THE PROBLEM WITH CONVENTIONAL PERFORMANCE EVALUATION

EVALUATING PAST PERFORMANCE DOES NOT TELL US ANYTHING USEFUL ABOUT THE FUTURE

Beacon Pointe Advisors
Service for Insurers

Garth K. Flint
Founder, Institutional Investment Consultant
(949) 718-1610
gflint@beaconpointe.com

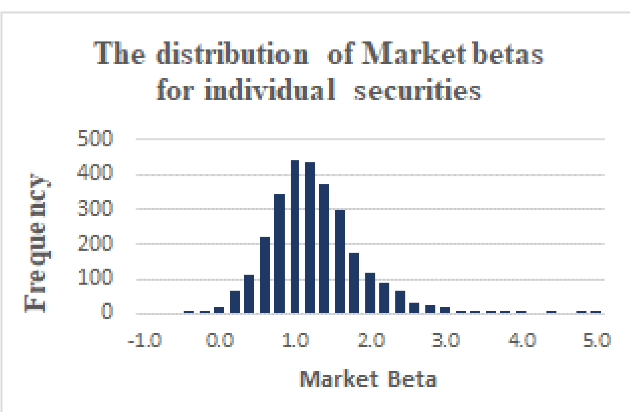
David Newsom
Principal
Peer Analytics
(949) 357-2290
newsom@peeranalytics.com

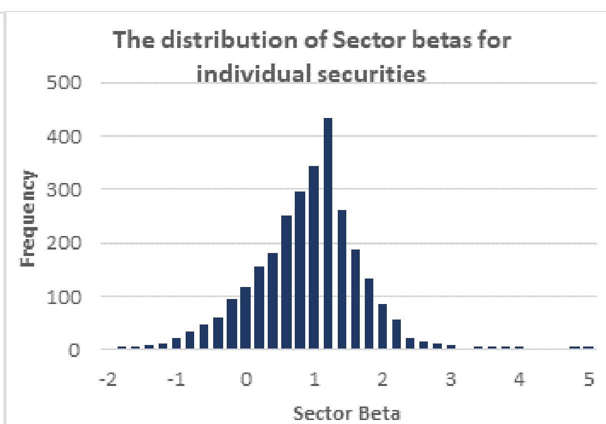
Problem: Investment performance evaluation is useful only if it can lead to actionable insights.

The uncomfortable truth is that conventional performance measurement has little to no value, and it is almost never actionable. We all understand that past returns are not positive predictors of future returns. In fact, managers in the top quartile in one period are more likely to be in the bottom quartile the next than to remain in the top.

Past performance is not a positive predictor because the impact of market randomness overwhelms return, if any, due to security selection skill. Every active portfolio has systematic bets relative to the benchmark, possibly unintentional, and common techniques cannot effectively distinguish return due to security selection from the return due to these passive differences.

The challenge is to separate performance due to security selection from performance due to passive systematic exposures (e.g., market, sector, and size betas) that differ from the benchmark.
Brinson attribution and Active Share – common techniques of risk and performance analytics software – attempt to distinguish active return (Brinson) and risk (Active Share) from their passive counterparts. Unfortunately, both approaches implicitly assume that individual securities all have identical systematic exposures, including identical market and sector betas. In fact, security betas vary significantly. As of 12/31/2020, U.S. security market betas ranged from -0.5 to 4.2 and sector betas ranged from -1.8 to 5.0.





Source: ABW Peer Analytics Statistical Factor Risk Models

The wide variation in market and sector betas is one of the serious flaws with Brinson attribution and Active Share. Failure to consider individual security betas prevents these methods from being effective. If they were effective, they would prove predictive.
Consider your own performance reports. Is there any data metric that, if it were different, would cause you to act?

Solution: New factor risk models, which model individual securities using a handful of (cheaply and passively investable) risk factors, accurately distinguish between return due to security selection and return due to passive factor betas. The result is a metric of security selection skill likely to persist. Skill exists, can be identified, and is persistent. But it does not last forever. This decay of skill makes it even more imperative to identify skilled managers quickly and reliably.
Managers can be identified who show statistical evidence of skill, take sufficient security-selection risk to overcome fees, and can be combined with others to mitigate unintentional market exposures. When hired, they should be monitored continually, looking, for example, at some of the following reasons to make changes.

- Does performance indicate that the security-selection skill confidence level has fallen below 90%?
- Has active risk declined below the active fee threshold?
- Are passive exposures changing too much to be effectively offset?
- Is there evidence the manager may be overcapitalized?
- Has the manager's contribution to aggregate portfolio risk changed?

None of the above reasons to act can be detected without robust factor risk models purposely built for manager and portfolio oversight.
This sample performance evaluation provides an illustration of a performance review in which all data are actionable.

Source: Peer Analytics https://peeranalytics.com/