

RESEARCH SPOTLIGHT

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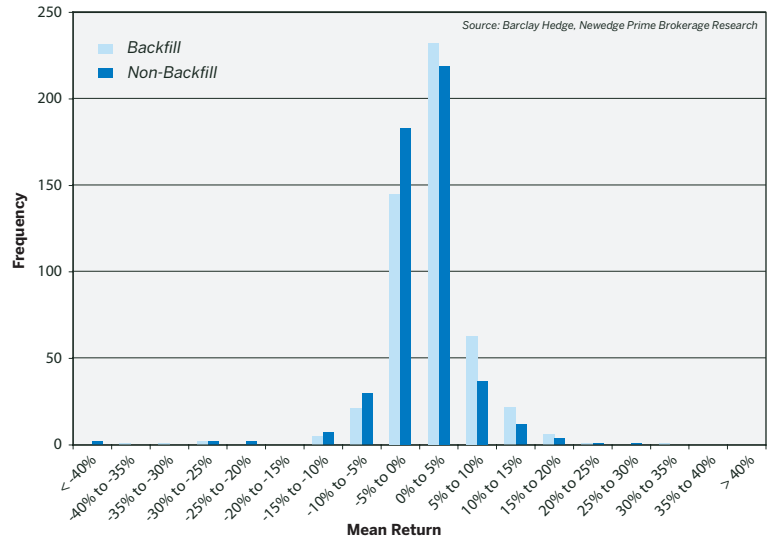
The backfill effect

When listing programs in a database, managers may choose to delay reporting the returns of a product until it would merit investor interest. This produces the problem of “backfill”, which is the portion of the track record that occurred before the performance results were distributed to the industry. The importance of being able to separate that part of the CTA’s track record that was backfill from that part that was reported “live” or “out of sample” is illustrated by the two return distributions in

Exhibit 1. Your eye will confirm what you might have already expected – that backfilled returns are higher than live or out of sample returns. The higher return buckets contain more backfilled returns than live returns, while the reverse is true for lower and negative returns. In these two samples, the average monthly backfilled return was 1.42%, while the average monthly live return was 0.22%. When compounded to annualized returns, the differences are huge. The annualized backfilled return would have been 18.4%, while the annualized live return would have been 2.6%.

Exhibit 1

The difference between backfilled and “live” returns



For this illustration, we took all CTA track records that were created in Barclay Hedge in 2009. We then created two pools of monthly returns. The first included the monthly returns for each manager prior to the date they were added to the database. These are the backfill returns. The second set included each manager’s monthly returns following the date they were created. We then drew random samples of 500 monthly returns from each set and to create the return distributions above. Although we only show the results of programs added to Barclay Hedge for 2009, we ran the same exercise for 2008 and 2007 and found similar results.

It is important to note that the amount of backfill in track records can vary quite a lot. Exhibit 2 shows the distribution of back filled months for managers who entered the Barclay Hedge database in 2009. Of the total of 278 newly reporting CTAs, roughly half reported less than a year’s worth of back filled returns, and about two-thirds reported less than two years of backfill. On the other hand, there were a few who reported several years of back filled returns, with one CTA reporting more than 15 years of past returns.

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We think backfill bias is a natural result of the research process and arises when a manager is constructing an entirely new program or adding a new model to an existing program. In its simplest form, a manager begins by developing an investment thesis, then constructs the strategy using in sample data and tests on an out of sample data set. If the strategy performs as expected the manager will allocate a small amount of capital and commence live trading. It is at this point that backfill is created. The manager is still “testing” the strategy and will hope to attract outside capital if successful. Otherwise, if performance is negative or outside of reasonable expectations, the manager may discontinue trading and revert to additional development and testing. This behavior is completely aligned with what we should expect from all actively managed investment opportunities.

So if backfill data are biased are they still useful? Perhaps, but we feel care should be taken and that it is constructive to know which part of the manager’s track record is backfill when analyzing historical data. As the circumstances will obviously differ from manager to manager, having a framework for dealing with this type of bias may help set the appropriate performance expectations going forward.

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Exhibit 2

Backfilled months for programs added in 2009



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