

# Performance Perspectives

## with Dave Spaulding

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### Can I get a witness?

A witness to risk measurement, that is. A witness to the challenges we face when trying to measure it. Perhaps Yale University's CIO, David Swensen, can help. One of my favorite quotes is from his book, Pioneering Portfolio Management, where he wrote:

"Quantitative Measures of Risk Leave Much to be Desired"<sup>1</sup>

I've yet to find anyone who disagrees with this, and why not?

Well, there are probably several reasons. First, we don't have uniform agreement on *what risk is*. Some say it's volatility, others say uncertainty. I like Frank Sortino's: the potential for loss.<sup>2</sup> Or, the possibility of not meeting your objective.

When we take an inventory of the risk measures, we quickly discover some of the challenges. For example:

- Standard Deviation – the number one risk measure.<sup>3</sup> Like a lot of the other measures, it focuses on *volatility* or *dispersion* of returns over time. While it's the most frequently used, it also seems to be the most criticized. One problem that is often cited about standard deviation is that it reflects both above and below-the-mean dispersion. Most of us don't mind being above average (although statistically only 50% of us will be), it's the below average side we're worried about. But standard deviation treats them equally. Also, its assumption that the distribution is *normal* (bell-shaped curve) often fails to materialize. And, to have any degree of value we require a substantial number of elements in our distribution, which often doesn't happen.
- Information Ratio – this measure is sometimes thought of as a variation on the Sharpe Ratio. Like the Sharpe Ratio, it is a *risk-adjusted* measure. It is a fairly common measure which was taken to task by Russell's Tom Goodwin.<sup>4</sup> The thing I found most interesting from his research was how he refuted the often-held opinion that the IR could be evaluated in an absolute basis (e.g., that an IR of 0.5 is "good"), while in reality it should be seen on a relative basis.

1. Swensen, David F., Pioneering Portfolio Management, (The Free Press, 2000). Page 309

2. Sorry, but I can't cite a reference for this - probably heard Frank say this at a conference or two.

3. Our 2001 performance technology survey asked the participants to list the measures they calculate. The winner, with a 95% response rate, was standard deviation. ("Performance Measurement Technology Survey," (Spaulding Group, 2001), page 52.)

4. "The Information Ratio – More Than You Ever Wanted to Know About One Performance Measure." (Russell Research Commentary, November 1997).

- Sharpe Ratio – who could ever find fault with this ratio, right? Well, if you saw the October 2002 issue of *Institutional Investor*, you were shown a rather interesting piece.<sup>5</sup> Here are just a few of the insightful quotes:
  - “It’s the Enron of ratios” - Kelsey Biggers
  - “You want to know if a number is very fuzzy or just has a little peach fuzz on it. Sharpe ratios tend to be buried in hair.” - Guy Miller (Barra)
  - “In terms of how the Sharpe ratio has done in evaluating mutual funds, I would say the answer is poorly.” - Jack Bogle (Vanguard)
  - “I didn’t call it the Sharpe ratio” - Bill Sharpe.

Enough said?

- Sortino Ratio - while this measure seems to do what Sortino wants (i.e., reflect the potential for loss), it is not that well used. And, as Frank suggested in the interview he did for *The Journal of Performance Measurement*, he doesn’t see this changing.<sup>6</sup>
- Tracking Error - If you check out the Sortino article, you’ll see that Frank isn’t a fan of this measure, as it doesn’t reflect the potential for loss, just the degree to which returns match the index. However, I think that this measure has some value, the index should reflect the degree of risk we’re willing to take, so the amount we’re performing away from it is worth looking at.
- Modigliani-Modigliani (M-Squared) - This is a relatively new measure, but one that I would encourage more firms to look into. It’s a risk-adjusted return which is stated in percentage terms, so it’s more intuitive than many of the other measures. I had the pleasure of interviewing the co-designer and Nobel Laureate, Franco Modigliani, and we spent some time discussing this measure.<sup>7</sup> He convinced me of its merits.

**If we compare these measures to our various definitions of risk, we see that most actually reflect volatility:**

|                           | <b>Volatility</b> | <b>Potential Loss</b> | <b>Not Meeting Objectives</b> |
|---------------------------|-------------------|-----------------------|-------------------------------|
| <b>Standard Deviation</b> | <b>X</b>          |                       |                               |
| <b>Beta</b>               | <b>X</b>          |                       |                               |
| <b>Sharpe Ratio</b>       | <b>X</b>          |                       |                               |
| <b>Treynor Ratio</b>      | <b>X</b>          |                       |                               |
| <b>Sortino Ratio</b>      | <b>X</b>          | <b>X</b>              | <b>X</b>                      |
| <b>Tracking Error</b>     | <b>X</b>          |                       |                               |
| <b>Information Ratio</b>  | <b>X</b>          |                       |                               |
| <b>Modigliani</b>         | <b>X</b>          |                       |                               |
| <b>Downside Risk</b>      | <b>X</b>          | <b>X</b>              | <b>X</b>                      |
| <b>VAR</b>                |                   | <b>X</b>              | <b>X</b>                      |

<sup>5</sup> Lux, Hal, “Risk gets riskier,”(*Institutional Investor*, October 2002), pages 28-36.

<sup>6</sup> “The Journal Interview,” *The Journal of Performance Measurement*, Vol 6, #3.

<sup>7</sup> “The Journal Interview,” *The Journal of Performance Measurement*, Vol 6, #2.

But is volatility risk? Perhaps it's a reflection of potential risk. But do we object to volatility on the high side? Some do, but many are content to have these high returns.

So, what's to be done when it comes to measuring risk? Well, first recognize that you can't settle on a single measure. As Harry Kat stated in the II article, "Risk is one word, but it is not one number."

What's key, I believe, is that you utilize multiple measures, recognizing the flaws in each, in an attempt to get a sense of what's going on.

Beyond the measures, we need to have a disciplined view and awareness when it comes to risk. Too often, when we see exceptional out-performance, we celebrate. Perhaps we need ponder and ask the simple question, "why or how did this happen?" In anything, if we see performance that is so far up the curve to be exceptional, such a question is worth asking.

As an example, in baseball a few years ago, we saw several players do what only two players in 100 years had ever done: hit 60 or more home runs in a season. Why was this? Could steroids have been a factor? Some have suggested that the answer may be yes.

If returns are exceptional, ask "why?"

### **Risk Management and Monitoring**

But now we're talking about risk management and monitoring, the other two Ms of risk.

I recently read Roger Lowenstein's When Genius Failed. I heartily recommend it. It's about the Long-Term Capital Management episode of a few years back. In addition to providing some great insights into what occurred, it also calls into question another one of the risk measures: Value at Risk. While VaR seems to measure the potential for loss, it often assumes a normal distribution. One thing Lowenstein points out is that the distributions often have fat tails (positive excess kurtosis or a leptokurtic distribution).<sup>8</sup>

At our fall (sorry, autumn, since it was in Europe) meeting of the Performance Measurement Forum in Lisbon, we heard Mark Tapley speak about the Mercury (now Merrill) / Unilever battle. Mark will be writing an article for *The Journal of Performance Measurement*<sup>®</sup> on this topic, so I won't bother to go into much detail here. However, it's important to realize that this was far from a simple case. I'd love to see a Harvard-type case study done, where perhaps we would consider whether or not Merrill should

<sup>8</sup>. I invite you to read Bruce Feibel's Investment Performance Measurement (John Wiley, 2003), for a discussion on distributions. This topic is discussed on page 151.

have settled.<sup>9</sup>

Goldman Sachs's **Green** Zone approach was very well described in a Dietz Award winning article<sup>10</sup> It serves as a good idea for a way to manage risk. The "three Ms" of Risk are all worth spending some time reflecting on to insure that your organization is doing what makes sense for you and your clients.

### **Hedge funds and performance measurement**

An area that we plan to spend some time in during the coming months is hedge funds.

Sabina Hastings recently interviewed Mark Anson, the CIO for CalPERS, for the Winter issue of *The Journal*. I had the opportunity to read the interview and was pleased to see that Mark felt that the AIMR-PPS (read "GIPS") needs to incorporate hedge funds. I agree. But, if you're at all familiar with hedge funds, you know it won't be easy. But we need to do something.

Hedge funds have grown tremendously over the past ten years, with no end in sight. But how does a customer compare one with another? Just as we did with the introduction of standards for more traditional asset classes ten-plus years ago, we need to do for hedge funds.

And, on a different topic, how about attribution for hedge funds? Since many funds don't use a benchmark, the allocation/selection/interaction approach we find in Brinson/Fachler and Brinson/Hood/Beebower models won't work here. But investors still want to know the sources of returns. There is definitely an opportunity waiting for some development and discussion. Stay tuned!

(Oh, and if you have any thoughts on this or any other topic we've been discussing, or if you have topics you'd like addressed in a future edition of the newsletter, please let us know. Simply e-mail us at [info@SpauldingGrp.com](mailto:info@SpauldingGrp.com) and let us know your thoughts.

We've already heard from several folks who have commented very favorably about this newsletter. We're also aware that we've stimulated some controversy, which is also helpful, yes?

So, please, keep those cards and letters coming...)

<sup>9</sup>. Having been involved with a few lawsuits in my very recent past life as an elected official (mayor), I know that often we settle simply to avoid the risk of greater loss, even when we know we're without fault. I'm not suggesting that this was Merrill's case, but there no doubt was a recognition that the cost and potential loss of continuing was a contributing factor in their decision to settle.

<sup>10</sup>. Litterman, Robert B., Ph.D., Jacques Longerstae, Jacob D. Rosengarten, and Kurt Winkelmann, Ph.D., Goldman Sachs and Paul R. Laubscher, IBM Retirement Fund, "The Green Zone... assessing the Quality of Returns", *The Journal of Performance Measurement*, Vol.#5, #3.

## **UPCOMING TRAINING DATES**

### **INTRODUCTION TO PERFORMANCE MEASUREMENT**

| <b><u>LOCATION</u></b> | <b><u>DATES</u></b> |
|------------------------|---------------------|
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|               |                     |
|---------------|---------------------|
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## **GIPS Luncheons**

|                          |                       |
|--------------------------|-----------------------|
| <b>New York, NY</b>      | <b>March 8, 2004</b>  |
| <b>Chicago, IL</b>       | <b>March 10, 2004</b> |
| <b>Boston, MA</b>        | <b>March 11, 2004</b> |
| <b>San Francisco, CA</b> | <b>March 22, 2004</b> |
| <b>Los Angeles, CA</b>   | <b>March 24, 2004</b> |
| <b>Totonto, CDA</b>      | <b>March 30, 2004</b> |

## **2004**

### **Performance Measurement Forum Schedule**

|                            |                               |
|----------------------------|-------------------------------|
| <b>San Francisco, CA</b>   | <b>May 6 - 7, 2004</b>        |
| <b>Edinburgh, Scotland</b> | <b>June 9 - 10, 2004</b>      |
| <b>Madrid, Spain</b>       | <b>November 10 - 11, 2004</b> |
| <b>Orlando, FL</b>         | <b>December 9 - 10, 2004</b>  |

