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SEI Manager Research: Our Solution to the Peer Group Problem

MAY 2021

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Snapshot

- One popular approach to deciding whether to hire or fire an investment manager is to compare its performance against others that share the same style.
- However, most off-the-shelf manager universes from institutional investor databases do not necessarily make accurate manager comparisons.
- SEI Manager Research has developed our own custom peer groups that share common portfolio characteristics based on actual manager holdings—not on manager judgment or past performance.

Performance is the most ubiquitous and common piece of information used to assess the success of an investment strategy. Most investors use it to decide whether to hire or fire a manager.

In our view, however, it can also be deceptive, especially when there are thousands of investment products from which to choose[1].

One popular method of simplifying hiring and firing decisions is to designate a peer group or universe to compare manager performance. Databases such as eVestment, Morningstar and Lipper classify investment strategies into one or more peer groups, such as Large Growth or Foreign Blend.

The problem

Off-the-shelf peer universes may seem to be the most convenient solution for comparing investment managers. However, we believe that they are not usually the most accurate way to assess performance. Assigning strategies to peer groups is not as simple as it sounds. Classifying a manager in the wrong peer group may lead to false conclusions about the manager's skill—or even expectations of when the manager may perform well or struggle, which may lead to poorly-timed firing or hiring decisions.

We see three issues with using off-the-shelf peer groups.

- Most are often overly broad; a given group may have hundreds of managers who really are not very similar.
- Peer-group classifications may be based on return patterns or (in some cases) the manager's own judgment, which may lead to inconsistency.
- A significant number of managers don't fit nicely or easily into the traditional style boxes of value, growth and core (or blend), forcing comparisons that don't make sense.

[1] Source: SEI, eVestment. As of April 27, 2021

Our solution

Instead of relying on third-party off-the-shelf peer universes, we have built our own.

We engage in ongoing research to identify the factors that contribute to a portfolio outperforming its benchmark, which are often referred to as drivers of excess return—or **alpha sources**. We do this through a combination of conducting proprietary market analysis and modeling, engaging with external investment managers and reviewing third-party academic research.

Our alpha sources fall into two broad categories: systematic (which are tied to quantifiable historical market inefficiencies) and idiosyncratic (which are generated by unique insights of traditional active managers).

We proxy alpha-source drivers through a series of closely correlated factors (in terms of both risk and return) that depict common characteristics associated with that alpha source.

Below is a table that includes examples of our alpha sources and factors.

EQUITY FRAMEWORK

Alpha source	Description	Investment strategy	Factor groupings	Examples of factor metrics
Value	**Mispriced securities** due to **investor overreaction** caused by an aversion to loss.	Systematic (behavioral)	• Cyclical value • Stable value	• Price-to-earnings • Price-to-book
Momentum	**Trending stock prices** due to **investor underreaction** caused by anchoring—as perceptions change serially on incoming data, and causes herding behavior.	Systematic (behavioral)	• Price momentum • Earnings revisions	• 12-month price momentum • Earnings revisions
Stability	Investor tendency to undervalue lower-risk, higher-stability businesses—resulting from a focus on **short time horizons and overconfidence** in forecasts for momentum-driven stocks. Stability-oriented stocks have the potential to exceed market expectations by consistent outperformance (rather than reverting to average market returns) along with potentially stable, long-term **compounding returns.**	Systematic (behavioral)	• Quality • Low volatility	• Profitability • Earnings strength • Volatility
Selection	**Idiosyncratic opportunities** through individual security, country or sector selection.	Idiosyncratic (analytical)	N/A	N/A

Source: SEI

SEI Manager Research leverages its insights, understanding and implementation of alpha-source drivers to create bespoke peer universes that share common portfolio characteristics of actual manager holdings—not manager judgment or past performance. These holdings provide portfolio-level factor exposure data, which is used in a proprietary decision-tree algorithm to determine the most appropriate peer group for each manager.

We believe a holdings-based approach is the soundest way to create peer group cohorts because it reflects the decisions that are within a manager's control. The manager determines what securities it buys or sells and the characteristics those securities embody. Returns are not something within a manager's control, and relying on self-selected descriptions does not yield empirical consistency due to a lack of a common framework.

The factors we use are those that we believe are the most closely associated with our systematic alpha sources. We conduct analysis on a regular basis to help ensure our peer group universes reflect the most recent data available.

How this benefits our clients

Using our own peer groups—rather than the broader off-the-shelf peer groups—allows us to view the investment manager universe through an alpha-source lens instead of a traditional style-box lens.

Our peer universes tend to be much narrower than off-the-shelf alternatives, which means that the investment managers in each universe tend to be highly similar. Thus, we can more accurately compare manager performance and determine whether a manager's performance is the result of luck or skill.

This approach helps to better distinguish beta from alpha, which can be useful in assessing appropriate fees to pay investment managers.

Our peer group work also allows us to refine our due-diligence efforts, gaining efficiency in focusing on key aspects that matter most to the manager's investment philosophy and process.

Our proprietary factor analysis uses data that reach back by more than a decade. The resulting information provides us with insight into a strategy's consistency (or lack thereof) in style over time. Knowing how an investment manager's portfolio has changed over the years through various market environments helps us to understand how it may change going forward. This allows us to more accurately set performance expectations and better communicate our beliefs about how a manager should perform in a given environment.

Finally, our peer universes provide valuable information about investment managers that are not currently active on SEI's platform. This knowledge can help us make portfolio construction decisions when working with clients who had previously invested with managers with whom we are unfamiliar.

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