Why We Love Standards

My dad always says, “It takes trust and integrity to sell elastic band by the yard!” The same thing goes for investment performance and risk measurement. Portfolio performance and risk measurement serve at least two purposes:

Purpose 1: Determine how a portfolio is doing.

Performance and risk are measured to quantify how well the portfolio has done over a certain timeframe, and to see if that performance is likely to continue in the future. Portfolio performance is measured by return, and portfolio risk is measured by volatility (standard deviation) of return. That seems straightforward until we zoom in on the details of what “well” means, and how return and standard deviation and their calculation frequencies are defined.

Purpose 2: Tell clients how their portfolios are doing.

It could be that the portfolio by which the performance and risk is measured is not owned by you, but managed for somebody else. That “somebody” could be external, like private or institutional investors, or internal, like the board of the company or an investment committee. This is where things can get less clear. While the performance and risk metrics should be transparent and objective, the chosen methodology should also put the numbers in the best light possible, as you want to keep your existing clients and hopefully attract new ones. The main way of doing that is to have an attractive track record. Again, we have yet to define the specifics of what an attractive track record means.

Between these two purposes there are enough nooks and crannies to make an English muffin envious.

Let’s start with return, and its very broad definition as the change in value over a certain time frame. Things to consider include how value should be defined, with what frequency value should be measured, and how value or return should be aggregated, both in terms of detail holdings to overall portfolio and across time.

The next thing to think about is whether the return metric(s) should stand alone or be compared to a benchmark. Measuring your performance and risk against a benchmark adds some desired transparency and objectivity to your metrics. If you are beating the benchmark, then it is even better. But you need to make sure that you are comparing apples to apples, which means that the metrics should be aligned with how the benchmark is tracked. Obviously, not all benchmarks are tracked in the same manner. There might be more than one appropriate benchmark, and in general benchmark details can be hard to secure.

Deciding on a methodology for return and risk measurement is just the first step to building a track record. Then there are headaches like data availability, quality and consistency, as well as the process of generating, validating, and publishing the metrics in a timely manner.

Even then, building a track record takes time, and things happen while you are building it. Data sources and benchmarks change. More importantly, the portfolio(s) you are managing might change, so the methodology that you started with might not be the best one over time. That said, it is not the best idea to change an established methodology, at least not too often, as it detracts continuity, transparency, and credibility of the track record.

That is why we love standards. A standard is the magic wand that makes all of these tiresome decisions and issues go away.

The Global Investment Performance Standards (GIPS standards) are specifically for investment performance.

The GIPS standards define how and when value should be measured and how portfolio return is derived. It is not necessarily the only way, but it is appropriate for most asset classes and scalable. That is the first thing advantage to standards: they define the details, so you do not have to.

Of course, standards are only as good as those following them. GIPS standards have been around long enough to set the bar and gain popularity, and have reached a level of maturity where details have been fleshed out.

Standards also provide a common language. Stating that the metrics are GIPS compliant can save you from spending a lot of effort explaining the methodology of the performance metrics, because everyone knows what that means.

Obviously, it also makes the metrics comparable, not only with benchmarks, but also with competitors that follow the standards. This provides the much desired transparency, objectivity and credibility of the metrics. If you are starting out, following the standards will lend you these traits even before you have a demonstrable track record. And while the standards could change, they rarely do, so you will not have to, either.

Last but not least, standards reduce the costs of generating performance metrics. Most data providers will support industry standards, meaning less data processing on your part. The same goes for benchmarks, so you will not have to convert your numbers, nor theirs. And if you need to implement a performance measurement system from scratch you can take advantage of a standard system.

In short, following a standard lets you focus on investment performance, rather than its measurement.