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Understanding Performance

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In my previous life I was a stockbroker for 22 years. In the 1980's I began working with money managers and hiring them for my clients. These were people hired to manage a person's portfolio on a discretionary basis, meaning that the manager made all of the investment decisions in the client's portfolio. At the time, this was relatively unusual. Most brokers only worked with managers through the use of mutual funds, variable annuities, or partnerships. Very few actually hired a manager to manage the specific account of a particular client.

One day, I was attending a meeting at my company with a small group of other brokers who were also engaged in this business. Collectively, in our firm we were the most active in the use of money managers, and certainly had the most total dollars invested with them. In many respects, this entire business within the firm was being developed based on what we were doing. Within this group, several were much more involved with managed money than I was, so I wanted their advice and input about what they were doing and why, what they thought of various managers, and so on. I tell you this so that you understand the significance to me of the conversation that follows.

One person mentioned that he had found a new manager that he really liked. I asked the obvious question, "So how is his performance?" The other broker stopped in mid-stride, turned and looked at me, and said, "Cindi, the first thing you should learn is that you should NEVER recommend a manager based on performance." I was flabbergasted! What do you mean? Why on earth would you hire a manager if not for their performance?

Seeing the look on my face, he tried to explain to me why this was something I should never do. Understand, this was someone I really respected. I wanted to benefit from his wisdom and experience, so I really tried to comprehend what he was telling me. After much conversation, I just gave up. What he was saying made no sense to me at all.

I worried about this conversation for years. What could he have meant? Why would he say such a thing? Why could I not grasp what he was trying to say? Was he missing something or was I? I think I felt the way a scientist must have upon first being told that the earth was NOT flat! It seemed very radical thinking to me at the time.

As the years passed, I became disillusioned with the whole structure of the investment management business. I liked the idea, but found great difficulty finding what I was really looking for. I wanted a manager who would actually manage my client's money, separately and distinctly from everyone else's. Instead, I found that most managers invested the money the same way that a mutual fund did. There was only one big portfolio and every account was the same as every other account. The difference was that your holdings were in a separate account instead of in one large combined account. There are significant tax advantages to this, and there were other small differences, but overall I was disappointed by the structure.

It was partly because of this eventual disillusionment that I decided to become a manager myself, offering what I had been seeking. More importantly, this disillusionment was what made me *finally* understand what my friend had tried to explain to me years before.

I have hesitated to discuss this for years. To be perfectly honest, I think most managers are reluctant to discuss it for the same reasons. First, because it is so counter-intuitive. Second, it sounds like an excuse for poor performance, so who wants to be the one to put the conversation on the table? (Can't you just hear it? "Don't judge by performance? Ha! Now there's a guy who *has* no performance!") And, third, because if you don't decide by performance, what do you look at?

I finally decided that I must at least make the attempt to explain some of the reasons to avoid this thinking. Bernard Madoff pulled off possibly the biggest theft in the history of the world precisely by using this investor thinking against his victims. They weren't looking for the superstar with the big numbers every year. They were very conservative, looking for slow and steady, but always up. (That was a mistake, by the way. There is no such thing as "always up".) I believe the likelihood of your ever running into a similar situation is very slim, but there are more compelling reasons to reconsider your posture.

In the following pages we will examine some of the more common errors in analysis. This is by no means a complete summary of all of the problems associated with using performance in your decision making process. Consider this no more than a starting point.

Aside from the most important fact, that past results do not predict future results (see letter, [The Black Swan](#)), there are three main reasons that reliance on performance numbers will lead you to make faulty decisions. In broad strokes, it is because they are deceptive and misleading, because it is a rare individual who understands the nature of compounding, and because they have nothing to do with you.

Let's divide this into three parts and we will examine each of these ideas more carefully.

PERFORMANCE NUMBERS ARE DECEPTIVE AND MISLEADING

That's a pretty strong statement, but do not read it to imply that there is anything malicious behind this. There isn't. In fact, just the opposite is true. There has been an enormous effort to develop some sort of reporting measure that is *not* deceptive or misleading. Something that is accurate and useful to investors, and gives them a way to compare one manager to another.

Let me illustrate the problem. I am going to oversimplify the math in order to make the concept more easily understood.

You are an investor and you give a manager or fund a certain amount of money to invest for you. Let's say that amount is \$100,000. After six months, your balance has grown to \$150,000. Very pleased by this, you give the manager an additional \$900,000.

In the second six months he doesn't do so well, and the value drops by 10%.

It seems simple. You took \$100,000 out of your pocket and six months later that had increased 50% to \$150,000. You now add \$900,000 to your original investment for a total out of your pocket of \$1 million. But now the manager has this \$1 million plus the \$50,000 profit from the first six months for a total of \$1,050,000.

From your point of view, the \$1 million you took out of your pocket is now worth \$945,000. If you ask for a check, that is how much you will receive. So, in your opinion, the manager lost you 5.5% of the money you took out of your pocket (\$55,000 divided by \$1 million) for this year. This is called period profit. It just compares what you took out of your pocket to what you put back in your pocket at the end of the year. For most investors, this is what they look at first. So the manager should report that the performance was -5.5%.

Not quite.

Had you given the manager the entire \$1 million at the beginning of the year, you would have had \$1,500,000 after six months, but finished the year with \$1,350,000. It wasn't the manager's fault that you gave him the money in the way that you did. His performance on \$1 was up 35% for the year. This is called time weighted return. It treats all subperiods equally (days, weeks, months, or quarters can be used for the subperiods) regardless of how much money was under management during each subperiod.

This is the performance standard that managers who adhere to AIMR or GIPS are required to report. It is the only fair way to compare the results from one manager to another.

But look what happened to you. You think you lost 5.5% of your money and the manager reports that he was up 35% for the year.

There is a third way to measure this performance. Your account grew from \$100,000 to \$150,000 in the first six months. That is an increase of 50% (or an annualized return of 125%). For the second six months, your value declined from \$1,050,000 to \$945,000. That is a decline of 10% for the second six months (or 19% annualized).

Using just these two subperiods, your internal rate of return for the year was -9.7%.

This more accurately reflects what actually happened to you than either of the first two examples. This is called the internal rate of return and it takes into account both the timing and value of the cash flows. It assigns more importance to the returns during the periods when the account is worth more.

Note: When you compare this number to the time weighted return, you can better determine how much of your result is coming from the cash flows and how much is coming from the manager. In this case, you can see that your cash flows caused a dramatic negative comparison to the performance of the manager.

So which one is correct, in the sense that it most fairly reports what happened? Did you lose 5.5% as you might think, make 35% as the manager will report, or lose 9.7%? For the manager, the 35% increase is the most accurate. For the investor, the loss of 9.7% is the most accurate.

Don't you think you could find these figures to be misleading and deceptive? At the very least, confusing?

DO YOU SEE WHAT I SEE?

The second problem with performance numbers can be illustrated by this quick quiz. Assume that these are the annual performance numbers for each of 4 different managers. Pick the one you think will do the best job for you.

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|----|--|-----|-----|------|-----|
| A. | 10% | 10% | 25% | -10% | 15% |
| B. | 10% | 10% | 10% | 10% | 10% |
| C. | 5% | 10% | 15% | 0% | 20% |
| D. | 25% | 10% | 20% | -20% | 15% |
| E. | It doesn't matter. They all add up to 50%. | | | | |

Write down your answer or say it out loud. You want these numbers to be reported to you so that you can use them to help you make a decision, so be sure to make a decision based on these numbers. Do it now before you read on.

Albert Einstein was asked toward the end of his life what was, in his opinion, the greatest discovery of the twentieth century. His answer? Compound interest. For most of us, our brains are just not wired to truly understand the awesome power of compound interest, or even its most basic properties.

The correct answer to the quiz is B. There is no combination of numbers that will result in more money in your pocket than the total number, in this case 50%, divided into equal parts. That's just the nature of compound interest.

The total compound return of \$10,000 invested with each of the managers above is

- A. \$15,654 B. \$16,105 C. \$15,939 D. \$15,180.

How did you do? If you picked B, congratulations! You are in a distinct minority. Most people who see a series of numbers will instinctively pick out the "big" numbers and equate that with being the "best" numbers.

So when we see a series of numbers, we do not all see the same thing. Someone who really understands compound interest will see the series in a different way than the majority of us.

This makes us singularly ill-equipped to evaluate the performance numbers that we do see. Unless you were one of the few people who selected "B", the performance numbers you saw caused you to choose the wrong manager.

Worse, if you chose any of the other managers, by the beginning of the fourth year you were probably convinced that you had made a mistake and switched from your manager to manager D. Look how much better he was doing for the first three years... Study after study shows this pattern in investor behavior, whether the investor is supposedly sophisticated or a novice. This is a clear example of how people use performance numbers to defeat themselves.

Let's look at the third problem with evaluating performance.

WHAT'S THAT GOT TO DO WITH IT?

Once again, aside from the fact that past results do not predict future results, this is the most important reason that an examination of performance numbers can lead you astray. Unless you are a money manager, what difference could it possibly make to you whether you beat the S&P 500 or not? Or any other index, for that matter?

When you invest your money, you would normally have some goal or objective in mind. It could be college education for your children, the purchase of a house, retirement income, a safety net for emergencies, a glorious vacation, or something else.

Whatever your objective, it would usually involve a specific amount of money that would be needed by and on a specific date.

If your child wants to go to Harvard in 2011, you need the amount of tuition money that Harvard says you need, and you need it in June or July of 2011. If you want to retire in 2015 with an annual income of \$100,000 from your investments, we can calculate pretty closely the dollar amount you will need in 2015 in order to make that happen. If you are an endowment or a foundation and you want to give away an inflation-adjusted 5% of your original money every year, then it becomes simple math to say that every year, on average, you need to earn 5% plus inflation plus fees.

Where in any of these situations did the performance of the S&P 500 enter into the equation?

It didn't! Whether the S&P 500 earns -5% or +50% does not change the fact that you need a specific number of dollars on a specific date in the future in order to achieve what you want.

Let's follow two examples. In the first, your child wants to go to Harvard in 10 years. After some research, we have determined that you will need x dollars in ten years for this purpose. Right now, you have some portion of that amount that you can dedicate to this objective. You invest it and with strong markets and good luck you have met your goal within five years. The wisest course of action is that you will now put that money in treasuries and KNOW the money will be there so that your child can go to Harvard as scheduled.

Instead, you decide that it is unreasonable to let all that money sit "idle" for five years, so you put it in the market. You find a great manager who has been doubling money every one to two years! Their performance numbers are swamping the S&P 500! You give the manager the money. The date in this example is Jan 1, 2000. Two years later most of the money is gone and you have to decide which, or how many, of your goals you are going to have to sacrifice to this debacle.

This is a common story. The investor got distracted by the performance of the S&P 500 and by how the manager was performing in comparison to it or to other managers and forgot the goal. Sadly, they now have also failed to meet the goal.

In the second example, let's look at the scholarship fund that we mentioned above. In that case, we need to spend a specific amount of money each year according to a predetermined schedule. In this case, we give 5% of the original fund balance each year in the form of scholarships.

A surprising number of Boards will now approach the decision making something like this: We have to make 5% plus fees plus inflation each year. At this moment, we'll pretend the following: that all adds up to 8%. Treasuries currently pay 4-5%. Therefore, we are going to allocate our funds so that 30% goes into treasuries earning 4.5% and 70% goes into stocks earning the long term average rate of return of 10%. The combined total will therefore equal 8.35% and we will have met our goal.

The first problem with this logic is that the market does not earn 10% per year. It also does not earn an average of 10% per year unless you want to measure over a century's worth of time. The Boards that recognize this will often then move on to the next logical error. They will then try to find the manager who consistently outperforms the S&P 500 and/or similar managers. Their thinking is that this will build up a cushion in the good years that can be drawn upon in the bad years.

But the real issue is that this forgets the objective. In this example, you have to earn this EVERY year. What they need to be looking for is a manager that can consistently deliver 8% or more per year, every year. Only when an actual cushion has materialized from the "or more" can you factor it into your strategy. You cannot create a strategy that *depends* upon an excess being created in the first years from non-guaranteed sources of return.

When you become focused on how you compared to the S&P 500, then you have lost focus on what you were trying to achieve in the first place. Many endowment Boards think it is ok to say that they have two-thirds the money they used to have, but they are proud of their performance because the S&P 500 has only half of what it used to have. They think you should praise them instead of fire them! The bottom line is that they set themselves up to fail to meet the objective, and so OF COURSE they failed.

Take this a step farther. Can you imagine someone running a company who says to their owners and employees, "Business was down 20% this year, but that's actually good news because the S&P 500 was down 25%"?

They would never confuse the difference between the performance objectives of the company and the performance objectives of anything else. Nor would they allow themselves to be distracted from their objectives by comparing them to anything unrelated.

Still not convinced? Let's look at the following five managers. These are real, not hypothetical performance results. All are very well known, even famous. In the case of each manager, I looked at how you would have done beginning in 1997 and then looking at your annualized rate of return after 3 years, after 5 years, and after 10 years. All dividends were reinvested and all fees were excluded. This covers some very good years in the market and some very bad years, so this should give a good idea of what to expect from a manager widely considered to be among the best in the business.

	After three years	After five years	After 10 years
Manager 1	25.65	10.02	8.05
Manager 2	26.11	10.23	8.00
Manager 3	18.58	3.26	6.72
Manager 4	17.58	.51	6.31
Manager 5	26.90	.22	5.94

With all of the benefit of hindsight, which one do you wish you had picked?

If you had manager 3 or 4 after three years, you would probably have been disappointed and switched to manager 5. Of course, that would have been a disastrous decision, shifting funds just in time to get enough bad performance to drop you all the way from an annualized rate of return of 26.90 to .22%. Overall, you probably have decided you would now hire manager 1 or 2.

So let's reveal who these managers are.

They are all the same. They are all the S&P 500 index with dividends reinvested. Manager 1 began in January of 1997, 2 began in April, 3 began in July, 4 began in October, and 5 began in December. All remained invested for three years, for five years, and for ten years from their starting date in 1997.

Were you aware that your starting date and ending date could have so much effect on whether you believe your manager has done a good job for you or not?

So what do you do? If evaluating performance results can be of so little benefit, how do you select a manager? You select a manager who has the style necessary to accomplish your goals in the time frame you have remaining, and the discipline to do what they say they will do. The objective is wealth preservation, risk management, and an acceptable rate of return for the amount of risk taken.

There is only one right way to measure performance.

Did you meet your objective *and* did you do it with the minimum amount of risk necessary to achieve the objective? If you answered "yes", then you had good performance. If you answered "no", then you did not. It isn't any more complicated than that.

Cindi Showalter

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