arnott in his recent article. [Attached](#) is a four-slide report. The first slide shows that for all 604 large-blend mutual funds in the peer group, the average return marginally beat the S&P 500 index over five and 10 years. The margin in the 10-year trailing rolling period is only 9 basis points and in the five-year trailing rolling period only five basis points. In the three-year trailing rolling period the margin grows to 60 basis points and in the one-year period ending 12/31/2009 the margin for the average fund grew to 162 basis points.

The second slide shows the S&P 500 index to be below peer median in the one- and three-year trailing rolling periods ending 12/31/2009. The index goes to 46th percentile in the five-year trailing rolling period and the 42nd percentile in the 10-year trailing rolling period.

My study makes no adjustments for survivorship but filters the peer group by eliminating funds based upon their holding in excess of 10% of their portfolios in non-correlated asset classes (bonds, foreign stocks, cash, etc.), so it is purer than either Morningstar or Lipper peer groups. Also, only one share class per fund is used and the results are after fees and expenses. The peer group does contain both index and actively managed funds. This study was created using MPI Stylus using 24-month regression periods.

Mr. Arnott appears correct, in my opinion, as to his conclusions about the published distortions relating to performance relative to peers insofar as funds are concerned. If only actively managed funds had been used the return spreads would probably have been higher in favor of the active managers and the peer group percentile for the index lower, as the index obviously bested all other index funds by the margin of the index funds' expense ratios – however low they are.

However, if the same study is conducted using only Separate Account Managers, a different picture presents. Now the return spread favors the managers by 17 basis points in 10 years, 76 basis points in five years, and 103 basis points in three years. The peer group comparison when using Separate Account



managers, gross of fees is starker. Using the eVestment Alliance database and peer groups, the S&P 500 index presents in the 90th percentile of peers for the 10-year trailing rolling period and fares no better than the 50th percentile for the one-year trailing rolling period. Different databases, different peer group methodology, different results. Also, gross of fees versus net of fees and expenses comparisons could account for the differences.

I am confident there are some lessons here:

1. There is no substitute for practitioners doing their own homework based upon their own core beliefs in a statistically robust manner consistent with sound practices. Also, just because it is published doesn't mean it is correct or unbiased.
2. The debate between passive investing and active management is alive and well and there will always be a sub-set of active managers (as small as it might be) that will provide higher returns (and added value) than their correct relative indexes – after fees and expenses – even in more efficient asset classes.
3. The challenge is to harness correctly selected indexes to measure and understand what these managers/funds did and how they did it relative to better parsed peer groups – like Surz PODs.

I want to thank Research Affiliates for their response below. Inasmuch as I function in a client universe of qualified plan fiduciaries, I believe that a higher standard is called for which is why I go the extra mile and do not accept publishers' peer groups or their index selections without my own empirical research. I agree wholeheartedly that individuals – especially “do-it-yourselfers” – will always be misled by what they perceive to be useful information. The bottom line lesson for the serious investor might be: data is not information, information is not wisdom.

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John West and Ryan Larson respond:

Thank you, Mr. Schwarzberg, for your response to our recent *Fundamentals* piece on peer groups. We think you hit the nail on the head!

In addition to the points you highlight with respect to relative performance, we think most investors are unaware of the magnitude of manager attrition (bad manager attrition) during the market crisis of 2008. Because peer groups show average fund and manager returns, we suspect average *investor returns* aren't nearly as rosy.

Your research on the mutual fund universes tells essentially the same story as our research—the average mutual fund just barely beat the S&P 500 for the 2000s. Our universe did a little bit better than yours, but the moral of the story is exactly the same...after adjusting for survivorship bias and taxes, the average mutual fund during the decade did worse than the S&P!

	1 year	3 year	5 year	10 year
Schwarzberg Mutual Fund	28.08	-5.13	0.47	-0.86
RALLC-cited Mutual Fund Universe*	26.76	-5.15	0.55	-0.43
S&P 500 Index	26.46	-5.63	0.42	-0.95

*Source: Lipper

Similarly, your results for separately managed accounts are consistent with our results. Our universe does not include index or enhanced index strategies, which could explain our higher returns than your SMA universe for the longer time periods. The end result is the same for both of our universes: the average manager (in the universe) outperforms the S&P 500 by about 2-2.5 percentage points over the 10-year period.

	1 year	3 year	5 year	10 year
Schwarzberg SMA	28.51	-4.60	1.18	1.12
RALLC-cited SMA Universe*	26.49	-3.77	1.91	1.48
S&P 500 Index	26.46	-5.63	0.42	-0.95

*Source: eVestment Alliance

But, there is more to the story...a peer group of surviving funds is not representative of what the average investor really experienced. Controlling for survivorship and backfill biases, and fees, the results are more like a wash.



We agree with your point that some active managers will always be able to provide higher returns than their corresponding indexes. We also believe it is a very difficult task for the average investor to find and select that small group of outperforming managers *ex ante* (before hand). Case in point was the 2000s – a decade where the average active manager had a nice tailwind, witness the returns of the Fundamental Index or even equal-weighted indexes. Yet, the average active mutual fund still lagged the S&P 500, while the average active separate account manager (after adjustments) was negligibly better! This is not awe-inspiring performance.

In closing, we applaud efforts by advisors such as yourself who are attempting to find a better representation of the average fund or separate account strategy. The active/passive debate is hard enough to settle with accurate data, let alone the Global Financial Crisis induced mirage that is today's peer groups.

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