

Out with the old and in with the new

A retrospective on Mesirow PrecisionAlpha® vs. the failure of traditional performance metrics

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Executive summary

This paper explores the impact of using trailing return to predict future performance. The results may not be what many investors expect.

Our findings:

- No truer phrase has been uttered than “past performance is no guarantee of future results.”
- The most widely used metric of trailing return is a poor predictor of performance at both the one-year and three-year horizon. The two broad equity category sets exhibited strong mean reversion tendencies, implying that the best on a trailing basis is the worst on a forward basis.
- Our results strongly confirm the tendency of traditional historical performance metrics to be negatively predictive of future relative performance (i.e., indicative of mean reversion), while supporting the historical efficacy of PrecisionAlpha as a positive predictor of future relative performance.
- PrecisionAlpha®, Mesirow’s answer to the shortcomings of traditional performance metrics, is the most consistent predictor of performance across broad category sets for both one-year and three-year horizon periods in our study.

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Executive summary

- No one should have believed that "past performance is no guarantee of future results" ...
- The most widely used metric of performance at both the one year and three year horizon. The two broad equity strategies with additional strong recent investment performance, leading that the best on a trailing basis is the worst on a forward basis.
- Our results strongly confirm the tendency of traditional historical performance metrics to be negatively predictive of future relative performance (i.e., indication of near overvalued), while supporting the historical efficacy of PrecisionAlpha as a predictive indicator of future relative performance.

PrecisionAlpha. Measure's answer to the disadvantages of traditional performance metrics. In the most consistent predictor of performance across broad category sets for both one year and three year horizons periods to our study.

Overview

"Past performance is no guarantee of future results" is a standard disclaimer that accompanies most financial marketing materials that are meant to highlight good past performance, while mitigating the legal disclosure to investors. The intention is that potential investors can look past the pretty, legal disclosure requirements and assume that past will be good in the future as well.

Historical data can, however, be used to assess an investment's statistical likelihood of success in the near term, based on a model based on the historical performance of performance when used as a predictor for the future.

An active manager that underperformed in categories over some historical periods may likely be outperforming their counterparts over a single period of measurement in the future. Numerous studies have been done over past decades that examine whether "winning" managers can outperform a sample in the future.^{1,2,3,4} Other studies have looked at the results of performance chasing, which is the tendency of investors to outperforming managers with other managers that previously underperformed with the hope that underperformance will continue.^{5,6}

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