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The Pesky Issue of Performance Measurement

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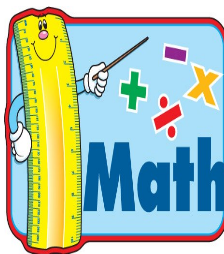
There's a saying that goes like this; the only things you can ever expect to manage are those that you can measure accurately.

This explains why individuals, businesses and governments spend unusually large amounts of money, energy and time to quantify various facets of their activities.

Measurements can provide timely feedback for any entity that takes the information seriously and is willing to change. Obviously, not all entities are open to this. Worse, some entities might be tempted to manipulate the data to achieve their goals without actually doing anything. One thing is certain, no one likes data that is unflattering (think Trump).

The act of collecting, analyzing and reporting information has become a huge business. There are many consulting firms that specialize in helping individuals, organizations or systems make necessary changes.

So it should come as no surprise that the investment management industry views the topic of performance measurement as critical (and has for decades). That's because the investment industry is essentially a wealth creation service that is relatively easy to measure. Investment performance is widely reported by the media. Good results can provide a huge competitive advantage. Bad results can destroy a firm.



Given such high stakes, it is very important to understand who is providing the data and what their incentives are. Remember, "there are three types of lies: lies, damn lies and statistics."

With this in mind, let's review a couple of recent examples about the use, and possible misuse, of investment performance statistics.

The first example is based on an article from a respected Canadian financial newspaper. In it, the writer tried to prove why diversification using an array of passive ETFs is preferred over just investing in a single Canadian passive equity index. The author compares the performance of a basket of eight ETFs against the S&P/TSX composite index.

The article contained three analytical problems, which the author may not have fully appreciated. First, the periods for comparison were 1, 2 and 3 years. This is just too short a timeframe to make any meaningful conclusions. Second, the results are end-date sensitive, which makes it hard to draw *(con't pg. 2)*

Why I Raise Funds for Alzheimer's?

By George M. Klar…..President, Alternativ Solution Inc.

Each year, I help raise funds for much needed Alzheimer's research. Experts believe this aliment will hit our generation (the baby boomers) hard since we live longer. Sometimes, I get emails from donors along with their contributions....one of which I am sharing below:

> "I wish you well. The disease has touched my family very closely and my thoughts are with you, so you are successful with your fund raising ."

My thoughts and prayers are with your family at this difficult time!

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Alzheimer's Fundraising Results:

Thank-you to my great supporters …..who helped me raise over $5,700 towards this year's Alzheimer's campaign. Our team has raised over $60,000.

Since embarking on this mission nine years ago, I have personally raised over $55,000, My hockey team has raised over $700,000, and the Alzheimer's event itself has raised in excess of $30 million.

Alzheimer's was virtually an unknown disease 20 years ago. Its devastating impact is well known today. Huge strides are being made in the area of treating brain illnesses, and hopefully, we will have a cure for Alzheimer's!

Thanks for your continued and unwavering support.

....Cheers, GMK

definitive conclusions.

The third (and most interesting issue) was that the author compared a 100% S&P/TSX Composite index to a basket of diversified ETFs. The basket itself had 50% exposure to the S&P/TSX Composite index and 50% exposure to 7 different US and global ETFs.

So whenever the US+Global portion outperformed the S&P/TSX index, the author's diversified portfolio would automatically outperform the benchmark. And guess what, during the period reviewed, it did just that.

Now clearly, the opposite must also be true. Whenever the US+Global portion underperforms the S&P/TSX Composite index, the author's diversified ETF basket must perform worse than the Canadian equity index.

In other words, the author did not prove that adding US+Global would **always** produce better returns relative to a domestic only index. Interestingly, the author also states that a diversified ETF portfolio might be expected to have lower volatility. But there were no statistics whatsoever about volatility in the article. The only data presented dealt with performance. Would any average reader be able to figure the flaws out?

Now let's move to an interesting and public performance measurement spat that surfaced in early March 2017. The issue surrounds an article written by Professor Wade Pfau, who teaches at the American College of Financial Services. He wrote the article in Advisor Perspective and titled it "A Warning to the Advisory Profession: DALBAR'S Math is Wrong". It questions the validity of a widely circulated performance report produced yearly by a Boston-based firm called DALBAR. As you can imagine, with a title like that, it was bound to provoke a furious response…..which it did.

DALBAR produces an annual report that reviews investor performance over long periods (1, 5, 10, 15, 20 and 30 years) and compares those returns to popular benchmarks such as the S&P500. The

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report is called the "Quantitative Analysis of Investor Behavior" or QAIB.

According to DALBAR, *"since 1994, DALBAR's Quantitative Analysis of Investor Behavior (QAIB) has measured the effects of investor decisions to buy, sell and switch into and out of mutual funds over short and long-term timeframes. The results consistently show that the average investor earns less – in many cases, much less – than mutual fund performance reports would suggest."*

The most recent publicly available QAIB report is for Dec 31, 2015. The focus of Pfau's article surrounds the methodology in calculating investor returns. The methodology DALBAR uses is proprietary (which is understandable since releasing this would allow competitors to copy it, rendering it worthless).

To simplify, the central question Pfau raised is whether the investor returns calculated by DALBAR are directly comparable to the benchmark index return. Secondly, if there is a difference or gap, how should the difference be interpreted. Does investor behavior causing the gap or is it something else altogether?

To get a sense of why this is important, the DALBAR report for Dec 31, 2015 states the average annual equity investor return for 20-years is 4.67% compared to 8.19% for the S&P500 index, or a gap of 3.52%. If you do some math (compounding), it means an investor who started with $10,000 would end up with $48,277 after 20 years if they invested in the S&P500 but just $24,914 if invested in equity mutual funds for 20 years.

But Prof. Pfau claims the returns calculated by DALBAR are not done properly and the methodology unfairly understates the returns from equity mutual funds.

So who is Wade Pfau? He received his PhD in economics from Princeton University (2003) and earned his CFA charter in 2011 (full bio). He writes extensively on retirement planning issues, is involved in fund management, does some consulting and public speaking. So he cannot be dismissed or taken too lightly.

For those mathematically oriented, Pfau suggests the issues relate to dollar-weighted versus time-weighted methodologies and dollar-cost averaging. More details are found in the article.

So what about DALBAR? The firm was founded by Louis Harvey (bio) in 1976 and provides a broad array of services to the financial industry, particularly the wealth management and advisory areas. Clearly, Mr. Harvey was not pleased with Prof. Pfau's article and gave a forceful rebuttal (found at the bottom of the Pfau's online article). Prof Pfau made some minor modifications based on the feedback…...but he did not change his findings.

So why does this matter? The question everyone wants answered is what causes investor underperformance? Is it investors' poor timing based on greed or panic or something else? Could the large underperformance gap simply be attributed to a calculation error? Our regular readers know that I spend a lot of time explaining human behavioral flaws and their negative consequences for investing.

There is no doubt that individuals do succumb to bad behaviors which can lower their returns. But is this gap really as large as 4.5% (as DALBAR recently indicated for 1-year ending in 2016).

Conclusions:

While I don't know who is correct in this dispute (I don't know how DALBAR does their calculations), Pfau's article is definitely thought-provoking. If DALBAR is correct, humans are lousy at investment timing decisions (I tend to believe this). Maybe they should leave investing to the professionals? (I'm not 100% sure about this one). But if Plau is correct, the large gap is just due to flawed measurement methodology and as such, grossly overstates the problem.

Either way, all investors need to be more aware of the challenges faced in both measuring and reporting performance information. ◘

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