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Feature Insight

The case for systematic investment management: Basics and Biases Part 2.

NVAM utilizes a rigorous systematic approach to designing investment strategies and implementing them in the Criteria Investment Partners LLC Fund. This is the second of a three part series discussing systematic approaches to investment management.

Systematic managers will usually present you with simulations of attractive historical results. We all know we should be suspicious of such historical "paper" results. After all, who has seen a presentation of a simulation with a poor outcome? Therefore, we should take the time to consider many of the possible biases which could be overstating results relative to what we should expect in the future.

What are some of these biases? In the first part of the series we discussed two biases: Hindsight bias and look-ahead bias. In this piece we will describe two additional biases:

Survivorship Bias-

A cousin of look ahead bias is survivorship bias. A securities database, even if accurate with respect to "look-ahead" bias, must also reflect the universe of securities as they existed through time. For example, if companies which no longer exist (because of bankruptcy or mergers) are not included in the historical data severe biases can result.

Thus It is important to verify that an investment manager's historical database reflected the world "as it was", not "as it is" today.

Information Decay Bias:

Results over the past may show good returns. However, over the years many factors, variables, ideas, and concepts have been identified by practitioner and academic as "market inefficiencies". These apparent opportunities do not go unnoticed by market practitioners, especially those with a quantitative orientation. As these opportunities become better known and more widely used, the inefficiencies can be reduced or wiped out. In this context, a history of good results can be rendered meaningless.

The best protection against "decay bias" is the use of ideas which are internally generated or are relatively unique variations of more established ideas.

Summary:

Simulated results can provide validation of a concept or idea and an understanding of the strengths and weaknesses of a methodology in different market and economic environments. Thus we should welcome such perspective. And an awareness of such biases can actually increase our confidence in a systematic manager if these possible biases have been at least understood and addressed to the extent possible.