Behavioral Finance and Performance Measurement

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Over the past two decades, behavioral finance has become a significant source of insight into the behavior of investors and the markets themselves. The basic premise is that investors are not only irrational, they are irrational in predictable ways. As humans, we have evolved mental short cuts to organize information. These "back of the envelope" short cuts are termed heuristics. Hersh Shefrin, in his book Beyond Greed and Fear,lists several:

**Anchoring**—the tendency to underreact to information, based on previously held beliefs.

**Mental accounting**—the habit of looking at investments separately rather than as part of a single portfolio. (We tend to treat our "safe money" differently than our "risk capital," thereby making the total portfolio less efficient.)

**Representativeness**—judgment based on stereotypes, e.g., "Losers will remain losers."

**Aversion to ambiguity**—not strictly speaking a heuristic, this is the human tendency to seek clear-cut answers.

**Performance Measurement**

This part of the consulting process almost has become a commodity. Vendors have created software to measure and compare portfolio performance to indexes and peer group universes. The statistics used are grounded in modern portfolio theory (MPT). Consultants meet with clients to review manager and composite performance. The composite typically is compared with a blended index that replicates the client’s asset allocation and a blended peer group that does the same. Risk measures (alpha, beta, r-squared, tracking error, etc.) are calculated against those blended benchmarks. Presumably the point of this process is to help investment committees make sound oversight decisions.

One inevitable outcome of selecting active managers is that, at times, one or more managers may underperform their benchmarks. In a recent DiMeo Schneider & Associates, L.L.C. study, we analyzed all mutual funds with a 10-year track record, focusing on those with top-quartile performance. We found that 91 percent of the top performers spent at least one rolling three-year period in the bottom half of their peer groups. Performance relative to an index is equally spotty. Particularly during a rising market, it is difficult for active managers to beat an index. For example, during the recent bull market for value stocks (January 1, 2000–June 30, 2007) the average large-cap value manager lagged the Russell 1000 Value Index (R1000V).

**Unintended Consequences**

Assuming the client has at least some active managers, the review process may not be entirely helpful. It takes the most important part of the process, asset allocation, as a given and instead shines the spotlight on manager performance. In behavioral terms, we aid and abet clients in becoming anchored on the wrong things. For example, since 2000, broadly diversified asset allocations that included foreign stocks, real estate investment trusts (REIT), small-cap stocks, and treasury inflation protected securities (TIPS), significantly have outperformed the traditional 60/40 mix of large-cap U.S. stocks and investment-grade bonds. The client may have made millions of dollars as a result of the asset allocation decision. However, the review focus becomes manager performance (the 5-percent contributor) and not asset allocation (the 95-percent contributor).

Furthermore, a well-diversified client may have allocations to 10 or more different asset classes and therefore 10 or more managers. Because of time constraints, the quarterly review may devolve into focusing only on the “problem children”—the underperforming managers—a form of mental accounting. Because of the representativeness heuristic, investors come to believe that their overall results are “bad,” and they are disappointed. The consultant may become defensive. Investment committee time, already in short supply, is wasted on the wrong things. There may be excessive manager turnover, with its well-documented toxic effect. The entire investment process even may be short-circuited.
Possible Solutions
Below are some suggestions for dealing with the unintended consequences of imperfect performance measurement intersecting with irrational human behavior.

Index everything, even inefficient asset classes. While avoiding the issue of manager underperformance, this strategy still may be counterproductive. First, passive investing works well in some periods and not so well in others, so there still may be disappointment. (Few were pounding the table for index funds during the three-year bear market.) Secondly, after a short time, committee members no longer may want to meet quarterly because “there is nothing to review.” And because quarterly investment committee meetings are the forum to introduce new investment strategies or asset classes, investment policy may cease evolving.

Create more appropriate benchmarks. “The previous allocation,” “similar funds,” “target return,” or “a typical allocation (e.g., 60% S&P 500/40% Lehman Aggregate Bond Index)” may be more appropriate. However, multiple benchmarks run afoul of investor aversion to ambiguity. As humans we all want simple answers to complicated questions.

Track the cumulative asset allocation effect. This solution requires that allocation changes be diligently recorded. After a number of years, committee members may question the relevance of a comparison to a previous allocation.

Move to a more qualitative review of manager results. Analyze “behavior” more than performance. For example, if the client hired a high-yield bond manager who avoids C-rated debt, the client should be happy when the manager lags a market in which C bonds outperform. Focus on people, process, philosophy, and specific actions and de-emphasize the purely quantitative.

All of the above. Ultimately, a consultant’s role is to help clients make sound investment decisions.

As an industry, we need to examine whether the standard performance reporting process helps or hinders achievement of that goal.

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Endnotes