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How Are My Investments Performing? Evaluating Your Family's Investment Performance

By: Terry Vaughan

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Introduction

You've done all the right things. You have an investment plan in place. You've worked hard to set up a structure for your family that aligns with your tax and estate planning. And you've allocated to several investments to construct a widely and thoughtfully diversified portfolio that aligns with your investment policy statement.

Now it's time to assess how your investments are doing.

The Theory...

The textbooks will tell you that evaluating investment performance involves the following[1]:

1. Measuring returns;
2. Adjusting returns for risk;
3. Comparing returns to relevant benchmarks[2], and, if you want to go deep;
4. Attributing performance between different factors (i.e., asset allocation, security selection, and currency exposure)

All of this is quite doable for portfolio managers with narrow mandates and professional investors with access to the information and expertise required to calculate and bring this information together.

….Is Often Not Easy for Families to Implement

What, though, should wealthy families do? Measuring and accurately consolidating performance metrics across a widely diversified portfolio (often from multiple sources) is challenging. And given the various

[1] Clare, A. Performance Evaluation. *CFA Institute Investment Foundations*, Chapter 19. https://www.cfainstitute.org/-/media/documents/support/programs/investment-foundations/19-performance-evaluation.ashx

[2] And the reference above will tell you that a relevant benchmark should be: Investable – meaning you could actually buy the underlying assets; compatible – meaning it should match the investor's objectives (risk in particular); transparent – meaning the rules governing the construction of the benchmark should be clear; and specified in advance.

goals and constraints considered in developing a family's investment plan, how does one determine the most relevant reference point(s)?

This paper reviews the many elements and challenges that wealthy families must navigate when evaluating investment performance. We consider the importance of patience, separating luck from skill, ensuring that comparisons are reasonable, paying attention to things within your control, and letting diversification happen. We also emphasize the importance of focusing on the investment process as much as investment outcome and, perhaps most importantly, knowing yourself as an investor – so that the process of monitoring your performance helps you make better investment decisions (vs. the other way around).

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There Are Several Factors to Keep in Mind When Assessing Performance

Risk. As a friend of mine says, "the currency with which we buy returns is risk." So, when we are evaluating returns, we need to consider the amount of risk taken to earn those returns and be sure that any comparisons we make are between investments with similar risk profiles.

Review Period. The shorter the period, the less attention you should pay to performance. Discerning luck from skill when evaluating investment manager performance is always tricky – and nearly impossible over short evaluation periods.

We'll use an oversimplified example to make this point. Let's compare an unskilled investment manager with a 50% chance of outperforming a benchmark over one year (we'll call this manager "Coin Toss Investments") to a skilled manager with, say, a 60% chance of outperforming the same benchmark.

After one year, Coin Toss Investments has an 83% chance of doing as well as the skilled manager relative to the benchmark (i.e., 50% divided by 60%).

So, what happens after three years? Often if a manager is not performing well, investors start to get uncomfortable around this time. Let's do the math - after three years, Coin Toss Investments still has a 58% chance of doing as well as the skilled manager relative to the benchmark (i.e., 50% x 50% x 50% divided by 60% x 60% x 60%).

The point is that it takes time (and judgment) to assess the extent to which the results you are evaluating are due to luck vs. real investment skill. So, patience is necessary.[3] And evaluating investment processes is generally going to drive better investment decisions and outcomes than considering performance figures alone—more on this below.

Taxes. As income taxes often represent the most significant cost faced by investors, ideally, investment reporting would be presented on an after-tax basis. Given the complexities involved in measuring

[3] It is not until 13 years have passed that Coin Toss Investments' probability of doing as well as the skilled manager falls below 10%. So, getting really comfortable that results are skill vs. luck-based requires incredible patience as outlined by this (again, very simplistic) example.

performance in this way[4], however, most investment performance reporting is shown gross of the investor's actual and expected tax liabilities. So, while most families evaluate performance on a gross of tax basis, they (and their advisors) must always be mindful of an investment's expected return character (i.e., from a tax perspective) and where best to locate the asset within the family's structure to drive the optimal after-tax outcome.

Fees. Performance should be evaluated net of fees (investment management and performance fees, custody and transaction fees, and investment advisory fees). And for comparisons to be fair, fees should also be considered when looking at benchmark performance (i.e., how much would it cost to invest in the benchmark?).

Private Investments. An important component of many widely diversified portfolios, private investments are often not "marked to market" regularly (i.e., they do not trade on an organized exchange and therefore are not priced frequently – or at all until they are realized). Private investments are often reported at their cost (or their most recent valuation), and therefore the reported value may not reflect actual value. For this reason, one must be careful when evaluating the performance of private assets specifically or portfolios that include private assets more generally.

How Returns are Calculated. When you invest, there are two primary determinants of how it plays out: how the investment performs and when you happened to add money to or remove money from it.[5] "Time-weighted" return calculations tell you how the investment itself performed. "Dollar-weighted" return calculations (also referred to as money-weighted or the internal rate of return (IRR)) tell you how the investment performed for you based on when you contributed to or redeemed from it. For more on the difference between these two performance calculations, please see this video[6].

[4] A few of the key challenges include timing differences between reporting periods and tax payments, information availability (including appropriate tax rates), and uncertainty around the timing and magnitude of deferred tax liabilities (unrealized capital gains for example).

[5] For years, DALBAR has been publishing research on the difference between mutual fund returns and the returns realized by mutual fund investors. Spoiler – investors' returns are lower because they tend to buy high and sell low. See here for the latest study.

[6] FAIR Canada. (2016, July 13). http://www.faircanada.ca

It is important to know which kind of return calculation you are working with to evaluate performance properly. Benchmark returns will be time-weighted most of the time, so comparing these returns to time-weighted investment performance is appropriate. If, however, you are comparing dollar-weighted investment performance to time-weighted benchmark performance, you need to be careful. If you made no additions to or redemptions from the portfolio over the period you are evaluating, then comparing time and dollar-weighted performance will be fine. However, if you made significant additions or redemptions during the evaluation period, comparisons between time and dollar-weighted performance may be misleading.

"Past Performance Is Not Indicative of Future Results." Boy, it would be easier if that's how it worked! And we all do it - we see an investment that's done well, and we're so tempted to jump on it, aren't we?

Three things are going on here:

- The luck vs. skill thing;
- That fact that the only thing we know about the future of financial markets (and a whole host of other things in life) is that nobody can know what the future will bring; and
- The concept of "mean reversion" (a fancy way of saying that after an investment has done well or poorly, it may head in the opposite direction for a while).

We covered the first item earlier. The second is self-explanatory. And regarding the third point, while it's a big generalization that financial markets tend to be somewhat cyclical, it's a valuable concept to consider (and the foundation of "buy low and sell high"). If you are evaluating a period of less than, say, five years, the probability of that performance being similar to the next five years is likely modest. If, however, you are looking at strong performance over ten years, that may indicate skill. And assuming you've done the work to understand the foundation of that skill and believe it will persist, then the last ten years of performance may well be indicative of what the next ten might look like (but keep in mind that all bets are off over the short term).

Diversification. Diversification is the warm blanket of the investment world. As Investopedia puts it:

> *A diversified portfolio contains a mix of distinct asset types and investment vehicles in an attempt at limiting exposure to any single asset or risk. The rationale behind this technique is that a portfolio constructed of different kinds of assets will, on average, yield higher long-term returns and lower the risk of any individual holding or security.*[7]

Who wouldn't want to do that?

When you are evaluating performance, there are a couple of things to keep in mind about diversification:

First, when you compare the overall performance of your diversified portfolio to various benchmarks, you are likely to find that the portfolio returns are neither the best nor the worst on a relative basis. Try not to let this bother you. Avoid the "If I'd only invested in [insert highest returning asset class here], I would have done so much better last year" mindset. That voice lives inside all of our heads – even the most sophisticated investors, as we discuss below. Please do your best not to give it much airtime.

Comparing a widely diversified portfolio's risk metrics and risk-adjusted returns to benchmarks should feel much better (i.e., they should compare favorably).

Second, keep in mind that the reason diversification improves risk-adjusted performance is that it puts a bunch of investments together that are expected to perform well over time, though do so at different points in times (i.e., the "correlation" between the investments should be as low as possible8). So, try to temper your disappointment when reviewing strategies that aren't performing well. While you should certainly seek to understand and feel comfortable with the reason for any underperformance, try to keep in mind that if everything is doing well, the portfolio is likely not very well diversified (which will not feel so nice when things aren't going so well).

Manager Incentives. Ironically, the easier it is to benchmark an investment strategy and the more focused investors are on doing so, the less compelled the investment manager may be to take risks and

[7] Segal, T (2021). Diversification. *Investopedia*. https://www.investopedia.com/terms/d/diversification.asp

[8] The video in this link provides a good introduction to correlation and how it influences portfolio diversification: Hayes, A. (2021). Correlation. *Investopedia*. https://www.investopedia.com/terms/c/correlation.asp

allocate to their highest conviction ideas. When an investment manager knows their performance relative to a benchmark is closely scrutinized, and that investors may throw in the towel if they underperform for a time, they may be less likely to stray far from the benchmark. So, managing business and career risk can get in the way of building the portfolio that the investment manager would genuinely like to.

"Active Share" is a metric that investors can use to determine how different an investment strategy is relative to its benchmark. See this video[9] for more on Active Share.

The Impact of Performance Evaluation on Your Investment Behavior

We've hinted at it in a couple of spots above. If investors are not careful, it's easy for performance information to tempt them to overthink and overact, especially when looking at this information frequently. And acting may undermine a thoughtfully constructed portfolio. Don't do this! Before acting, seek to understand what's going on.

And this is not a challenge faced only by novice investors. Professor Daniel Kahneman, who won the Nobel Prize for his work on behavioral finance, admits struggling with this.

Very briefly, behavioral finance is the study of the influence of psychology on the behavior of investors. And unlike traditional financial theory, behavioral finance recognizes that investors are not always rational, have limits to their self-control, and are influenced by their own biases.10 In other words, investors are human.

Professor Kahneman says that looking at quarterly investment reports makes him want to tinker with his holdings, which he recognizes may hurt his returns. So, he looks at them less frequently to help control his desire to mess with his investments.[11]

[9] Sensible Investing. (2015). www.sensibleinvesting.tv.

[10] What is Behavioral Finance? How Processing Errors and Biases Impact Investors. (n.d.). Corporate Finance Institute. https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/behavioral-finance/

[11] Brewer, J. (2019, August 14). Do You Really Know How Your Investments Are Doing? Forbes. https://www.forbes.com/sites/jbrewer/2019/08/14/do-you-really-know-how-your-investments-are-doing/. The article also

If a Nobel Prize-winning thinker in the field of behavioral finance admits to getting in his own way when faced with the "emotional hits" from frequent investment reporting, then the rest of us really need to keep our guard up.[12]

The key is to know yourself. If you are interested in learning more about investing and believe you can stop yourself from acting when you shouldn't, looking at your investments frequently can be a terrific opportunity to learn about financial markets and investing. If this isn't you, then Professor Kahneman's approach is probably best.

Evaluating Process vs. Outcome

Charley Ellis calls investing a loser's game. He means that successful investing is not about somehow making all the right calls. Instead, successful investing is about making fewer mistakes than your fellow investors (i.e., avoid losing). And how do you make fewer mistakes? You develop, execute, and refine processes that help you lose less. You follow a thoughtfully designed investment plan, you stick to your investment principles, and you stay curious – refining as you go.

Professional tennis is a winner's game – you win by making more great shots than your competition. Since evaluating investment performance is akin to keeping score, the message here is that while the score of a professional tennis match will tell you which player was more skilled that day, the "score" that you glean from evaluating your investment portfolio:

1. May not provide you with meaningful insight depending on the time frame (i.e., luck vs. skill); and
2. May encourage you to make the mistake of adding more of what's done well and selling what hasn't done so well (i.e., buy high and sell low).[13]

references a series of experiments by psychologist Paul Andreassen which support the notion that the more news investors receive related to their holdings, the more they will trade and the lower their investment returns will be.

[12] Related, I've often thought it's a good thing that residential real estate is slow and expensive to transact in. If it weren't, many would be tempted to trade their houses – which I'm quite certain would not end well most of the time!

[13] Rotblut, C. (2013, November 5). The Role Of Luck And Skill In Investing. Forbes. https://www.forbes.com/sites/investor/2013/11/05/the-role-of-luck-and-skill-in-investing/?sh=6f92d675b737

Not to say that keeping score shouldn't be part of your portfolio management process – it just shouldn't be the only part. Doing everything you can to understand and evaluate the investment processes and strategies that drive your portfolio should help you lose less.

So How Should You Evaluate Your Family's Investment Performance?

Peter Drucker famously said, "*you can't manage what you can't measure*." And while there is a great deal of wisdom in this statement, one must also keep in mind that you can't manage what you can't control.

So, while measuring and evaluating investment returns and risk is a necessary component of best practice investing, past performance alone really doesn't tell you much about future results. So, we must all be careful with what we are trying to manage and with what information.

We hope this paper has offered food for thought on this important topic. We'll leave you with some dos and don'ts that we've touched on:

Do:

- Be patient with comparisons – and spend more of your time learning about why your investment plan and the strategies that comprise it make sense for you, how they fit together, and why they are performing as they are.
- Pay attention to the things that are within your control, such as:
    - Asset allocation relative to a sensible target;
    - Sub-asset class diversification and position sizing; and
    - Fees and tax optimization opportunities.
- Let diversification happen – don't get hung up on poor short-term performance from strategies that improve portfolio diversification.
- Know yourself – if frequent score-keeping isn't emotionally (and financially) healthy for you, then adjust accordingly.

Don't:

- Compare apples and oranges – be thoughtful about risk when making comparisons, be careful when evaluating private investments (they need time to execute their strategies) and ensure the performance calculations you are relying on are simpatico (dollar-weighted vs. time-weighted).
- Waste too much time evaluating performance for periods less than five years or so (luck vs. skill).
- Put your investment managers in too tight of a box – they may start behaving like they are caged (manager incentives).
- Overthink or overreact to the score. Your emotional brain will be screaming for you to sell what hasn't been working and buy more of what has. Before acting, seek to understand what's going on, and stick to your plan!

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