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Blinded by data: Finding the truth behind the numbers

Vanguard commentary

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Executive summary. When evaluating portfolios, all too often we forget that numbers can be deceiving. And, even worse, we're coconspirators in the process. We treat the output from our models and formulas with such reverence that we fail to ask the right questions. We get blinded by the clinical precision of the figures and fail to grasp what our portfolios are really telling us.

So consider this a wake-up call for investment committees everywhere. As you regularly assess how well your portfolio is meeting the needs of your organization, remember that this analysis involves more than just quantitative assessment. It requires you to apply qualitative judgment, marrying IQ with EQ, or emotional intelligence. Achieving that balance is no simple task. It's tricky because on one hand you have tidy metrics, numbers, and formulas. But on the other hand your committee also has to navigate the messy group dynamics that come into play whenever you have people involved. Needless to say, the combination of these disparate elements can lead to interesting results.

In the business world and in our personal lives, we rely on data—all kinds of data—to make decisions, whether that's to offer a new product, select a contractor for a home remodeling project, or even buy a new cell phone. Typically it's a process that involves weighing alternatives, and reflecting the specific facts, personalities, and situation to determine the ultimate outcome. Investments take those responsibilities to the next level. As fiduciaries, we need to apply an even higher level of care and deliberation—and documentation—to our decision-making process because we are acting on behalf of others.

The performance conundrum

Too often our investment discussions focus on a single topic: performance. Admittedly, investment managers fuel this dynamic with their investment reviews and reporting that slice and dice performance figures every which way imaginable. It's no surprise, then, that investment committees typically spend a great deal of time discussing performance. Whether the results are good or bad, few can resist the magnetic draw of performance.

Performance can't be ignored. After all, a portfolio's performance directly relates to an organization's ability to achieve its objectives. But assessing performance using the right framework is key. For example, unless a goal is short-term in nature, dwelling on short-term performance can be counterproductive. Instead, it's essential to focus on the long-term—at least five years and preferably ten—for a truer test of how the portfolio has performed under various market conditions. The goal is to identify how much of a manager's success is due to skill, rather than luck or a certain segment of the market currently being in favor (e.g., small-cap stocks outperforming).

We tend to make performance decisions based on emotion rather than careful reflection. If a manager hits a rough patch, we're all too ready to fire him, even though market cyclicality is a fact of life—and even managers with outstanding histories underperform at times.

Performance represents an outcome over which we have little control. And this rear-view look at our portfolios offers little insight into what lies ahead. It's important then to reframe the conversation around the factors that drive performance, which we will discuss next.

Key drivers of performance

As part of a comprehensive evaluation process, investment committees need to vigilantly assess the factors that influence performance—a firm's people, philosophy, process, and portfolio—and stay alert for any changes that may indicate potential trouble ahead. Admittedly, this is no easy task because investment performance numbers can mesmerize us. When they are bad, they are like a scene in a scary movie that we can't draw our eyes away from. When they are good, they grab our attention and tempt us to put our guard down. That's why it takes work to refocus the conversation on more productive areas of inquiry.

For example, staff changes at your investment manager warrant your committee's attention. So if a manager or analyst leaves the investment management firm, try to find out why. Change isn't necessarily a bad thing but it's important to know what's behind it. In addition, read industry publications and network at industry conferences to gauge how your manager is faring competitively. A manager whose assets under management are declining dramatically may be forced to make staff cuts that could affect the firm's ability to execute its strategy.

Conversely, a manager may face capacity issues with a portfolio whose assets have recently ballooned. Or the rise in assets may force the manager to change how he implements his strategy, so that a 50-stock portfolio evolves into a 100-stock portfolio as the manager is forced to make concessions in how he picks stocks based on his larger book of business.

Your committee might also look at your managers' compensation. It should be aligned with the success of the portfolios for which they are responsible. With private investment firms, this is often accomplished with the managers having ownership stakes in their firms. When the ownership structure changes, that represents an opportunity to investigate how that may affect managers' compensation and—even more important—the culture of the firm and its decision-making process.

As these examples show, the factors that drive performance are multidimensional. Therefore, it's helpful to have a framework to apply them. One way to do that is when you meet with a manager, start the meeting by asking for an update on the firm and its people. Then segue into a discussion of the portfolio and its performance, which are outcomes. This approach will give you insights into whether there has been a philosophical or process change that may affect the portfolio. And, just as important, this helps draw your committee's attention away from performance.

Judiciously applying common measures

At some point, the investment committee will need to examine the portfolio from a numbers perspective to get insights on how well it is meeting the organization's needs. We believe this should be a detailed, multifaceted approach. Otherwise, it's easy to get caught up in a particular set of measures and miss the big picture. Below are some common ways that investment committees can stumble:

- **Peer groups.** What could be more straightforward than establishing a peer group for a particular investment? As it turns out, the label given to a set of funds may mask a lot of variation within that category. Consider an equity income fund. The Lipper peer group may include funds that invest not just in equities but also convertible bonds, preferred stocks, and straight debt. But if the fund your committee owns doesn't include those types of holdings, any comparisons might not be that useful. In that case, it may help to construct a custom peer group of funds whose holdings and approach more closely resemble the fund in question.
- **Number of holdings.** Some people would conclude that a manager with many holdings in a portfolio is not executing a very active strategy and may, in effect, be a closet indexer. But you have to understand the segment of the market in which the manager is operating. A 200-stock, large-cap portfolio is not likely to be very active or volatile. But a 200-stock, small-cap portfolio may be very active because of the many stocks that make up that particular universe. In addition, calculating the portfolio's active share may provide a truer sense of the degree of active management.

- **Sharpe ratio.** Sharpe ratios are used to compare investments from the same asset class or from asset classes with similar liquidity and valuation characteristics. This measure is an essential part of the financial analyst’s toolbox. Sharpe ratios, however, are not without caveats. They are extremely time-period dependent, can vary greatly depending upon the length of the period selected, and cannot be used for negative returns. In addition, Sharpe ratios might not be as valid when used with certain asset classes (e.g., private equity) because there is a high degree of manager discretion with price estimates. That has a smoothing effect on standard deviation, which ultimately affects the output for Sharpe ratio.
- **Active share.** Defined as the percentage of a portfolio that differs from a benchmark index, active share is designed to evaluate the degree of active management in actively managed portfolios. A high or low active share isn’t necessarily good or bad. It depends on the investment. A quantitative manager might have a very low active share while a manager who is very much benchmark-agnostic would typically have a high active share.

Metrics like these are critical tools in the oversight of a portfolio, but a simplistic use of them can lead to faulty conclusions. Potential pitfalls are related to the:

- Limitations of historical data.
- Integrity of the data.
- Implied assumptions.
- Challenges in adapting metrics to a specific portfolio.

Maintaining awareness of what these metrics can tell you—and what they can’t—is the best way to sidestep these pitfalls. Avoid placing too much merit in any one piece of data: Instead use the measures in a mosaic fashion for a more fully developed sense of what’s going on with the portfolio.

Avoiding confirmation bias

When it comes to the people dimension of evaluating portfolios, confirmation bias is one issue that investment committees must particularly guard against. It seems embedded in our DNA that we seek information that confirms preconceived ideas while dismissing contrary views or data. As investment committee members, we may begin with the best intentions, but as meetings drag on and job and family pressures encroach on our time, the expedient decision seems more and more attractive—especially when the numbers seem to support it. As fiduciaries, it’s our job to prudently evaluate all relevant information before making decisions. But that doesn’t always happen.

In fact, a Vanguard survey of more than 200 investment committees found that about half of the respondents acknowledged that their committees tend to seek information that confirms their preconceptions. This tendency can lead to less-than-optimal decisions by investment committees, which can affect portfolios’ performance and increase fiduciary risk. Here are some guidelines that can help lead to more thoughtful decision-making.

In addressing confirmation bias, heterogeneous groups appear to be valuable because they can broaden the experience of the group and engender healthy debate. As such, investment committees should strive for member diversity in knowledge, skills, attitudes, and demographics. If your investment committee meetings become too comfortable and predictable, that's a warning sign it's time for a change. A rich, complementary set of skills and backgrounds enables committees to debate issues from a variety of perspectives. Heterogeneity can be accomplished by hiring diverse members or by inviting outside experts to share their perspectives.

Another way to counter confirmation bias is by selecting a devil's advocate. This person can challenge inherited wisdom and question the majority view. Ideally, this role should rotate among committee members. Note that an institutional consultant or advisor may also fill this role. A contrarian, whether by nature or design, helps prevent hasty decisions that warrant more debate.

Finally, although it's tempting, avoid placing too much faith in any single measure. With this approach, you can launch a counter-offensive on confirmation bias before it takes hold of your committee.

Portfolio evaluation requires both sides of the brain

The portfolio evaluation process has to start by defining objectives properly—both for the overall portfolio and for individual mandates. These objectives will vary based on the organization's needs. Although it's important to set clear strategy expectations, it's also vital to allow investment managers the leeway to execute their strategies even during prolonged periods where their particular investment style is not in favor. For example, investment committees can significantly limit their flexibility if they specify in their investment policy

statement that a fund has to be in a certain decile, have a certain number of stars, or even maintain a certain Sharpe ratio.

Because you will be assessing managers over time, carefully select the appropriate benchmark or peer group. And be aware of what goes into those benchmarks and peers groups and how they might evolve over time.

As part of the assessment process, apply any measures judiciously. Of course, avoid reading too much into any one result. Recognize the inherent biases and the shortcomings of the tools, which reflect the assumptions.

Finally, devote some time to educating committee members about the measures used and how they are applied. Strive for ongoing, candid discussions so any decisions are given the weight they deserve and reflect all the relevant data. Qualitative analysis must be supported by quantitative analysis so the committee doesn't make assumptions that aren't supported by the facts. Quantitative measures help in assessing factors such as long-term performance, risk measures, style consistency, and security selection. But decisions about a manager's fitness often come down to qualitative issues such as the experience of the investment team as well as a firm's research and trading capabilities.

Evaluating portfolios is never a simple process, but a comprehensive framework can help your investment committees find the truth behind the numbers.

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