portfolio construction forum

Assessing manager risk & risk-adjusted performance

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"Assessing Manager Risk: Looking beyond the Numbers" & "Risk-Adjusted Performance Measures: A Case Study" by Deborah Kidd, CFA, 2012

Fund research is something of a dark art - there is little quality information available on how to go about it. Further, fund research is not taught in an in-depth way anywhere than on the job. And, in reality, there is no way to speed up the learning process. Investors, researchers and others can really only learn on-the-job. And there aren't a lot of teachers to go around.

When trying to find good papers on the topic, I spent days scouring journals, magazines, conference presentations and so on. I was not surprised with the lack of good content - but I was pleased to find a very worthwhile, long running series of articles produced by CFA Institute on the topic. Articles in their "Investment Risk and Performance Feature Articles" series cover more practical aspects of investment analysis and assessment. Here, we consider two papers in particular, covering qualitative and quantitative analysis of funds and fund managers.

The first paper - Risk-adjusted performance measures: A case study - considers quantitative analysis, taking the reader through an example of two bond funds. It comes complete with performance and analytical spreadsheets, and calculations and analysis of a series of ratios - naïve alpha, risk-adjusted alpha, beta, R-squared, tracking error, information ratio, and Sharpe ratio.

It pieces together the story of how this information can be used to uncover what the funds are really doing. In this example, Fund B performs better than Fund A and has a much higher risk-adjusted alpha over the medium term. Fund B seems like a winner. But, its beta is also much lower. Is Fund B's return being driven by the index or is the manager taking other risks? The answer is partly in the R-squared as it tells you how reliable the beta figure actually is. Fund B has a comparatively low R-squared, meaning the manager might be taking risks outside its style to generate returns. Looking at tracking error will help to clarify this. A high tracking error suggests Fund B is taking more risk than Fund A. The information ratio will tell you whether the risk (tracking error) has paid off. In this case, Fund A's and B's information ratios were similar.

Overall, it tells us that Fund B may have performed better, but the manager has taken risks that might not be related to the index and therefore might not be within its stated style or mandate. In terms of returns adjusted for index-related risk, the payoff had been similar. The issue arises - Fund B has performed better than Fund A and the index, but do we know how the returns were generated, and whether they are repeatable?

The second paper - Assessing manager risk: looking beyond the numbers - discusses qualitative aspects of fund manager assessment. Through an interview with two very experienced fund selectors, they consider many of the important points in the due diligence process including the traditional 4 Ps - philosophy, people, process, portfolios - and other important indicators such as ownership structure, operational risk and fund sizes. One interviewee also proposes that "the intangible 4 Ps" - passion, perspective, purpose and progress - should also be considered in the due diligence process. "Managers who are highly motivated and intensely competitive are more likely to be focused on excellence in performance results", he argues, adding "It is rare that very experienced people with thoughtful processes don't perform well over the long term."

The most important point in the second paper is the lack of discussion about performance. In fact, simple past performance compared to an index is not considered in the fund manager selection process at all. Rather, performance analysis is deeper and more complex than this, as highlighted by the first paper.

In combination, these two papers go well beyond the standard, simple fund statistics and discussions seen in many fund research reports, and provide us with clues as to how to use the numbers and how to interrogate fund managers, to find a level of skill others only pretend to understand.

Read "Assessing Manager Risk: Looking beyond the Numbers"
Read "Risk-Adjusted Performance Measures: A Case Study"