Portfolio Performance Evaluation: Old Issues and New Insights

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This article presents a model that provides insights about various measures of portfolio performance. The model explores several criticisms of these measures. These include the problem of identifying an appropriate benchmark portfolio, the possibility of overestimating risk because of market-timing ability, and the failure of informed investors to earn positive risk-adjusted returns because of increasing risk aversion. The article argues that these need not be serious impediments to performance evaluation.

One of the widely held "folk theorems" in finance is that informed investors can achieve a better risk–return trade-off than uninformed investors. Risk, however, is difficult to define and measure in markets with asymmetric information, especially when one considers that it must be evaluated by an uninformed observer. For this reason, there has been a great deal of controversy over whether the performance measures proposed by Treynor (1965), Sharpe (1966), and Jensen (1968, 1969) can identify investors with superior information.

Jensen's alpha, which measures the deviation of a portfolio from the securities market line, has been the focus of most of the controversy because it is the most

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