Performance Attribution: Understanding Portfolio Returns

by *Sundar Sankaran*[1]

In the fund management business, it is normal to compare portfolio return with the return generated by a diversified index or the relevant style index or the best-performing scheme in that category or the relevant industry benchmark. Accordingly, out-performance or under-performance (i.e. the *active returns*) can be determined. Such benchmarking is important, but it only reveals a part of the picture. The focus is only on relative returns – not the underlying risk.

Sharpe Ratio, Treynor Ratio and Jensen Alpha serve the purpose of a 'composite measure' – a single risk-adjusted return number that explains the performance of a portfolio. However, these risk-adjusted measures, as well as relative return measures do not help in understanding how the performance came about.

Performance Attribution seeks to decompose the active returns generated by a portfolio, into its elements.

- In the case of equity, how much of the active returns can be attributed to sector calls, and how much came through stock picking? Or, did one eat into the other? How much was a momentum-play?
- As regards debt, how much active return can be attributed to credit risk calls? What was the contribution of duration play?
- In either case, what came about merely because of passive exposure to an asset class or style, as compared to trading calls?
- In multi-asset class portfolios, what was the contribution of the asset allocation decisions?

Such higher level insights into portfolio performance help management ensure that the fund management style remains consistent with investment objectives – deviations are highlighted early.

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Performance attribution also facilitates better appreciation of strengths and weaknesses of fund managers. Therefore, it needs to be an important part of the Management Information Systems (MIS) of any fund-management business. More so, in the ultra-competitive mutual fund industry.

The concept is nascent in India, and tends to be based on a single model (mostly the *Brinson-Fachler* model or *Brinson-Hood-Beebower* model). We have found that the Brinson models suffer some serious construct limitations. Besides, they are equity – focused, and consider return to the exclusion of risk.

We have studied the leading international models of performance attribution. Recognizing their limitations, we have conceptualized various refinements for specific portfolio situations. Given the range of approaches available to analyze portfolio returns, performance attribution is more of an art than a science.

- The approach needs to be consistent with the investment objectives of the scheme and the charter given to the fund manager.
- The results of the attribution analysis should be sensible.
- There needs to be a buy-in, especially from the fund manager(s).
- The model complexity should be in synch with management comfort.

[1] The writer is author of "*Indian Mutual Funds Handbook*" [Vision Books (2012, 3rd edition)] and "*Wealth Engine*" (Vision Books, 2013). Sundar, an alumnus of IIM Ahmedabad (1986-88), has deep consulting and training experiences in the banking and financial services space. He can be contacted at sundar@advantage-india.in

While the measurement of performance attribution is post-facto, the results are a useful aid in managing fund management performance and taking timely corrective actions. Once the approach gains prominence in India, we believe it will become part of mandatory reporting to trustees, or at least one of the best practices in the industry. The framework will also help in better understanding of competitors' schemes.

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