

# Affect of Recent Legal Suits on Investment Management Practices

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# How Do Recent Legal Suits Affect ...

- Contracting for Services
- Diversification and Risk Controls
- Return Performance



# How Did We Get Here?

*“... that he conduct himself faithfully and exercise sound discretion and observe how men of prudence, discretion and intelligence manage their own affairs-not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested.”*

The Prudent Man Rule – Harvard vs. Amory, 1830 –  
The Original Fiduciary Standard.



# How Did We Get Here?

*“... with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;”*

The Prudent “Expert” Rule – ERISA, 1974 –  
Current US professional fiduciary standard.



# “Good” or “Poor” Process Vs. Result

- Courts have looked to the process.
- “Poor” results bring attention to the process.
- Managers can control processes, but not the result.
- The lesson: Apply the best current investment processes, including risk and diversification controls, and monitor their effectiveness.



# Evolution of Measurement

- Rate of Return Population Comparisons -- Barron's, A.G. Becker, others, early 1960's
- CAPM for Performance Measurement -- O'Brien/Sharpe/PRC, 1964
- Statistical Inference for Performance Assessment, Coin-Tossing -- O'Brien/FAJ, 1970
- Commercial CAPM-Based Performance Measurement Services -- Merrill/Wilshire (then O'Brien Associates, Inc.), early '70's



# Evolution of Measurement (2)

- Components of investment performance – market risk, market timing, security selection -- Fama, 1970's
- Introduction of the Index Fund, creating a real alternative to active management -- BGI (then Wells Fargo), 1972
- Sophisticated risk measurement and portfolio construction models -- Barra, mid '70's
- Refinements and extensions -- numerous commercial and academic papers and services developed --  
Various sources, late '70's onward



# The Challenge of Performing

- **Performance** – Creating “excess” return in an environment where there are thousands of roughly equally talented managers, with roughly equal access to information, and that collectively largely comprise the market they are attempting to “beat”.



# Measurement and Assessment

- **Performance Measurement** – Separating total return into performance-driver components requires many assumptions. There is no universally accepted method to do this, and hence no universally accepted method to answer the question, “What did the manager contribute?”
- **Performance Assessment** – Weak signal-to-noise ratio means a big role for *chance*.



# A Pragmatist's Conclusion

The enormous influence of chance in performance assessment forces everyone, courts included, to focus on the professional quality of the manager's investment process, from the techniques for gathering information and impounding it into a diversified portfolio, through techniques for controlling diversification and risk.



# Thinking About Performance

- The current state of understanding is plagued by three issues:
  - Non-Stationarity
  - Chance
  - Non-Intuitiveness
- Simulation Methods and Options Theory can help.



# Simulating the Implications of Unique Risk

- Simulate historical returns of current portfolio.
- Creating a scatter diagram of these returns against the benchmark.
- Provides an intuitive illustration of the lack of perfect diversification.



# Simulated Return “Ranking” Distributions

- Randomly select 10,000 portfolios of 100 stocks each from benchmark.
- Calculate the return of each, and form a “synthetic” distribution.
- The rank of the actual portfolio’s return estimates the likelihood such a result occurring by chance.



# Performance-Protective Put

- Measures the cost of assuring that the portfolio's return would not fall below the promised maximum benchmark-shortfall.
- Calculated as the cost of a put option with the strike set to the shortfall limit, using the actual portfolio volatility relative to the benchmark.
- Alternative measures of management risk.



# Managing to “Assure” at least the Performance Minimum

- An interesting extension of the performance-protective put would be to actually manage the portfolio in that way.
- Blending the benchmark with the active portfolio.
  - The dynamics are specified by the put replication mathematics.
- This process maximizes portfolio expected return subject to the “assured” minimum.



# A Dynamic-Alpha Management Company

- Maintain only one active portfolio.
- Blend that active portfolio with the benchmark, and benchmark-risk preference, of each client.
- The firms “alpha-seeking” resources would be focused, and all clients would appropriately share in its results.



# The Potential Dampening Affect of Risk Control on Return Performance

- Effective risk control will affect return, but it can improve risk-adjusted performance.
- Creative integration of alpha seeking and risk control processes can improve returns.



# The Choice/Application of Diversification and Risk Controls

- Barra, and others, offer thoroughly researched models for diversification and risk control. Select those that you are most comfortable with.
- Implement a management process that assigns responsibility, free of inherent conflicts, to apply these selected models.



# Contracting for Services

- Excess return should not, and need not, be “promised”.
- A thorough and professional investment process can, and should, be promised and delivered.

