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MONEY MANAGEMENT

Positive past performance may foretell negative future

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Pension funds that set performance-based hurdles to screen manager searches — such as requiring top-quartile results over the prior three years — might be shooting themselves in the foot.

A recent study of 12,500 institutional strategies by Mercer Investment Consulting Inc., New York, concludes that excellent recent performance not only doesn't guarantee future results but "generally leads to underperformance in the subsequent period."

Terry A. Dennison, a Mercer senior consultant in Los Angeles and the study's author, said in a telephone interview that the results raise the tantalizing question of whether past performance is actually a "slightly negative indicator" of future returns.

If so, the widespread use of performance-based screens to identify "hot" managers — understandable in organizations where decision-makers have to defend their choices — might be "just about exactly wrong," the study concluded.

Mr. Dennison looked at institutional offerings of more than 2,300 investment managers globally to see how often strategies that posted above-median or top-quartile results for an initial three-year period repeated that feat in the subsequent three years. In all cases, the results fell below what a random coin toss would have predicted.

For example, while at least 50% of the portfolios that delivered above-median gains for the initial period might have been expected to repeat over the following three years, Mercer's study of managers in 15 separate domestic and international investment styles showed only the small- to midcap core and value segments coming close, at 46.9% and 45.7%, respectively.

35% effective

The bulk of the remaining market segments only succeeded 35% of the time in posting above-median results the second time around. Small-cap core strategies trailed the pack at 29.6%.

And while 25% of top-quartile managers for an initial three-year period should have been expected to achieve that goal again over the subsequent three years, Mercer's study showed only the developed market international segment exceeding that target, at 28%.

Many more styles posted consecutive bouts of top-quartile performance only 15% of the time, while managing to deliver above-median returns in the subsequent period only 30% to 40% of the time. “It does not appear that even top-quartile performance provides much predictive value,” the study concluded.

But managers fared better with their ability to add value, defined as outperforming their benchmarks by more than 100 basis points.

The study found managers who made the grade in the initial period were able to deliver again in the subsequent period between 50% and 60% of the time for most styles.

Far from being shocking, Mr. Dennison depicted his initial findings as “more a proof of what everybody in the back of their mind knows” — that picking managers on the strength of their latest gains does little to separate the lucky from the prescient.

No change

The findings won’t alter Mercer’s own manager search operations, which already focus on qualitative aspects such as a manager’s investment process, risk controls, sell discipline and ability to generate investment ideas, he said.

However, Mr. Dennison expressed the hope that the results — which have been distributed to Mercer’s institutional clients — could prompt pension fund executives to consider introducing more flexibility into their use of performance-based screens.

Citing his own involvement in “hundreds of manager searches,” Mr. Dennison said he couldn’t remember a single case in which an institutional client agreed to hire a manager with poor recent results, no matter how highly rated that manager was in qualitative terms.

In its recommendations for further research, the study asks whether institutional investors seeking managers with a high probability of future outperformance should look at those highly regarded in qualitative terms that have underperformed recently.

Mr. Dennison called his research a work in progress, and said the next installment may examine how individual managers in the study fare in terms of their rank order from one period to the next. Falling from fifth place to 52nd place is different from tumbling to 95th place, he said.