

## **The Trouble with Investment “Track Records”**

Most prospective investment clients want to have some idea of how well an investment advisor has done with other people’s money before turning over any of their own. Unfortunately, records of past investment performance, often called “track records,” are, at best, not completely representative of the advisor’s actual past results; and, at worst, can actually be misleading.

Trying to understand an investment advisor’s past investment performance begins with finding out how his record was compiled in the first place. In so doing, however, the potential client is confronted with two problems: one having to do with choosing the right rate of return to consider, and the other involving the procedures used for the rate of return calculations.

To begin with, there are two quite different, and seemingly contradictory, rates of return that can be calculated for investment portfolios. Further, each rate of return is an accurate and correct measure of two distinct investment results.

One rate of return, called an “internal rate of return,” or IRR, correctly reveals the results achieved for the owner of a securities portfolio. The IRR, also called a “dollar weighted” rate of return, is dependent upon the amount and timing of all the portfolio’s cash flows, over which the portfolio manager usually has no control. Because the timing of cash flows has such a bearing on the IRR, it is the wrong measure by which to judge the success or failure of the portfolio manager. Another rate of return can be calculated, called a “time weighted,” or geometric mean, rate of return, and it is independent of the portfolio’s cash flows. As such, the time weighted rate of return is the only fair basis on which to judge the performance of the investment manager. However, it must be kept in mind that the time weighted rate of return will not usually provide an accurate record of the results actually achieved for the owner of the portfolio.

The calculation of the portfolio rates of return requires identifying each and every cash flow into and out of the portfolio for the entire time period covered by the performance analysis, including all purchases and sale transactions, reinvestment of income and capital gains distributions, deposits and withdrawals, etc. The procedure is both complicated and time consuming and can be quite expensive if done by an independent accountant. It is, therefore, unusual for an investment manager to have returns calculated for all of his portfolios by an independent outside party, who can vouch for their authenticity. As a compromise, most investment management firms have returns prepared for an average of several selected portfolios or for a single “model portfolio,” presented as representative of all the portfolios managed by the firm.

Many investment managers claim to present audited performance data when, in fact, the accountant involved has merely accepted the manager’s cash flow data and done nothing other than simply make the rate of return calculations based upon the data submitted, without in any other way verifying its accuracy.

Another potential problem with “track records” posted by many investment managers has to do with the fact that returns, whether for separate portfolios or shown as an average of several

different portfolios, are almost always calculate only for *existing* portfolios. Rarely are returns shown for *all* portfolios, past as well as present, that were actually managed. Those accounts lost by the investment manager, often as a result of poor performance, are not included. Consequently, many such performance records have a built-in upward bias. They are based largely on a manager's surviving clients, which are usually his better account. Most investment advisors' "track records," then, tend to include all of the "good news" and omit most of the "bad!"

In summary, to receive an unbiased measure of a manager's past investment performance you would have to obtain the complete returns for all of the portfolios he has ever managed; and those returns, to be acceptable, would have to be calculated by an independent party who could also verify the complex cash flows upon which the rates of return are based, as well as the accuracy of the actual calculations. It is not at all surprising, therefore, that an investor can rarely choose an investment advisor solely, or even primarily, on past performance figures. Most investment "track records" have to be taken with the proverbial "grain of salt!"

Happily, there is a way to avoid the performance dilemma in which so many prospective clients of most investment advisors find themselves. A large class of investment managers have complete, reliable and publically available performance records.

The managers of *mutual funds* have to operate always in the limelight of a very competitive and regulated marketplace where their investment results are constantly updated, displayed and independently monitored. Consequently, the "track record" of a public mutual fund manager, whether truly indicative of future results or not, is at least a comprehensive and dependable representation of what that manager has actually accomplished in the past. Practically all of the previously described problems with the determination of representative portfolio rates of return are completely avoided when dealing with mutual fund investment performance data. With mutual funds, then, it can indeed be said that "What you see is what you get!"