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Testimonials on Popular Index Portfolio Opportunity Distributions (PIPODs)

Ron Surz, PPCA, Inc.

Author's Note: In the June 2003 issue of *Bloomberg Wealth Manager,* the "Market Matters" column on page 80 talks about StokTrib and PODs, our attribution and universe services, respectively. The article is quite fair in interviewing several people – some positive, some not so positive, on the two ideas. But one individual's criticism stands out as being singularly stupid: "It's not caught on."

Downside risk has not caught on, despite the growing recognition of its appropriateness. MPT took 25 years to catch on, by which time it should have been called OPT – Old Portfolio Theory. The Black-Scholes options-pricing model took years to catch on, in part due to the fact that no one would publish it. Hedge funds have just recently caught on, after 70 years as a vehicle utilized only by the wealthy. "Not catching on" is not synonymous with bad idea, nor is it indicative of an immutable condition.

In his book *The Tipping Point,* Malcolm Gladwell writes the following: "In the end, Tipping Points are a reaffirmation of the potential for change and the power of intelligent action. Look at the world around you. It may seem like an immovable, implacable place. It is not. With the slightest push – in just the right direction – it can be tipped." We believe that PIPODs can be just such a push.

Please keep an open mind, and try not to let a current lack of acceptance sway your opinion. PODs and StokTrib really are good stuff, as the following testimonials bear out.

David Loeper, CIMA, CIMC, President, Financeware

There are so many known problems inherent in any manager universe. Obvious problems like survivor bias, managers included in multiple and often contradictory universes, difficulty in properly classifying managers and of course, the inherent randomness of where a manager falls within any particular universe at any point in time. It is a wonder the industry has placed much value in using manager universes at all. However, PIPODS offers an objective and reasoned view of what the real investable market is for any particular style. It represents not only what some managers have done but also exposes what some managers might have done. 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.

Barton Waring, J.D., Head of Client Advisory Group, Barclays Global Investors

PIPODs provide the only scientifically controlled method of creating a "peer group" for comparison to your managers' portfolios. Unlike raw data drawn from real managers, which is messy and undependable because of the many little but cumulatively important differences in their normal portfolios, PIPODs use simulation techniques drawing on first principles. Surz draws on the most sensible source – carefully simulated averages of all likely portfolios that could have been constructed from the securities that are actually in the benchmark. This simulation makes perfect sense. It's the perfect peer group, actually a "phantom" peer group in that it captures the spirit of everything that the investor could have achieved.

Meir Statman, Glenn Klimek Professor of Finance, Santa Clara University

PIPOD seems to be a sensible way to assess the performance of money managers. Imagine a manager who always chooses 50 stocks from the S&P 500 list and invests in them in equal weights. We can calculate the distribution of the returns of randomly selected 50-stock portfolios from the S&P 500 and see where the return of this manager lies in the distribution. The distributions vary greatly from year to year. For example, the 1999 distribution had a huge standard deviation. Why not ask money managers to play a well-specified game alongside their real game. Let's ask them to pick 50 stocks from a specified list and see how they stack up relative to the distribution of 50-stock portfolios from the same group. This way we can hope to identify performance, free of the danger that a manager would look good by picking stocks outside the benchmark group. Something is wrong in a system where managers make performance evaluation complicated. If managers cared about being evaluated correctly, they would have arranged their work to help the task.

Andrew Schaffernoth, President, Chesapeake Investment Marketing and Advisory Group

We all have heard the saying, "I'd rather be lucky than good." That is fine with a few things in life (such as when your golf ball hits a tree and bounces into the hole) but not in investment management. Everyone who has the responsibility to evaluate managers needs a tool that provides an unbiased performance assessment and helps determine the quality of an investment manager. PIPODs are the answer. Given the turmoil we have experienced over the past five years, it has been difficult to separate skill from luck. With PIPODs, you can determine how a manager has performed against all of the combinations of possible portfolios within a given index. It is a very quick litmus test as to the quality of the manager. Plus this analysis is available DAYS, not weeks after period end! Coupling PIPODs with an attribution program such as StokTrib, provides a wealth of information that shows the true colors of an investment manager. In the end, this is what we all strive for: to feel confident that we are working with investment managers who provide quality investment management on a consistent basis. PIPODs do a great job of establishing that confidence.

Dr. Jay Shein, Professor of Finance, Florida Gulf Coast University

Portfolio Opportunity Distributions (PODs), combined with style analysis, is the best method of peer group performance measurement. It reduces some of the problems associated with peer group rankings, for example, survivorship bias. Portfolio Opportunity Distributions (PODs) allow us to develop peer groups that represent the entire stock selection universe that is unique to the manager's style.

Consultants who are not using PODs are really at a disadvantage, because they are not adequately representing the total investment managers' peer group universe. With PIPODs, or Popular Index Portfolio Opportunity Distributions, Ron Surz has developed and enhanced the peer group analytical process, bringing style analysis to a new level of sophistication.

Laurence Siegel, Director of Investment Policy, The Ford Foundation

My recent book, *Benchmarks and Investment Management* (AIMR, 2003), says that the proper benchmark for any active portfolio is the mix of style index funds that has the best fit to the portfolio being analyzed, and suggests returns-based style analysis as a way to determine this mix. But it's helpful to use a second method as a check or alternative. PIPODs – synthetic peer groups – are such an alternative, and Ron Surz, who is an outstanding thinker on performance measurement and many related issues in investment management, has designed and implemented synthetic peer groups in a very intuitive and user-friendly way.

PIPODs are clearly better than PODS if the manager's style exposures are close to a given style benchmark (or broad market benchmark). But, contrary to what some may say, PIPODS actually make the pigeonhole problem worse if the benchmark is not well fitted to the manager. Let's say that a manager is 20% large value, 60% large growth and 20% small growth. Under such conditions, the manager's own stocks make a better POD than the single best-fit benchmark (which would be large growth). To fix the problem you would have to be able to generate the PIPOD from the "mix" of benchmarks, which brings you back to the original POD concept.

(**Note from the POD Father:** We will provide a blending capability.)

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> – DAVID LOEPER, CIMA CIMC, FINANCEWARE

Dr. Russ Wermers, Associate Professor of Finance, University of Maryland

It is an interesting approach, and seems to make sense. Basically, you are bootstrapping an estimate of the p-value of the measure of an active fund for the chosen period, instead of waiting for a number of months (or years) to go by to use the realized returns to estimate the variability of the performance measure around the benchmark. My concerns would be:

- Suppose the fund is a fairly consistent high performer among all possible portfolios, but sometimes does quite poorly. It may be true that this manager loads up on the riskiest stocks in the index.
- Related, the manager may be a small-cap value manager and the benchmark is wrong – perhaps the manager is even untruthful about his true strategy, making this a tougher problem. The small cap value manager might even have no really bad periods.
- Also, how do you decide which portfolio weights are allowed and which are not? This seems like a tough problem. For example, you cannot allow heavy weights on small cap stocks, at least when judging a large fund.

(**Comment from the POD Father:** Answers to these and several other questions can be found at http://www.ppca-inc.com/podsfaq.html.)

Michael Leverone, CFA, Partner, First American Fund Services

Starting from the premise that virtually all investment management performance is statistically insignificant at the 5% level, we must look elsewhere for signs that support our intuition that the manager is skillful and not just having a lucky streak. The PIPOD technology is an extension of the Portfolio Opportunity Distributions (PODS) that Ron Surz has incorporated into the StokTrib performance attribution system. PODS are a superior method of peer group analysis because it distills out the style effects that are often confused for performance skill in manager returns. We use the PIPODS technology to map out where our managers fall with their unique style blend against the universe of all possible portfolio returns unique to their style. Until this new

development we were handicapped and ran the risk of comparing apples to oranges. PIPODS are a welcome addition to the performance attribution toolbox developed by PPCA.

Dr. Roger Ibbotson, Professor, Yale University; and Owner of Ibbotson Associates

I like PIPODs better than PODs since PODs seem to compare managers against their own stocks, whereas PIPODs generate a distribution from the index itself. I might have lots to debate as to how the distribution is calculated, but that is a separate question. Are PIPODs better than actual peer groups? Probably. Both could have biases when they are mismatched against a manager, etc. But it is easier to get the data for PIPODs than for peer groups, so PIPODs do have their advantages. Overall, I think PIPODs are a good idea but will have to be marketed hard.

Mark Finn, Chairman of Vantage Consulting Group

PIPODs are a great noise reduction tool. At Vantage we use these universes extensively to assist us in evaluating the results of our clients' managers. PIPODs, with their very early availability, also help us prepare our clients' "Flash" reports. In addition PIPODs are much more reliable and accurate than traditional peer groups. Everyone should be using these universes.

Rob Fletcher, CFP CIMA, Principal, Madison Investment Advisors

Comparing the return and risk distributions from PIPODs with those of traditional, widely used universes underscores the magnitude and the prevalence of survivor and selection biases in the traditional universes. This is particularly true for periods of three years and longer since survivor bias becomes aggravated over time as poor performers merge, go out of business and/or drop out of manager databases.

Other advantages of PIPODs include a very high degree of style purity, and the monthly availability of PIPODs just three days after month end. Consequently, performance reports that include clearly defined, style-specific universe comparisons can be generated more promptly and as frequently as monthly, where appropriate.

Dr. Christopher Petruzzi, Professor of Finance and Economics, University of California Fullerton; and CEO of Smart Execution,Inc.

PIPODs provide the most accurate method I have seen for estimating the likelihood that the excess returns of a money manager are attributable to skill. Investors who intend to reward managers for excess returns should not ignore the information provided by PIPODs.

Stephen C. Winks, Publisher and Editor-in-Chief of Senior Consultant Magazine

If we are to fulfill our fiduciary obligations as financial advisors, we have the responsibility to provide comprehensive and continuous counsel to each of our clients, each requiring their own unique investment consideration. The common thread that makes this manageable is the creation of custom benchmarks for each client (built around the continuous revalidation of investment policy) around which each client portfolio will be managed. By extension, the level of professional investment and administrative counsel that can be achieved by the use of PODs and PIPODs make them essential. PODs and PIPODs can help you evaluate investment performance and discern the difference between skill and luck of the managers you engage on your clients' behalf. This provides clarity to historical track records that are often misleading. It takes two decades or more of performance data to validate a large enough sample to warrant the use of scientific evaluation methodology. And, 90+% of all investment managers have not engaged in the management of a single investment discipline for 20-30 years. Even if they did, they would be nearing the end of their careers. And for the few managers with long tenure, there is always the subjective question of what is the appropriate benchmark against which to gauge their success as most managers have a blended investment management style. If by default, you look to peer group rankings of managers by investment management style, you have to wait for months until all the data is in before you can use it. By then the resulting counsel, by definition, is neither continuous nor comprehensive. PODs and PIPODs have resolved these questions of sample size, subjectivity in style classification and timeliness. The sample is a cross section of all possible portfolios the investment manager could have held using the specific universe of stocks that are the stated focus of the manager. This is more encompassing data providing greater validity than that of traditional peer group analysis and is available with in days. If the manager is in the top decile, they are outstanding. And, the advisor is not vulnerable to misinterpreting manager performance because of inadequate sample size, style bias and untimely data. How important are PODs and PIPODs? They are essential for advisors who wish to distinguish themselves on the basis of the accuracy and depth and breadth of their counsel. This would hopefully mean that all financial advisors would find PODs and PIPODs as being integral to their day-to-day counsel to their clients.

Barry K. Mendelson, CIMA, AIFA; Managing Director, Capital Market Consultants, LLC

Ron Surz is today's most inventive and practical thinker in the business of quantitative analysis of the investment management process. Ron has been on the leading edge of investment performance evaluation for more than a generation; his methods are a culmination of years of critical and comparative thinking. While every method used to create perspective on investment performance contains weaknesses and assumptions of one sort or another, Ron's PIPODs come closest to giving the professional a fair and timely perspective they can share with their clients and use to improve their portfolio oversight skills. For those who use Stoktrib, it is empowering to feel "ahead of the curve" through its use. ■

To learn more about this new performance monitoring technique, visit the PIPODs links found on *Senior Consultant's* Toolbox Solution at http://www.srconsultant.com/Toolbox/toolbox.html#PIPODs).