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The Importance of Actual Returns In The Due Diligence Process

By Mike Posey

Seven Reasons Why Investment Managers Should Document Actual Performance

Introduction

Everyone is familiar with the old Chinese proverb saying, "A journey of a thousand miles begins with a single step." The same can be said about the journey to become an Investment Manager, whether it is for direct clients, on behalf of other Advisors serving as asset accumulators and subadvisors, or both.

Laying the proper groundwork can set the stage for a successful Investment Manager to attract millions (or maybe billions) of dollars in assets. Failure to do so can result in just the opposite, even if the investment model is viable. The important thing to remember is that the journey is a process, not an event, so planning is a must.

> *"…imperfect as it is, actual performance beats whatever is in second place by a country mile."*

Once the heavy lifting of developing a model strategy is done, the next step is to prepare for the due diligence process. Investopedia defines due diligence as, "An investigation or audit of a potential investment. Due diligence serves to confirm all material facts in regards to a sale." To say the least, due diligence is an integral part of the investment industry and is among the first hurdles that must be cleared by new Investment Managers.

The role of a due diligence team is to dissect an investment from every way possible. It not only includes detailed analysis of performance data, but also administrative and operational reviews as well. Some have described the due diligence process as a cross between an IRS audit and a police interrogation, where no stone is left unturned.

While the subject of due diligence covers a lot of territory, this white paper will focus on the importance of documenting and verifying actual performance of model investment strategies during the due diligence review process. In doing so, it will also expose the limitations of backtesting and hypothetical returns. It is intended to be a resource for both investment management professionals providing third-party investment management as well as due diligence professionals seeking out this talent.

Background

Everyone in the investment industry is very familiar with the disclosure, "***past performance is not necessarily indicative of future results***." However, having spent more than 16 years of my career participating in due diligence reviews of third-parties, I know that large individual investors, institutions and third-party Investment Advisors are often drawn to impressive historical performance. After all, imperfect as it is, actual past performance beats whatever is in second place by a country mile.

That's why, during the due diligence process, an actual track record is often the first item of documentation requested. It's only natural that a due diligence team would want to verify the returns that attracted them to the Investment Manager in the first place. Unfortunately, the due diligence process is often derailed when it is discovered that all or part of a promising long-term track record is hypothetical, based on backtesting of a quantitative model after-the-fact.

The presence of hypothetical performance often represents little more than a best guess generated by a mathematical algorithm applied to historical market data. It is therefore important for the due diligence professional to understand the limitations of backtested data as well as know the advantages of actual performance that has been verified by an independent third party. This white paper will address both of these issues.

Thoughts and opinions expressed in this paper are based on the research and experience of the author and are not intended to constitute legal or compliance advice.

For purposes of this white paper, the tracking of actual investment performance will be defined in terms of managed accounts using quantitative model strategies in which one representative account reflects the performance of all similarly situated accounts.

Tracking Guidelines for New Strategies

Before getting into the advantages of actual performance, let's discuss strategies that have never been traded in an actual account. The reasons for this vary. Some models have been sold as signals to other Advisors or published in a newsletter and not traded in a real-time account by the model developer. Others represent concepts that are too new to have an extensive actual track record. Still others do have some actual performance but supplement a short actual track record with backtesting to provide a longer-term view, albeit hypothetical.

It is extremely important to have a realistic view of backtesting and hypothetical performance. While backtesting can be an invaluable tool in the search for investment management talent, it is of limited use in a due diligence review.

Why? Because if a trading model does not produce an acceptable backtested return, you'll never see it. Unsuccessful models are usually scrapped or modified until they do work. That means there can be a significant optimization or "curve fitting" built into the model that you eventually get to see. Only actual trading of the model over time can tell whether or not the concept and methodology are viable.

While Investment Managers with new models have no choice but to rely on hypothetical figures based on backtesting, they should start tracking actual performance as soon as possible using the following guidelines:

"One thing you cannot do is re-create an actual track record – what you can do is start."

1. **Innovate and Then Incubate:** The first suggestion should be common sense but there are some Investment Managers who neglect to trade their model in a test account at all. Rule number one is that test accounts should be established and traded strictly according to the model's discipline.

   There are some model developers who currently seek only to sell or publish signals and not actually manage money. Unfortunately, proof of issuing a signal is not necessarily the same as actual real-time trading results when it comes to due diligence. Should the model developer later decide to start managing assets, performance from historical signals may be deemed only hypothetical. Since no one knows what the future holds, it's a good idea to establish a tracking account for each model as early as possible even if only selling signals, just in case there's a change in plan.

2. **Keep It Simple:** Select an account or fund a new one with few or no planned additions and withdrawals to make performance verification easier. The tracking account should also be net of fees, wherever possible.

3. **Avoid Commingled Accounts:** Trading multiple models in a single brokerage or mutual fund account can make a due diligence team's verification of a single model's performance difficult if not impossible. The team is required to figure out which trades go with what models as they seek to reconstruct the historical performance. In situations where it's impossible or impractical to separate the performance of multiple models in one account, the Investment Manager could see years' worth of actual performance simply disregarded.

4. **Third-Party Verification:** Establish a relationship with an independent third party to verify results. Whether it is an accounting firm, online tracking and publishing service or other provider, arrange to have performance documented and verified. Some providers can only verify future performance while others can reconstruct an historical track record if sufficient documentation exists.

While new models must rely on backtesting and hypothetical results, the ultimate goal of the model developer is often to serve as an Investment Manager. That, in turn, means scrutiny by due diligence teams who will want to see actual, verified returns. That's why this paper recommends moving away from backtested performance results in favor of actual, verified returns as soon as possible. As a successful Investment Manager colleague puts it, "*One thing you cannot do is re-create an actual track record – what you can do is start.*"

Seven Advantages of Actual Performance

It should be clear by now that actual performance is superior to virtually any kind of backtested or hypothetical track record. In addition, there are a number of other advantages of actual performance that are evident for purposes of due diligence:

1. **Trust is Not a Due Diligence Tool:** Self-reported performance numbers are often not verified by a third party before being published. Obviously, mutual funds and hedge funds are required to have audited returns, as are firms that comply with the Global Investment Performance Standards (GIPS), but many separate managed accounts depend upon the accuracy and honesty of the Investment Manager for historical returns.

   While most managers are professional and honest, there are those who "cook the books" to appear better at managing money than they really are. If you don't believe me, just look over the misrepresentation cases brought by the SEC and FINRA every year.

   "Many Investment Managers claim to have a 100% mechanical system when, in reality, they find it hard to follow the model during volatile market environments."

   In the due diligence process, it is important not to let trustworthiness replace documentation and verification. To do otherwise could put your clients' accounts in harm's way. Just remember, clients of Ponzi scheme promoter Bernie Madoff had the utmost confidence and trust in his performance numbers, even after they had been called into question.

   From the Investment Manager's point of view, don't get bent out of shape if a due diligence team seeks verification of your published track record. They're just doing their job.

2. **Pulling the Trigger:** Actual performance during pivotal market environments allows you to see how investment models actually handle these different scenarios rather than how they might have (or should have) handled them as illustrated by backtesting.

   Look at it this way, if you are hiring an Investment Manager to manage part of your clients' assets, isn't it important to know how accurately trades are executed? An excellent model strategy can be rendered substandard if not executed properly. In a backtesting scenario, market environments, computer breakdowns, vacations or lack of a viable backup trader never come into play, but they do when actually trading funds.

3. **I Second That Emotion:** Another benefit of actual performance is that it shows how the model was actually traded during periods of elevated volatility when stress and emotions run high. In other words, actual performance includes the effects of emotional trading, if any. Some Investment Managers claim to have a 100% mechanical system when, in reality, they find it hard to follow the model during volatile market environments.

> *"I wish I had a nickel for every time an Investment Manager told me that he made some adjustments to his model to 'smooth out' high and low spikes in backtested returns."*

Backtesting simply cannot illustrate an emotional decision to trade or not trade based on a swirl of negative global events. Most quantitative investment models are 100% mechanical, meaning that they produce a trading signal without regard to any human discretion.

However, is that how it would be traded in an actual market environment in which the manager is being influenced by his or her own emotions? Or angry calls from clients? Think October of 1987 or September of 2001 or even October of 2008.

When the wheels appeared to be coming off of the market, did the manager trade the signal or override it? Backtested results say the trade would be made because emotions do not come into play. However, you can never know for sure what the effect of emotions might have been unless you see how the model was actually traded.

4. **Making Life Easier for the Due Diligence Team:** Due diligence teams often ask for a strategy's actual performance as one of their first items of business. The reason is that these returns are usually input into a variety of sophisticated software products designed to slice and dice the data for further analysis.

Having access to actual performance that has been verified by a third party saves a step in the due diligence process. Otherwise, absent an audit or other performance verification, the due diligence team will have to go through stacks of statements to prove the track record is the same as is being marketed. Access to actual, verified performance ready for review can make the due diligence team's life a lot easier.

Fortunately, there are online performance tracking and publishing firms that provide third-party verification of actual trading results. The service provided by these firms allows due diligence professionals to go straight into analysis without having to go through the time-consuming process of verifying performance.

5. **Pig in the Python:** It's common knowledge that long-term averages are sometimes skewed by large short-term gains and losses. Actual performance lets you see how the strategy performs during good markets and bad, including large up and down spikes.

I wish I had a nickel for every time an Investment Manager told me that he made some adjustments in his model to "smooth out" high and low spikes in backtested performance. Actual performance allows the due diligence team to see these roller coaster rides and make up their own minds as to whether the Investment Manager was lucky or smart.

On a related note, actual performance also allows a due diligence team to witness any effects of capacity constraints in real-time trading. It can also document any performance consequences from a large influx of assets under management (AUM) which often occur after a large spike in performance. Here again, backtesting simply cannot factor in capacity and AUM constraints that occur in the real world.

"Unfortunately, many investors look only at return metrics and leave risk out of the equation, which is why due diligence teams tend to concentrate so much on risk management"

6. **Don't Forget the Downside:** While it's true that past actual performance cannot predict favorable future results, studies have also shown that past risk is a pretty good indicator of future risk. Unfortunately, many individual investors look only at return metrics and leave risk out of the equation, which is why due diligence teams tend to concentrate so much on risk management.

   One of the more important risk metrics available from actual performance is that of **"maximum drawdown."** In a nutshell, max drawdown is a measure of an investment's performance from a peak in value down to a subsequent low. Knowing a model's history of drawdowns, how long they lasted and how long it took to break even again are all important facets of a strategy's performance.

   You might be thinking that backtested data would also show these drawdown statistics, and you'd be right. However, remember what I said earlier about wishing I had a nickel for every time an Investment Manager tweaked a model to smooth out peaks and valleys. The result of this smoothing is that you'll likely never see a hypothetical performance record with a major negative drawdown.

7. **Beware of Style Drift:** A final feature of actual performance that is superior to backtested results is that of style drift. Normally, style drift refers to mutual funds whose actual portfolio is not in tune with their stated objectives. In relation to managed accounts, style drift occurs when trading patterns are modified and/or investments are traded that are not in line with the original strategy of the model.

A good example of such a style drift would be a model developed to trade Nasdaq 100 index funds suddenly performing well when using the Dow Jones Index instead. Such an event is likely to happen with almost any strategy, but it's rarely a lasting phenomenon.

Conclusion

For the Investment Manager seeking to build assets under management through the use of model strategies, it's important to plan for the eventual due diligence process. The above discussion has sought to provide guidance regarding the documentation and verification of an actual track record as one of the initial steps toward becoming a successful Investment Manager.

It should be noted that tracking and verification of actual track records are not only beneficial for model developers, but also Advisors and investors seeking out effective third-party investment management talent. It's one of many tools required for a comprehensive due diligence review, but I would argue that it's one of the most important such tools available.

Tracking and verification of actual performance data is provided by a number of different firms in the industry, ranging from accounting firms to online providers. Theta Research is one such firm, specializing in verification of actual performance based on data from third-party sources. For more information on Theta's services and prices, call or e-mail Mike Posey using the contact information below.

As always, keep in mind that past performance, no matter how well documented, cannot guarantee favorable future results of any investment strategy. This publication is not intended to provide any individual investment, financial, legal, regulatory, accounting or tax advice. You should consult with your own professionals for information regarding your specific situation.

About the Author

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