PERFORMANCE – What it means and how to use it

The tremendous irony of performance analysis is that there simply is no other pursuit in the entire process of managing a fund that demands more of our time and energies and yet provides so little meaningful information. Statistically, time is not on our side – we simply cannot derive any comfort from the short term time frames that are shown us. The following question should make that point emphatically:

Question: How many years of performance history do trustees require before they are 95% certain whether a manager's performance was a function of skill or luck?

a. one year
b. three years
c. five years
d. nineteen years
e. seventy-five years

Answer : Nineteen years (approx.) for a traditional balanced fund. Seventy-five years (approx) if you want to test a manager's asset allocation skill[47]

" Most manager changes are a mistake."

"Firings are a mistake because clients usually bail out just before a manager's style turns: and hirings are a mistake because clients are chasing recent successes.

"By the time investors accumulate sufficient evidence suggesting that an investment approach (or asset class) produces superior returns, the big bucks have already been made."[1]

"Consultants are trapped by their own incentives and cognitive biases. They too are tempted to overemphasise past performance data when evaluating future manager skill." [48]

"Why doesn't past performance predict future performance?[49]

- A Manager's investment style has significant influence on a manager's ranking in performance tables. Different phases of the market cycle produce different rewards [to different investment styles]. This cycle of returns can have a bigger impact on results than stock or sector selections.

- Investment firms change as they grow. The outstanding records of firms are achieved when the firm is small. As the firm grows, the amount of assets under management increases, and the market impact of their trading can offset the positive value of their investment insights.

- Investment personnel and their roles also change over time. The investment "star" may become more of an administrator and less of a portfolio manager. When new managers are hired, the truly skillful manager may not be able to transfer his or her skills to them. Other investment managers important to the company may leave to start their own companies."

"People tend to place greater weight on evidence that confirms their views, rather than on data that could disprove their prior beliefs. The poor predictive power of past performance is rarely challenged by trustees (or even their consultants)."

"Trustees confuse good performance records with investment skill and thus overestimate the probability that good past performance will lead to good future performance, despite all the evidence that indicating that relatively few of the firms with good past results will be successful in the future.

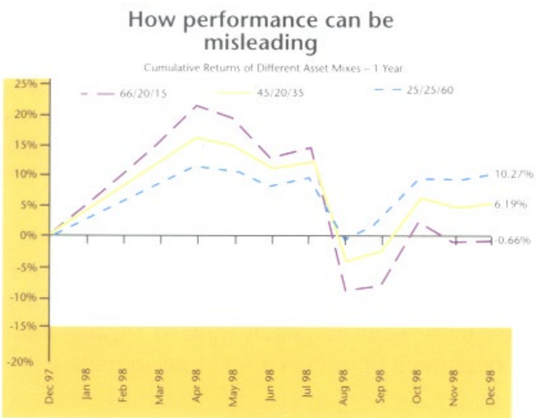
"Few trustees have been fired, let alone rebuked for recommending managers with top-quartile performance" [50]

How performance results can mislead us:[51]

What are we really seeing when we compare performance results on different balanced managers at a specific point in time? Trustees often forget that these performance figures are calculated using a rolling window of performance over time. Where the performance assessment begins and ends can produce extremely misleading results. Take the test below and see for yourself:

Question 1:

Identify which is the better managed portfolio: the fund with the 10.27% return over the year? the fund with the 5.19% return? Or the fund with the –0.68% return?



Answer:
Invariably respondents will select the manager who produced the 10% return, in spite of the fact that the performance is truncated at both ends by the one year rolling-window "frame". While within this frame the portfolio that delivered the 10% return *appears* to be the better managed portfolio, the stark reality is that each of these portfolios here held exactly the same shares, bought and sold at exactly the same time, by exactly the same managers.

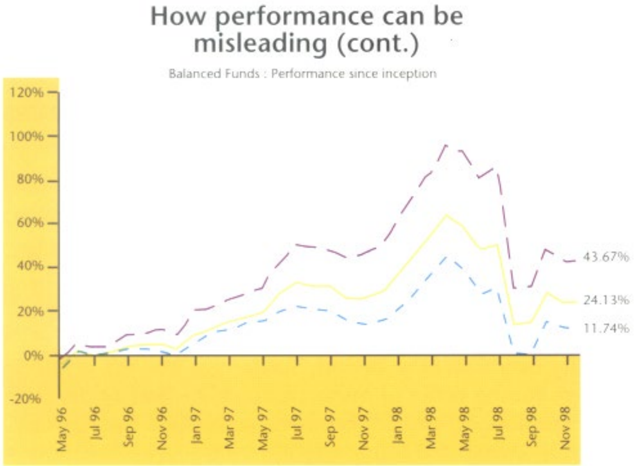
What accounted for the different performance results? Each of these portfolios were structured to meet the different funding requirements of three very different kinds of pension funds. The top performing fund, designed to meet a funding requirement where the members were mostly pensioners, had an asset mix benchmark of 25% equities, 25% bonds and 50% cash. The worst performing portfolio was designed for a very young and aggressive member base. As such, it held as much as 65% in equities over a time period when the equity market fell 44%.

Lessons to be learned:
1.Over a longer term time frame – say 5 to 10 years, we would expect the portfolio with the 65% exposure to equities to significantly outperform the portfolio with only 25% in equities. Short term results can easily mislead trustees into thinking their long term investment objectives are not being met.

2. The performance differentials between these portfolios had nothing to do with manager skill. The lesson is that, more often than not, the performance results we see in the league tables will owe more to asset allocation differentials between managers (often to meet different funding requirements) than manager skill

Question 2

Test yourself again. Now we have a three year performance history on three additional portfolios. Which is the better managed fund?



Answer:
Again, in spite of the dramatic differentials in performance between the three funds, these three funds all held exactly the same shares that were bought at exactly the same time by exactly the same portfolio managers – so we know that the performance differentials had nothing to do with manager skill. Additionally, these three portfolios held exactly the same asset mix (65% equities, 20% bonds and 15% cash).

So what accounted for performance differentials this time? Each of these portfolios was mandated to maintain different risk profiles. The top-performing fund was the most aggressive and the bottom-performing fund was the least aggressive. While each portfolio held the same shares, they were held in different proportions from one portfolio to the next. The more aggressive portfolio would have had the higher proportion of small cap shares and the lower risk portfolio would have had a lower exposure to large cap shares.

Lesson to be learned:
Again, what often appears to be superior performance because of the skill of the manager may in fact be performance that is a function of the risk of the fund. While over a long term time frame, a high risk portfolio may indeed outperform a lower risk mandate, that performance will typically display significantly more volatility over that time period. Similarly, a low risk portfolio may appear to outperform during times of market turbulence, but as the time frame moves out longer and longer, this performance advantage may quickly disappear.