DRIVING FORCE

How performance evaluation is becoming an engine of investment industry growth

CFA Institute

INDEX

INTRODUCTION

Performance evaluation is coming of age. Once a narrow, back office role focused solely on crunching returns, it has become ever more integrated into the DNA of investment firms. Both internally and externally, performance evaluation adds value, helping senior management make key judgement calls where the difference between the right solution and the wrong solution is the difference between growth or decline. The performance analyst of the future will provide valuable input into nearly every area of an investment firm.

What began as a mathematical task—calculating investment returns—is morphing into something much broader. The objective of performance evaluation today is determining what is behind the return being analyzed. What were the key drivers—allocation or selection? What risk was taken to achieve the return? Was it skill, or was it luck, that produced the return?

Outsourcing and technology, once seen as threats to the performance analyst role, have only enhanced it, giving it more tools to work with. A world of technological advancement, more complex investment strategies, and more demanding investors necessitates skilled people with industry insights to process it all. In this world, performance analysts will increasingly be viewed as problem solvers, called on for any number of data-related tasks.

So where is performance evaluation heading next? And how might performance analysts interact with and enhance other key investment firm functions?

1. THE LITTLE-KNOWN MOTOR UNDERPINNING THE INVESTMENT INDUSTRY

Few people on Main Street have heard of performance evaluation. Even the specialist investment media focus on investment strategy and on the star portfolio managers without specifically referencing performance evaluation.

Yet without performance evaluation, ordinary investors would have no visibility into their funds' performance and no way of comparing one fund to another. That is the performance analyst's fundamental role. But what started as a purely mathematical task—calculating historical performance over specific time intervals—is morphing into something decidedly broader.

In recent years, performance analysts have extended beyond performance measurement to performance attribution and appraisal, evaluating data quality, assessing the worth of competing benchmarks, helping asset owners choose fund managers, comparing factor models, and much more.

The objective of performance evaluation today is determining what is behind the return being analyzed. What were the key drivers—allocation or selection? What risk was taken to achieve the return? Was it skill, or was it luck, that produced the return? If it is skill, the performance analyst needs to identify which skill, how much of that skill, and in which circumstances that skill prevails.

A DAY IN THE LIFE

Joe Kavanagh's job title tells half the story, at most. As head of performance measurement and risk analysis at KBI Global Investors, he manages a small team of analysts measuring and analyzing the investment performance of client accounts. He is responsible for the performance attribution reporting process. Joe, a CFA® charterholder, is also in charge of the market risk measurement function for KBI's equity strategies. In addition, his team provides quantitative support to the product development team by constructing business cases for new product ideas, backtesting and modeling new product ideas, and creates key marketing messages for the sales teams. In fact, there is hardly an area of the firm's activities that Joe and his team are not involved in. Joe's job title only hints at all the tasks he and his team are required to perform.

A cornerstone of performance evaluation is still the calculation of portfolio returns and measures of risk, combined with benchmark and peer group analysis. This core process is then layered with performance attribution that seeks to uncover the source of returns, incorporating the risk taken to achieve them.

Appraisal then assesses the extent to which returns are attributable to luck or skill, feeding the finding back into the investment process. The appraisal process can also be used to inform decisions about the retention or hiring of investment managers and may also affect other processes, such as sales and marketing.

As Carl Bacon, chief adviser to StatPro, a technology provider to investment firms, says, "Performance evaluation is moving from the fringes of the organization toward its center."

2. THE WHIR OF MACHINES GROWS LOUDER

The evolution of performance analysis has been driven in no small part by the rapid increase in the availability of data. Without useful, relevant data, none of the processes just described are possible.

The problem, if anything, is too much data. New and complex strategies create new variables and correlations. Unstructured data from sources such as surveys and sensors, emails and video, and webpages is stretching the worldwide web to its limits.

Making sense of all this data—interpreting it so it adds value—has become a priority for most investment firms.

The solution to making sense of all this data is technology. The technology sector is aware of the investment industry's growing needs and provides solutions that help the investment industry as a whole and service the specific needs of individual investment firms.

Machines are now edging performance evaluation away from the inefficiency of spreadsheets. "The evolution of technology and the increase in capabilities that can be automated mean a lot of processes that analysts were trained do to are done by computers," says Frances Barney, head of Global Risk Solutions at BNY Mellon Asset Services.

Computers can process massive quantities of data simultaneously. Analysis can be performed daily, rather than monthly or quarterly, as it was in the past. It can be performed on each security, not just on portfolios, and it can break security returns into factors. Technology translates data into workflow, allowing for swift communication of data with stakeholders and clients, often via cloud-based networks.

And the scope of technology has widened far beyond the computation of investment returns. "Yes, it performs calculations, but the ingestion and translation of data has more and more downstream uses," adds Barney, a CFA® charterholder.

So while accounting systems with core data are standard at investment firms, systems designed for "downstream" deployment of data are growing fast. KBI Global Investors, for instance, regards its accounting system as its data hub but can migrate that data into a variety of value-add technology tools. These include a performance attribution tool and a style analytics tool that assess the tilt of a portfolio, whether to value or growth, to a high P/E or a low P/E, and so on. Some systems are developed internally, while others are built and installed by external providers. "We have a wealth of toys from a variety of sources that help us build knowledge and expertise," says KBI's Kavanagh.

As a result, performance analysts can now use time, which might have been spent on repeatable, standardized activities, applying their experience and judgement to add more value across the firm.

Alongside advances in technology, another factor having a major effect on performance analysts' work is outsourcing. Rather than retaining teams and buying expensive systems for performance measurement, investment firms and asset owners are increasingly outsourcing the function—or part of it—to specialist providers of performance evaluation.

These providers may have hundreds or thousands of investment clients, which means they can harness economies of scale. Their workforce may be subdivided into specialized teams that deal with certain types of investments—equities, bonds, real estate, hedge funds, and so on. The specialist providers have the resources to update their technology to reflect new developments and then share this cost across a large number of clients. They use their knowledge of one client to inform how they service other, similar clients. They may also offer self-service apps, giving clients access to technology that allows them to drill down into their data, however and whenever they choose.

The dual advances of technology and outsourcing have created concerns among performance analysts that their role will become redundant. This fear was voiced in the May 2019 Investment Professional of the Future survey of CFA Institute members and candidates. When asked whether their roles would still exist in 5–10 years, approximately 19% of performance analysts responding thought their roles would cease to exist compared to 3% of all respondents.

However, many experienced performance analysts are emphatic that their role will not only survive but also grow in importance because the role will change.

"I see some roles pivoting to external vendors, but I don't see performance roles ceasing to exist," says Todd Jankowski, partner and head of performance reporting and analysis at Adams Street Partners. When a young member of Jankowski's team expressed anxiety about his job, Jankowski was able to reassure the individual that the role adds value and would always exist in some form.

Kavanagh agrees: "I don't believe that by employing machines I am the author of my own demise. I am a big believer in getting the maximum help for the grunt work that used to eat up all our time, and then using this time more productively."

So why are experienced performance analysts so confident about their future, and the part they will play in a technology-enabled investment industry?

3. MAKING DATA MAKE SENSE

Far from undermining the performance analyst, technology has emphasized performance evaluation not just performance measurement. While technology enables mass calculations and increases the accuracy of research, the output often leaves gaps in understanding that require interpretation. Without interpretation, calculations and research may not be practically applicable, meaning the technology alone does not add value.

"If you automate data, you are not always going to understand the number that comes from that automation," says Jankowski. "You can have a system spit out a number, but if you can't explain it and can't put it into the context of the marketplace, then you are not adding value."

He points to a large global institution that has over a dozen external data systems but struggles to reconcile the numbers that emanate from each. Part of the problem is that users can employ the technology without needing to understand the underlying concepts. "If you build a car from scratch, you need to know exactly how a car works," says Jankowski. "The trouble is, most people just want to drive the car."

Only by understanding the fundamentals of the evaluation being performed can users assess the outputs from technology systems and spot errors and issues before, based on that output, they disrupt the investment process.

Kavanagh confirms this. "I've never regretted learning this job from the bottom up," he says. "I don't consider it a waste of time, despite today's technological advances, because you need that knowledge to understand the output. Who else in the room is going to tell you a number can't be right?"

Performance evaluation is evolving: performance analysts are pivoting to become interfaces, explaining and interpreting data that flow both within a company and out to clients. They may also be important in the rollout of self-service models, helping colleagues understand and use third-party technological tools.

Rather than heading for extinction, the performance evaluation role is evolving. Except for return calculations for complex and illiquid strategies, traditional performance measurement will likely be automated and some processes will be outsourced. But the performance analyst's role will increasingly be essential in helping investment firms, wealth managers, and asset owners to interpret, contextualize, and repurpose data.

If performance data reveal that a strategy is underperforming, the fund manager's natural response is to retest the underlying assumptions behind the strategy. But performance analysts have the ability and tools to ask different questions: Is the benchmark the right one? Has it changed? Is the peer group comparison valid?

In other words, they can interpret data from different perspectives and be forensic in evaluating the success or failure of a strategy.

4. THE SKILLS TRANSFORMING PERFORMANCE ANALYSTS INTO PROBLEM SOLVERS

Occupying this new position between a firm's data and how those data are applied to everyday tasks propels performance evaluation far beyond its traditional range of responsibility.

Performance analysts will increasingly be viewed as data scientists, called on for any number of data-related tasks. Armed with the right skill sets and a business mindset, they are a firm's potential problem solvers.

"Give us a good set of data, and as data scientists, we can do anything with it," says Kavanagh. Freed from time-intensive return calculations, performance analysts can demonstrate their true worth. They know where the data are, they understand the systems in which the data reside, and they have the analytical minds to process the data in ways that benefit the company. "They are often the smartest people in the room," adds Kavanagh.

So what is required to become the "smartest in the room"? What are the key skills and aptitudes that investment firms will seek?

Tomorrow's performance analyst will, broadly speaking, possess "T-shaped" skills. People with T-shaped skills make valuable connections and are capable of lateral thinking. They frame issues coherently and then ask the right questions before deciding the best way to answer them.

WHAT ARE T-SHAPED SKILLS?

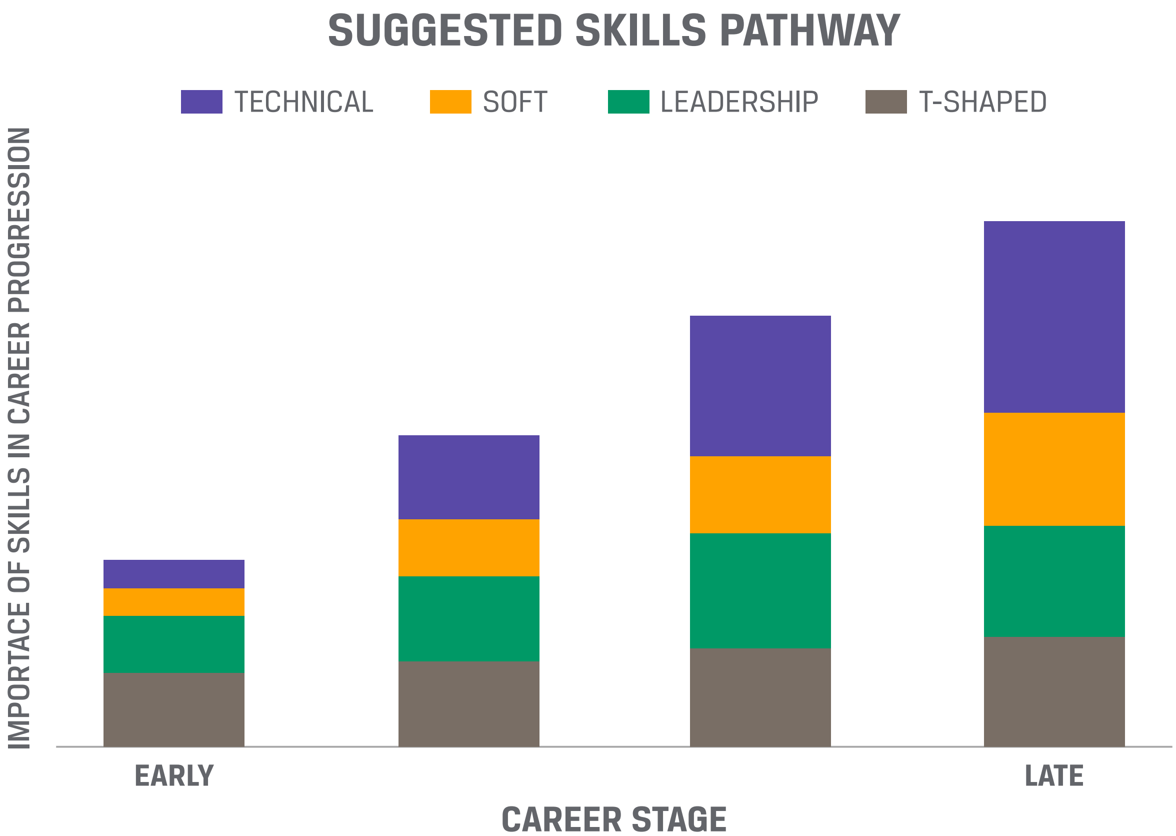
Individuals with T-shaped skills are able to

1. **connect across disciplines,**
2. **be systems savvy,**
3. **comprehend the wider organizational context,**
4. **are able to achieve situational fluency and adaptability,**
5. **cultivate a network of contacts, and**
6. **understand and leverage diverse perspectives.**

People and teams with T-shaped skills combine deep knowledge in a single field and wider knowledge of other fields, and have the competencies to connect them. For this reason, T-shaped skills usually come with experience and are developed only as an individual's career progresses.

Exhibit 1 shows the skills needed at various career stages.

EXHIBIT 1



Source: CFA Institute® Investment Professional of the Future, 2019

T-shaped teams can adapt to changing environments and work across disciplines and technologies. Investment industry leaders rank T-shaped skills as the most important future skills (49% rank these first), followed by leadership skills (21%), soft skills (16%), and technical skills (14%).

Along with T-shaped skills, many soft skills will underpin tomorrow's performance evaluation function.

Attitude is critical, says Jankowski: "I'm looking for analysts who want to roll up their sleeves, look at the data, and dive right in."

Communication skills will be important, too. Data gold does not glisten like physical gold, so the fruits of research must be sold to stakeholders. "You need numerical facility and attention to detail, of course, but every performance evaluation team also needs good communicators," says Bacon, who holds a Certificate in Investment Performance Measurement (CIPM®) credential.

Communication can be face-to-face when presenting findings to or working on projects with investment analysts and portfolio managers, or through informal missives which can be used by investor relations and marketing personnel. Summarizing data that tells a story is increasingly as important as the analysis itself.

Part of using data to tell a story comes down to presentation. "I'm big on presentation skills," says Kavanagh, who adds that there is nothing worse than providing people raw data without meaningful analyses. Performance analysts must become "artists," adept at creating attractive analysis, useful dashboards, interactive tools, and displays. "It is no longer good enough to hand over a big dirty table with multiple columns and rows of numbers," Kavanagh asserts. Less, he contends, is more.

For performance analysts to present themselves as problem solvers may require one further skill: self-confidence. They must learn to be less modest about their role, according to Kavanagh. "They must step up and grab the attention of the business about their true worth," he says.

5. HOW PERFORMANCE EVALUATION ENHANCES KEY ORGANIZATIONAL FUNCTIONS

Their new roles as problem solvers and data scientists will steadily change the way performance analysts are viewed inside organizations. Performance analysts are much more than "human calculators", and other investment firm functions seek to harness these individuals' problem-solving skills and know-how.

Performance evaluation has become more internal than external in focus, observes Kavanagh: "My biggest customers are within the firm now. My investment team and my sales team have a big appetite for analysis of this type."

In fact, the areas of an investment firm into which performance analysts, functioning as data scientists and problem solvers, do not provide key inputs are few.

INVESTMENT MANAGEMENT

Performance evaluation is becoming a pivotal enabler of the investment function. With active investment management struggling to prove it can add value, skilled performance analysts are increasingly sought to unearth different ways of delivering alpha. "We can help them find it, verify it, [and] access it," says Bacon. Performance analysts who understand the business and have good interpersonal skills can dovetail with a fund manager's investment philosophy and style, enhancing and streamlining the investment process.

Once averse to external interventions in their work, many portfolio managers now welcome independent checks that a strategy or an instrument delivers the expected results. To take extra risk today often requires independent confirmation that the returns will provide sufficient reward for any risks investment managers take with client assets.

Performance evaluation may also serve as a steppingstone to the front office. "There is no better place to learn how to construct portfolios than in performance analysis," says Bacon, noting that portfolio managers with a performance analysis background tend to stand out from the crowd. In fact, a growing number of CFA® charterholders have chosen to seek the CIPM designation to enhance the skills present in their firm and advance their own careers. Similarly, performance analysts with CIPM credentials may seek to become CFA® charterholders, to improve their understanding of the investment function and, in some cases, to move into it.

Some firms have gone a step further and integrated performance measurement and portfolio management. At Adams Street Partners, for example, the two teams work side by side. "Normally, you'd expect our team to be in a nearby building," says Jankowski, who is a CFA® charterholder and also holds the CIPM credential. "Here we sit with the investment team, while the accounting team is elsewhere."

Sitting together, the two teams can collaborate when providing information to the investor relations, sales, and marketing teams. "Every day, we talk to the investment teams to figure out how to customize a new mandate for clients," Jankowski adds. He contends that if the teams were in different buildings or on different floors, they would be collectively less productive.

SALES AND MARKETING

The sales team is another important internal customer. Sales executives are typically information hungry, looking for new ways of understanding their own funds and innovative methods of displaying information to prospective investors. Performance analysts can help them prepare answers to the questions they receive every day: What does this strategy do? How does it do it? What is the performance? What drives performance? What are the risks, and how do we handle them?

Performance analysts increasingly help create and validate these messages, says Kavanagh. "If a sales guy says we have a lower risk product than the competition, it is up to me to prove that by measuring the risk of a portfolio and providing a meaningful comparison to the risk taken by other firms," he says. And just as the performance analysts at Adams Street Partners have integrated with the investment function, so performance evaluation and the sales team have become intertwined at KBI Global Investors and even share a similar compensation structure.

SUPERCHARGING SALES

"Our salespeople going out to talk to clients are typically carrying material we generate for them," says Kavanagh.

Performance analysis is integrated into the sales functions, with senior performance analysts attending all sales meetings. "It sounds odd," says Kavanagh, "but the salespeople are under pressure to deliver analysis and what makes a strategy tick. My team and I usually have something that can help."

In early 2019, KBI was concerned that the market did not recognize that companies in the portfolio had greater earnings growth than the benchmark. As a result, price appreciation in the portfolio lagged the market. The performance measurement team used a tool to measure the portfolio and benchmark characteristics, conducted style attribution, and demonstrated that the manager's thought process was correct and that the portfolio appeared to be undervalued. "That analysis now sits in the sales pack," says Kavanagh.

INVESTOR RELATIONS

The investor relations (IR) team is part sales, part marketing, and part administrative in its focus. Its value is most apparent when a firm's performance suffers relative to a benchmark or to peers. The IR machine jumps into action, proactively reassuring clients and fielding calls from concerned investors. Doing this effectively requires judicious input from the performance evaluation team. This input typically takes the form of well-reasoned analysis of the portfolio, combined with historical return series and forward-looking forecasts to demonstrate that performance should recover over time.

Performance analysts also help IR professionals produce client-specific reports showing how investments are performing relative to the goals of the individual client.

RISK MANAGERS

Clients' demands for risk management reports and tools have exploded, with asset managers working hard to keep pace. Demand is particularly high for reporting of expected risk versus expected return (ex-ante reports). This takes risk-return reporting from two dimensions to four: ex-post return, ex-post risk, ex-ante return, and ex-ante risk. Performance analysts are exclusively able to produce this four-dimensional data, facilitating the role of dedicated risk professionals.

CHIEF OPERATING OFFICERS

Chief operating officers (COOs) increasingly need performance analysts to be well-rounded (with T-shaped skills). One of the biggest challenges for COOs is translating data to business performance.

The subtext here is whether unstructured data can become a valuable, sellable concept or product. The COO looks to performance analysts to provide context for clients, to sell strategies, to help IR and marketing staff explain products, and even to stage informal sales seminars to reveal the inner workings of strategies to sales, IR, and marketing teams. The performance evaluation team may also intersect with the finance team, such as when helping calculate performance fees.

Large outsourcing providers are establishing services for the COO office. Barney at BNY Mellon, for instance, oversees a core technology team in addition to teams focused on product management, technology monitoring, industry-trend monitoring, auditing, market data integration, investment guidelines monitoring, and risk. Together, these teams offer an a la carte performance evaluation service for the COO.

INVESTMENT BOARDS

Boards of asset owners and asset managers may not come into direct contact with performance analysts. But performance evaluation is nevertheless key to the work of the board. Chief investment officers (CIOs); periodically, must submit reports and justify their investments to the board. The board's duty is to be thorough in considering the work of the investment team and to carefully examine the details when necessary. CIOs therefore need considerable support to articulate their strategies and goals. The responsibility may fall to performance analysts, whether internal or third party, to provide the answers and to devise formats that can be understood by board members of differing skill levels and experience.

6. THE NEW ENGINE FOR INVESTMENT FIRMS

Would contending that the performance analyst will be key to an investment firm's future innovation, growth, reputation, and business model be stretching the argument too far? Perhaps. But performance analysts will certainly play leading roles. They are effectively the nerve center of a firm, sitting on all the key information and processes.

Take Bacon's testimony. "Performance analysis is moving right to the center of asset management," he says. Both internally and externally, performance evaluation adds value, helping senior management make key judgement calls where the difference between the right solution and the wrong solution is the difference between growth or decline.

"Ok, it's a support function, but it's also an enabling function," Bacon argues, which also adds significantly to an firm's control environment. It is in direct contact with, but independent of, the front office. It is close to, but still separate from, the sales teams. It facilitates both these activities but imposes checks and balances on each one, too. Performance evaluation will devise solutions to challenges, but just as often, it will spot problems as they emerge, before they become ingrained in processes.

Consider also the wide range of responsibilities Jankowski has at Adams Street Partners. "My forward-looking focus here is to be able to scale operations in the performance area for anticipated future AUM [assets under management] growth over the next five to 10 years," he says. Taking (partial) responsibility for business growth over the long term is clearly a strategic role, and one that considerably exceeds the traditional narrow role of the performance analyst.

Equally, performance evaluation has a central role to play in creating and maintaining intangible value, such as reputation. That one's reputation is slowly earned but can be quickly lost is axiomatic. Accurate data and coherent solutions are essential to retaining the trust of clients and the wider stakeholder community. This latter constituency is not to be underestimated; in the wake of instant news and social media, mistakes and errors travel far and wide. Once Pandora's box has been opened, it can rarely be closed.

CONCLUSION: BUILDING SKILLS IN THE CLASSROOM, AND ON THE JOB

Customers everywhere demand great service, performed with speed and accuracy, and communicated with clarity and coherence. The investment industry is no exception. Fail, and clients will vote with their feet.

Skilled performance evaluation will play an increasingly larger role in meeting these demands. The best performance analysts have the appropriate skills, an understanding of the industry and their own firms, and a willingness to get to know their clients and communicate effectively with them.

In the future, investment firms will likely seek to create T-shaped performance evaluation teams that embody these attributes. Such attributes are not always easy to find, which is why investment firms will look increasingly to prospective employees with specialist training, such as the CIPM credential.

Given that few performance analysts today are required to perform manual calculations, the work required to achieve the CIPM credential becomes even more important. CIPM candidates must demonstrate practical expertise in key analysis areas and are introduced to simulated work scenarios. They are taught how to go beyond simple calculations and spot actionable analytical information, how to evaluate investment managers, and how to articulate information. Do all of this well, and they will build credibility and trust in themselves, their organization, and their industry.

As Jankowski says, "Technology is great, but you should be a master, not a pupil, of it. The CIPM credential helps you with that. After that, it's about diving in, doing it, and getting your hands dirty. It's a great job, and it's getting better all the time."

CFA Institute

WWW.CFAINSTITUTE.ORG