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Professor says customised benchmarks fail everyone

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Customised benchmarks and performance tracking methods can mess up markets, reduce economic growth, diminish investment returns and deny good fund managers the recognition they deserve, professor Ron Bird has argued.

Measuring managers' performance by comparing their returns against a "continually updated customised benchmark" is unsound because it does not take into consideration the work managers do to improve the design of their process, Bird said.

Customised indices came into prominence in the 1990s. They have led the industry into crafting manager-specific benchmarks that reflect only how good the manager has been at implementing processes in the past.

"What I observed during the 1990s, to my dismay, was a continuing movement towards further customisation of benchmarks in line with refinement. As managers developed a particular style, the trend was to refine the index," Bird said, speaking at the PortfolioConstruction Forum Strategies Conference 2017, in Sydney on Thursday, August 24.

A multifactor performance model employs several factors to explain market phenomena. They incorporate mispriced factors – such as value, momentum, quality, size, high dividend and volatility – which fund and asset managers work hard to exploit in the markets. However, when these mispriced factors become more known, they're added as "explanatory variables", which means managers who identify and exploit them are given no credit and their efforts are undermined, Bird said.

"Think about it. What else can a manager do besides build a portfolio around mispricing in markets? [Yet] the models are refusing to credit the managers for building portfolios that seek to exploit these mispricings."

The value-add is in design, not implementation

To illustrate, Bird gave the example of an exercise that was conducted on US equity managers to find out "how much of the performance they achieve is due to their process, and how much is due to the implementation".

The results revealed that managers offer the greatest "value-add" in their designing of the investment process; whereas the implementation of that process is less significant. Despite this fact, Bird said, the exercise highlights that much of management time is spent on implementation, "adding nothing in either strong or weak markets".

"The name of the game is not implementation…And if we measure [managers'] performance relative to a customised index, we are measuring implementation," Bird said.

Customised indices divert "attention away from the main element", when the industry "needs to focus on the process", Bird said. By applying a "quantitative approach", the investment process should be designed around market inefficiencies, with the key questions being: What are the inefficiencies? How does the investment process exploit those inefficiencies? And why does the manager expect them to exist in the future?

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