A case study on shifting the performance evaluation mindset

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On Board With a Long-Term View

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Background

Active investment management has been disrupted with respect to the roles managers, intermediaries and owners play, the investment techniques available and the metrics used to evaluate success. The issues centered around this disruption are complex and have caused confusion about the time horizons needed to measure risk and ultimately performance. The resulting misalignment between principals and agents — asset owners, boards, advisors, consultants and their investment managers — can lead to a lack of trust and create inappropriate incentives and poor decision-making by all parties. While performance can be measured over long- or short-term periods, what that means to different investors is often murky and misunderstood. In fact, that could be the key driver that creates misalignment, ultimately eroding understanding and the ability to achieve strong long-term outcomes for end-investors.

With this growing disconnect, it only made sense to bring the topic to light and begin to challenge ourselves and others about how we got here and what needs to change. As a result, we began to have many conversations with asset owners, boards and advisors worldwide on how to better align the dialogue around performance metrics and engage in our collective fiduciary roles going forward. We included our own mutual funds board in the conversation, and the two-year discussion that followed resulted in new performance metrics for evaluating the funds and a basis for better dialogue around long-term objectives.

The following case study illustrates that significant progress is possible, and it starts with a more aligned conversation on performance metrics.

In brief

- To get the teams at MFS® and the MFS Funds Board on the same page took self-assessment and recognizing that we had some internal misalignments in reporting and communication of investment performance. There needed to be more clarity on investment approach, time horizons and relevant performance metrics.
- We made a shift in focus from short- to long-term performance, presenting the most relevant metrics (long-term) first and using rolling in addition to fixed time period returns.
- Engaging in a more aligned conversation promoted a collective focus on the end-investor and provided further opportunities for education about our different roles and responsibilities along the investment chain.

The following case study reflects the work done with our mutual funds board and the process it took to push us forward and think differently.

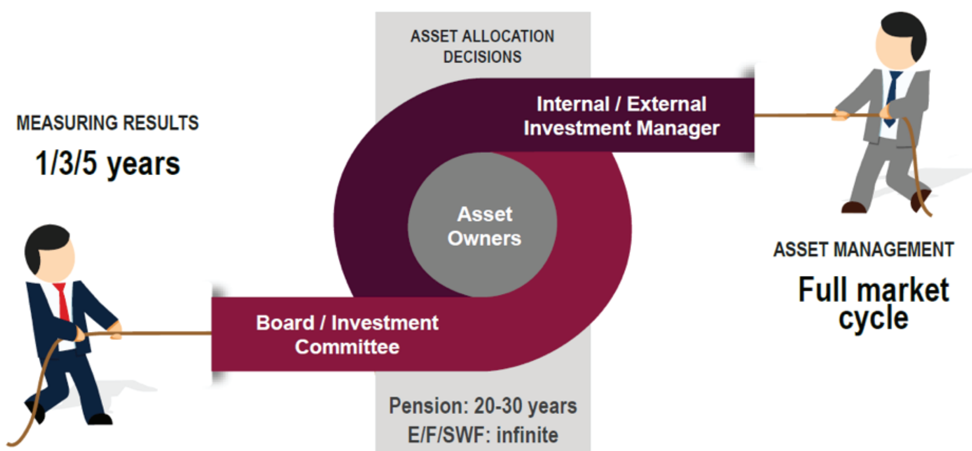
The dialogue began with the MFS Funds Board requesting options for fund performance evaluation that aligned with what we were doing internally. That meant we had to look carefully at how we evaluated performance internally versus how we presented performance in the board reports. Their queries sparked a productive ongoing discussion that spanned two years and resulted in greater clarity and alignment on performance evaluation. Notably, it also helped us see a disconnect in how we were presenting investment returns to clients and intermediaries. We recognized that we could be doing a better job aligning our conversations about investment returns with our long-term investment approach to managing portfolios.

Early on, what helped the discussion was the board's clear understanding of our approach as long-term investors. Not all conversations about performance start from this point of clarity. In this case, however, the board's knowledge and expertise, along with our strong working relationship, made for a more productive conversation, especially at a time when short time horizons prevail. However, there still had to be more clarity. When we say we are long-term investors, what do we really mean, and more important, why does it matter?

Focused on full market cycles

Like many active managers, MFS states an explicit goal to outperform over a full market cycle, and there is a good reason for this, especially in managing risk and investors' return expectations. However, evaluating an active manager over a full market cycle today is not easy, and there is plenty of confusion around how the cycle is defined. The most common performance metrics are anchored on three and five years, whereas a full market cycle is typically longer, closer to seven to 10 years. Without collective understanding about this one issue, the potential for a misalignment in the way a board evaluates an active manager and how that manager actually invests the money is significant. (See Exhibit 1).

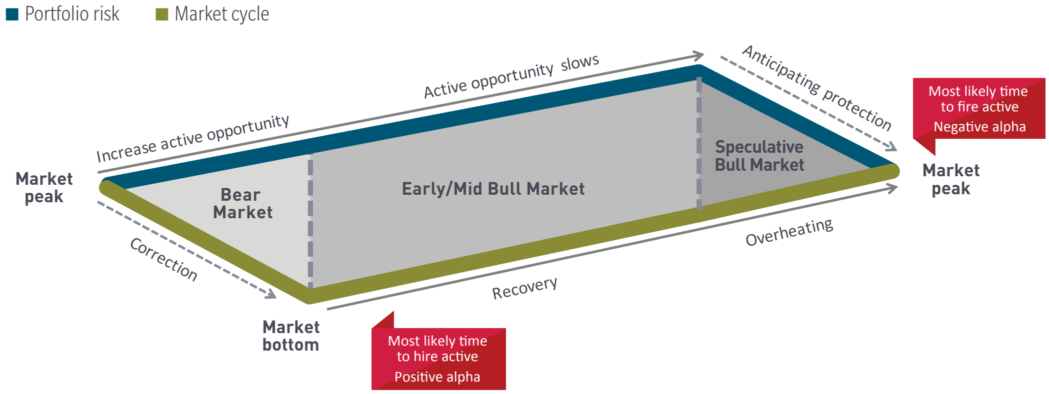
Exhibit 1: Conflict in the delegation of decisions



*E - Endowments, F - Foundations, SWF - Sovereign Wealth Funds.

Accordingly, we realized it was important to engage with the board on how we aim to create value responsibly over time and that meant we had to clarify what our investment process is as we move through a market cycle. This may seem to be an obvious point; however, with benchmarks now being the measurement base, it can be overlooked.

Exhibit 2: Leveraging a full stock market cycle



Source: "Defining a Market Cycle," Manning & Napier, Dec. 2014.

Recognizing the need to change the dialogue

A big part of the process was coming to an understanding with the board that the way we were presenting performance information at board meetings was not aligned with our portfolio objective of outperforming over a full market cycle.

Our primary goal was to promote the idea that short-term performance should not be the primary driver of performance measurement. We realized, however, that the data we were providing focused the conversation around short-term results, which left little time to discuss managing risk throughout the cycle.

As we worked through this misalignment, we also wanted to offer the board tangible options for measuring our long-term philosophy. One simple way to do this was to measure turnover, especially in equity portfolios. For example, our asset-weighted average turnover is less than half the industry average. We believe using turnover data shows evidence of our process and conviction. The important connection here is a metric that could assess our stated investment philosophy and process. Through deep global research, we thoroughly vet investment ideas, and this builds confidence in our ability to hold securities over these longer periods of time. This aligns with the longer-term outcomes of end-investors, such as those in pension or DC plans.

Exhibit 3: Investors' time horizon

[1] MSCI, as of 12/14.
[2] Based on the MFS US Retail Equity Funds, as of 3/31/19. Please see mfs.com for individual fund information. The MFS US-registered funds are generally only available to US residents with a valid US tax identification number (and to certain other qualified investors). Holding horizons vary by fund and are calculated differently than holding period. Holding horizons for MFS and the average equity manager are based on the inverse turnover calculation (100/1 year turnover). Turnover methodology: (Lesser of Purchase or Sales)/Average Market Value of the Date Range.
[3] 23rd Annual DALBAR Quantitative Analysis of Investor Behavior Study, 2016.
[4] Morningstar (US) Equity Categories, ex index funds and fund of funds, as of 3/31/19.

The progress we made, which included our own self-reflection around measurements, was as follows:

1. Clarifying that our investment process is structured to add value over a full market cycle, which, generally lasts closer to seven to 10 years.
2. Aligning our performance metrics and the way we manage portfolios for more consistent reporting to the board, as well as developing new metrics (discussed below) to better reflect our long-term investment philosophy.
3. Adjusting our own mindset on how we "present" during a board meeting; getting comfortable talking through the full performance stream — both short- and long-term — but making sure to give the relevant full-market-cycle context.

Shifting the mindset

Once there was more clarity, the mindset about performance evaluation began to change. This allowed for an open discussion on what measurements would work, while also recognizing the board's fiduciary obligation to measure performance across different time periods. How could we help the board find the right balance of committing to a long view and holding us accountable along the way? It became our responsibility to give them options that were better aligned with the way we were managing the portfolios. Together we looked at new ways to measure or present performance that reflected the long-term experience while allowing for clarity over shorter periods.

As a result, we adjusted the presentation of performance time periods and suggested looking at shorter periods as markers to a longer term destination — possibly points at which to start a performance dialogue. That way, the shorter-term figures might help the board gain insight into whether the funds were performing in line with the expectations we had set for a particular strategy during different market environments. Based on the information we shared and their own knowledge and expertise, the board decided to use a five-year performance period as a main marker. This was more closely aligned with the primary lens used by our investment teams to manage portfolios.

Next was to be clear about our relative position in the portfolios, helping the board understand our performance in context with a particular strategy and the current environment. As a simple example, a fund that was underperforming in an overheating market might actually be working to mitigate losses ahead of a downturn, not timing the market but instead, being disciplined about valuations. It was an opportunity for us to point out the role of countercyclical discipline rather than trying to outperform a benchmark at the wrong time.

Performance in proper context

A critical part of the context discussion focused on transparency about comparisons and style differences. We determined we needed to do more in three areas:

1. Clarifying what the relevant benchmark is for each of the funds and why we chose it.
2. Documenting any style differences relevant to a fund's benchmark or peer group and setting performance expectations in different market environments based on those style differences. For example, with a portfolio biased toward high-quality stocks, we may underperform in markets that do not favor those stocks.
3. Assessing what we believe are the differences between peer group versus benchmark comparisons, but agreeing that both are important for a thorough analysis and performance conversation.

We also needed to deliver more consistent messages around the value of our long-term process and generally be less reactive when discussing short-term underperformance. That started with being clear on how we were positioned and how security selection supported our longer-term strategy. For example, if we were trying to add value by implementing a strategic out-of-index allocation, we needed the board to understand this and what impact it had on performance. Even though we always disclose specific details in our regulatory documents, we thought it was important to bring strategy positioning, performance metrics and market environment expectations together in one report. Of course, recent market events or news in relation to a portfolio's positioning may still be addressed when appropriate.

Reversing the time lines

One of our easiest but most significant shifts in reporting performance was to change the order of the timelines, which helped us to focus our discussion with the board on longer-term numbers. Instead of beginning with year-to-date, one-, three-, five- and 10-year figures, we began with the 10-year figure and dropped the year-to-date altogether. We also stopped highlighting the three-year figure, which made a significant visual impact. In addition, we now sort the numbers and rankings by the five-year figure. The former approach perpetuated a focus on short-term results, while the latter shifted the focus to a more relevant long-term performance view, creating better-aligned conversations from the start with each portfolio manager (Exhibit 4).

Exhibit 4: Sample equity funds report

Before (July 31, 2016)

Sorted on 3-year with 3-year highlighted

	Annualized total return^				Percentile ranking^						
Fund/Benchmark name	YTD	1 year	3 year	5 year	YTD	1 year	3 year	5 year	Total net assets (Mil)	Fund manager	Mgr. start date

After (July 31, 2018)

Sorted on 5-year with 5-year highlighted

	Annualized total return^ A share class at NAV (IC for VIT)				Percentile ranking^ A share class at NAV (IC for VIT)				Excess return I share class (IC for VIT)				
Fund/Benchmark name	10 year	5 year	3 year	1 year	10 year	5 year	3 year	1 year	10 year	5 year	3 year	1 year	Total net assets (M)

	Lipper rankings				Excess return
	10 year	5 year	3 year	1 year	Excess return
Funds with Lipper rankings at or better than	40th	30th	20th	20th	Greater than 2.5%
Funds with Lipper rankings at or worse than	60th	70th	80th	80th	Less than -2.5%

Prioritizing rolling returns over fixed

Another significant change was to complement our fixed period performance measurement with rolling returns. We believe the use of rolling returns may better reflect a typical shareholder experience. Moreover, it became clear that over two back-to-back fixed periods, performance could go through swings significant enough to move a fund from the top quintile for one period to the bottom for the next. Rolling returns, on the other hand, might better illustrate how frequently funds have periods of underperformance. Accordingly, we now include a fund's rolling returns, as shown in Exhibit 5, which reflects better alignment on measuring consistency and realistic investor experience. We developed the report format shown in Exhibit 5, which uses periods in which the benchmark returns were either positive or negative, to show more clearly how the fund would perform in each type of environment.

Also supporting this change was a global study we had conducted to better understand investor preferences for performance measurement. In this study, 74% of investors we surveyed considered rolling returns to be better indicators of performance.[1]

Exhibit 5: Rolling performance results, as of 12/31/18

Date range from 12/31/98 to 12/31/18

Ten years	Positive	Negative	Total
% Periods – Benchmark	%	%	
% of Periods – Outperformance	%	%	
Average Relative Performance (excess return)			%
Contribution to Alpha			

Five years	Positive	Negative	Total
% Periods – Benchmark	%	%	
% of Periods – Outperformance	%	%	
Average Relative Performance (excess return)			%
Contribution to Alpha			

Three years	Positive	Negative	Total
% Periods – Benchmark	%	%	
% of Periods – Outperformance	%	%	
Average Relative Performance (excess return)			%
Contribution to Alpha			

One year	Positive	Negative	Total
% Periods – Benchmark	%	%	
% of Periods – Outperformance	%	%	
Average Relative Performance (excess return)			%
Contribution to Alpha			

Overall progress and results: Internal and external

The dialogue with the board will continue, and we appreciate how much we have learned along the way. The evolving conversations have addressed key issues around evaluating performance, namely transparency, alignment and clarity.

Transparency – Here we have made significant strides, particularly with respect to benchmark and strategy biases, where we highlight strategic moves away from the index and how that might impact performance in the short term. This transparency has fostered more proactive discussions with the board. We have been able to offer the board more insight into how we evaluate our performance in different environments and compensate managers.

Alignment – Our progress on alignment is reflected in the different ways we are now representing the performance most relevant to our mission to manage through a market cycle. In addition, while not directly part of our dialogue with the board, we revised the portfolio manager compensation language in our SAIs and 15c material to reflect how we align their incentives with longer-term client objectives.

Clarity – We are working on metrics that we hope will better illustrate how we invest, revising individual portfolio reviews to show the board how shareholders benefit from the value of our process and how to emphasize longer-term performance.

At MFS, we had our own internal challenges. It took more time than we expected to build an understanding with the board and ensure that our efforts were not viewed as self-serving. However, it has been worth all the effort. We have collectively focused on the end-investors we serve, and the key takeaway is that it can be done!

Continuing the journey

Our journey has given us a great opportunity to reflect on how we can better align with our board and clients, and we will continue to make improvements as we progress.

We recognize that there is still much more to be done, so we will also continue to work alongside our clients, the board and many other organizations facing similar challenges. We know we are not alone in this work. There's plenty of research showing that misalignment in the investment chain is growing and we are obligated to educate principals and agents about behavioral biases overwhelming the investment chain and work to alleviate them together.

As part of the effort, we are working closely with several global organizations that are objectively analyzing the industry's current state and offering education, dialogue, studies and benchmarks that should help change the focus going forward. These organizations include Focus Capital on the Long Term Global, PRI, the Investors Stewardship Group, the Thinking Ahead Group at Willis Towers Watson, and MIT, among others.

Ultimately our goal is to establish new ways to measure what matters to long-term value creation and to ensure that we can build trust along the way.

Endnote

[1] **MFS Survey Methodology:** MFS Investment Management partnered with CoreData Research, an independent third-party research provider, to field a study among institutional investors in North America, Europe and the Asia-Pacific region. The sample totaled 540 respondents, including pensions, endowments, foundations, SWFs, insurance organizations and banks. To qualify, study participants had to be responsible for the management of institutional assets totaling $100M or more. In addition, a proportion of these assets had to be allocated to active strategies and had to be managed by external asset managers. The survey was conducted from October 23 to December 5, 2018. MFS was not identified as the sponsor of the survey.