Measuring Investment Performance Part I

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One of the more important issues facing investment advisors is how to determine the appropriate investment options for clients. One of the first places some advisors go to is a cursory evaluation of investment returns. Even though prospects and clients claim to be long-term investors, they can be very sensitive to short-term volatility in stock prices. The first quarter of 2020 was a good example as many investors decided to get out of stocks and hold cash. Market bottoms are usually characterized by a surge in stock liquidations right at the bottom. The opposite is also true; when equity markets are hitting new highs investors pile in so that they don't "miss out."

When evaluating a portfolio manager's performance record, it is important to consider long-term returns, but evaluating short-term returns is equally important. The reason for considering both time frames is that short-term performance can have an important impact on long-term results. For some reason regulators like to see returns reported on a one, three, five, ten and since inception basis. If the one-year number is unusually strong, the 3, 5 and 10-year returns can be enhanced to make it appear that the manager has been consistently above-average. The short-term return is so strong that it colors the entire history. If this analysis is misleading, what can you do to minimize the distortions that show up in looking back in time as the only way to measure performance? One way is to look at historic returns over stock market cycles. Many years ago, this methodology was standard practice in the institutional investment community but has lost adherents over the years. We still think looking at returns over full market cycles is the best way of getting a handle on a manager's performance. To calculate market cycle returns, just measure the returns from one market cycle peak to the next peak and then from the trough to the next trough. This approach can provide insight as to how good a manager is over a market cycle. Seeing what happens in a rising market and a falling market can also be valuable. Measuring performance that is heavily influenced by recent performance can be misleading. As one colleague said a few years ago: "When it comes to measuring investment performance, don't ask someone who wins the lottery how they picked the numbers."

Another misleading statistic is standard deviation. This measure calculates how much of a difference in returns there is among accounts with the same investment objective. In the institutional world where all accounts are tax free, a portfolio manager attempts to make all accounts look alike to ensure that the standard deviation is low, otherwise he or she could be accused of not effectively managing those accounts. However, in the world of private client investing where there are taxable portfolios, the use of standard deviation doesn't make a lot of sense as each account's holding will be different over time and attempting to standardize those accounts would likely have important tax implications. The bottom line in assessing a manager of taxable accounts is to avoid using any measure of standard deviation to evaluate the consistency of how accounts are managed.