How to Rate Management of Investment Funds

▸ *The performance of mutual, trust, and pension funds can be quantitatively compared despite market fluctuations and different risk policies.*

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Investment management has become an important industry in the United States. The responsibilities of investment managers are enormous, and their potential rewards are great. In order to reward management for good performance in this field, however, it is necessary to be able to recognize it. Unfortunately, pension funds, trust funds, and mutual funds all share one serious problem: to the extent that they are heavily invested in common stocks, the return achieved in any one period is subject to wide fluctuations which are beyond the control of investment management. The result has been that, although many believe the quality of investment management is important, no one has devised a satisfactory way to measure its impact on performance.

In this article we shall look at a new way to rate the performance of a fund's investment managers. The comprehensiveness of this rating is a question for the reader to decide for himself, depending on how he thinks about the "quality" of investment management. Most readers are likely to agree, however, that at least one dimension — and a critical one — of the quality of the investment management is analyzed by this new method.

Analyzing Risk

It is almost ironic that the presence of market risk should pose such a serious problem. The assets controlled by investment managers are remarkably liquid. To a degree almost unmatched in other enterprises, the investment manager is free to act independently of the investment decisions of his predecessors. Furthermore, although there are varying institutional restrictions placed on the investment manager's decisions, by and large he competes directly with other investment managers, buying and selling securities in the same market. If it were not for the problems created by market risk, therefore, performance comparisons in the investment management industry would be more meaningful than in many other industries.

Actually, of course, there is more than one kind of risk in a diversified fund. There is a risk produced by general market fluctuations — the volatility of the stock market. There is also a risk resulting from fluctuations in the particular securities held by the fund. In any