Metropolitan City Teachers' Retirement Fund Performance Appraisal Teaching Notes

What Are the Relevant Facts?

1. Bill Fredericks' firm has underperformed [relative to] both a growth stock manager benchmark and Growth Unlimited, according to MCTRFs usual three-year appraisal standards.
2. John Spence has received professional development benefits from MC'TRF's association with Bill's firm and from John's personal relationship with Bill.
3. MCTRF's staff, and perhaps the pension fund's performance, have benefited from services provided by Bill's firm. But the value of these benefits is undetermined, as is the capability of Growth Unlimited to offer the same services.
4. John has a new boss, Mary Trenkler, who likely will judge John's abilities based on his recommendation and analysis. Mary has twice mentioned Growth Unlimited as a potential fund manager.
5. John Spence must make a decision to support Bill Fredericks' firm over Growth Unlimited or vice versa.

What Are the Ethical Issues?

1. By supporting Bill's firm, John Spence may be putting his own personal interest above the interests of the retirement fund beneficiaries and local taxpayers.
2. By presenting the standard "objective" numerical analysis, John may be taking the easy route by telling his boss what she wants to hear (i.e., go with Growth Unlimited) and perpetuating a poor system for allocating the retirement fund's assets.
3. If John changes the decision-making criteria in a way that favors Bill Frederick's firm, is it because the alternative to three-year historical results is a preferred alternative or only because it yields the desired result (i.e., retain Bill Fredericks' firm)? As an aside, portfolio performance appraisal is a vexing problem in practice. There are many ambiguities and practical constraints that preclude a purely objective measurement. Issues include the following:
   - What is a suitable benchmark--equities in general, a growth stock universe, further style delineations such as small companies vs. large, or earnings momentum?
   - Over what time span should the comparison be made?
   - What is the suitable risk measure or adjustment--the standard deviation of returns, beta risk (and if so how should beta be calculated), or possibly multifactor model risk indexes?
   - Can skill be separated from luck in past performance?
   - To what degree can skill be perpetuated in the face of turnover of investment professionals and widespread dissemination of information about "successful" investment strategies? Are markets efficient?
4. Answers to the previous questions could certainly take on a very academic, analytical character. However, when our answers are affected by the parties involved in an individual decision, they are not purely academic or objective, but also ethical in nature.

Who Are the Primary Stakeholders?

- John Spence
- Bill Fredericks and his firm
- Growth Unlimited
- The city and the taxpayers
- Mary Trenkler
- Fund beneficiaries--retired and currently working

What Are the Possible Alternatives?

A. John could provide the MCTRF's standard three-year performance appraisal which would show Growth Unlimited as the preferred fund manager.

B. John could reorient the performance appraisal analysis to provide more favorable comparisons for Bill Fredericks, ie., accentuate the long-term (seven-year) performance or very near term (latest quarterly returns) "comeback" by Bill's firm.

C. John could reorient the appraisal analysis to include the value of other services offered by Bill's firm for MCTRF stakeholders and cite the ambiguities arising from the use of historical performance analysis to predict future performance.

What Are the Ethics of the Alternatives?

A. Alternative A appears to be superior to the others in terms of justice and the rights of the firms that are evaluated by John Spence. After all, John has performed this same analysis for MCTRF's other equity managers in the past. All managers are treated similarly. Also, Mary Trenkler has the right to receive an "undoctored" performance appraisal hypothesis by John. On the other hand, if MCTRF's historical appraisal hypothesis has no validity in predicting future performance (as implied by the efficient market hypothesis), the beneficiaries and taxpayers as well as John, Mary, and MCTRF are not well served by perpetuating this system. In fact, if one accepts the efficient market hypothesis, the extra services given by Bill's firm (if not available from GU) would indicate that Bill's firm dominates GU in spite of the differences in historical performance.

B. Alternative B appears to be ethically suspect. Regardless of how John feels about historical risk return analysis as a predictor of future performance, this course of action appears to be an attempt to justify a preconceived ranking in Bill's favor, and it may set a poor precedent. This arbitrary treatment of Bill violates the rights of other equity managers who would be unlikely to get the same kind of consideration. It violates Mary's right to get an even-handed appraisal from John. Also, such an arbitrary system of evaluation is unfair because the benefits would be concentrated among those whom John likes, while the burdens would be borne by the other stakeholders--the taxpayers, the plan beneficiaries, MCTRF, and the equity managers who are not in John's favor.

C. Alternative C appears to be the best from a utilitarian perspective, especially if one is a strong believer in market efficiency. It affords John the opportunity to discuss his "dilemma" with his new boss and analyze the strengths and weaknesses of MCTRF's appraisal process for all fund managers. As long as this alternative is chosen in conjunction with an effort to reorient all appraisals in a similar fashion, it seems quite reasonable from the perspective of the rights of the individuals involved as well as justice. Still, it raises the question of why John has waited until now to bring up this dilemma. Thus, it is important that John be forthright and realize his bias in this regard.

What Are the Practical Constraints?

1. The practical constraints may relate to the relationship that John has established with Bill Fredericks, his new boss Mary, and other MCTRF staff members. John should be concerned about establishing his integrity with his new boss and maintaining productive, ethical working relationships with Bill Fredericks and the staff.

What Actions Should Be Taken?

1. There is likely to be some disagreement over the preferred alternative, depending on one's opinion regarding the efficient market hypothesis. To those who do not believe in market efficiency, A is the likely choice.

2. If C is chosen, John should be careful in his implementation of the alternative. He should set up a meeting with Mary to discuss his two dilemmas: (1) whether or not to use historical performance in the appraisal process and (2) his desire to reorient the appraisal process when Bill, a friend, is being appraised.

