PPMAMERICA

Revealing Performance Consistency With Information Ratios

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It can be difficult for an investor to gauge manager performance.[1] Looking at a fund's return is easy and straightforward, but how the manager generated that return is likely just as important. Investors can place constraints on a fund around asset classes, sectors and ratings that differ from benchmarks and peers. Then the overall amount of risk taken has to also be considered.

Take tracking error as an example. Tracking error is a measure of the volatility of excess returns relative to a benchmark. A lower tracking error implies less volatility between a fund's performance and its benchmark, while a higher tracking error implies more volatility between a fund's performance and its benchmark. While it can be an important metric, it can also come with limitations, particularly when market volatility spikes and the assumptions embedded in tracking error models lag observed volatility. PPM monitors tracking error, but it is only one of the many metrics used to evaluate risk.

However, PPM places more importance on the information ratio, a metric in which tracking error is an input. The information ratio is a ratio of portfolio returns above the returns of a benchmark, compared to the volatility of those returns. In other words, it is a fund's excess returns divided by its tracking error.

GETTING PAID TO TAKE ACTIVE RISK

A fund with a higher total return can look good on paper, a fund with a higher excess return can look better, and a fund with a higher information ratio can look even better. For example, assume a fund (Fund A) returned 10% over the last year, the benchmark returned 9% and the fund's tracking error was 9%. Assume another fund (Fund B) returned 5%, its benchmark returned 3% and the fund's tracking error was 7%. Fund A initially looks better given its higher total return. But Fund A produced an excess return of 1% while Fund B produced 2%. Further, Fund A produced an information ratio of 0.11 while Fund B produced 0.29.

	Fund A[2]	**Fund B[2]**
	Inputs: • Fund Ret. 10% • Benchmark Ret. 9% • Tracking Error 9%	Inputs: • Fund Ret. 5% • Benchmark Ret. 3% • Tracking Error 7%
Total Return	10%	5%
Excess Return	1%	2%
Information Ratio	0.11	0.29

We believe such an analysis of risk-adjusted returns is crucial to due diligence, especially when conducted over multiple periods. Using an information ratio time series can show the consistency of risk-adjusted performance. Has the investor consistently been paid for the active risk their manager has taken?

(1) As of 13 November 2024. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) Any returns or metrics presented herein were not achieved by any portfolio managed by PPM and are intended only to illustrate how information ratio may be used to help evaluate performance over time.

THE CONSISTENCY OF EXCESS RETURNS

Let's take a step back and focus on the numerator in the information ratio calculation – excess returns. Assume a fund (Fund C) has consistently produced higher excess returns in up markets (i.e., "higher highs"), while another fund (Fund D) has produced lower excess returns in up markets. But the extra risk likely taken in Fund C has contributed to its underperformance in down markets (i.e., "lower lows"), while Fund D has outperformed in down markets. Taken together, Fund C has underperformed Fund D over the entire period on an excess return basis, despite outperforming in six of eight years.

Year	Fund C Excess Return[3]	Fund D Excess Return[3]
1	1.0%	0.9%
2	1.0%	0.9%
3	-1.2%	-0.7%
4	1.0%	0.9%
5	1.0%	0.9%
6	-1.2%	-0.7%
7	1.0%	0.9%
8	1.0%	0.9%
Total	**3.6%**	**4.1%**

This is just one example that shows why we believe the focus should be on performance consistency, instead of overall outperformance regardless of risk. Bond markets have historically experienced many more up years than down years. At many points in a cycle, an investor can look at performance and see which manager is outperforming. But until that cycle has run its course, which typically includes down markets, the investor may not see the whole picture.

In the interim, an investor can layer in risk-adjusted performance metrics, such as the information ratio. They can also conduct additional due diligence on high-level returns, such as excess returns, to analyze the consistency of their manager.

(3) Any returns or metrics presented herein were not achieved by any portfolio managed by PPM and are intended only to illustrate how excess return may be used to help evaluate performance over time.

ABOUT PPM AMERICA

Our mission is to be seen by clients and their advisors as a consistently reliable partner to help them achieve their long-term value goals.

PPM is a US-based institutional asset manager with $76.66 billion in assets under management as of 30 September 2024.[4] Established in Chicago in 1990, PPM exists to consistently support institutional clients in achieving their long-term value goals. We offer our Midwestern mentality of hard work, straight talk, full transparency and humility. Our success is supported by a team-based culture that encourages debate, collaboration and consistency. At the center of our belief is the fact that our best ideas to date have and can come from any team member anywhere in our firm. We believe the success of our investment culture is best demonstrated by the strong retention of our clients and investment professionals.

(4) AUM includes committed but unfunded capital for PPM's private equity and commercial real estate businesses.

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