

PERFORMANCE PERSPECTIVES

with David Spaulding



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Since 1990, The Spaulding Group has had an increasing presence in the money management industry. Unlike most consulting firms that support a variety of industries, our focus is on the money management industry.

Our involvement with the industry isn't limited to consulting. We're actively involved as members of the CFA Institute (formerly AIMR), the New York Society of Security Analysts (NYSSA), and other industry groups. Our president and founder regularly speaks at and/or chairs industry conferences and is a frequent author and source of information to various industry publications.

Our clients appreciate our industry focus. We understand their business, their needs, and the opportunities to make them more efficient and competitive.

For additional information about The Spaulding Group and our services, please visit our web site or contact Chris Spaulding at CSpaulding@SpauldingGrp.com

"[Performance measurement] is a great thing...

By dint of perseverance one learns to like it...

The dullness will vanish from your brain."

– Leo Tolstoy
War and Peace

Okay, so Tolstoy wasn't speaking about performance measurement...he was actually speaking of mathematics. But arguably to some (hopefully not you) the quote would hold true.

I had the pleasure to speak at First Rate's user conference last month and for the first time used this quote. It seemed to be a great lead-in to my presentation and also generated some laughs (and, being the frustrated comedian, I'll do almost anything for a laugh (see below)). But it does take some perseverance to learn it and perhaps a bit more to become passionate about it. Performance measurement, perhaps more than any other aspect of investments today, is a huge growth area, undergoing a continuing amount of change. We're excited to be part of it and hope you feel the same way.

CLOSING A COMPOSITE...HOW TO?

A client recently asked me how to close a composite. The answer: you can't...today. And, this, to me, is a problem. Why *can't* you close a composite?

Let's say that five years ago you created a mid-cap U.S. equity composite. But perhaps after a couple years you realized that some of these accounts are actually value and some growth, thus you were seeing a fair degree of dispersion and the return's usefulness became questionable. So, you decided to create two new composites: mid-cap growth and mid-cap value. What do you do with the original composite? You have to keep it.

I recently suggested that this be reconsidered, and hopefully it will be. I propose that a composite be able to be closed as long as all of the accounts in the composite are now in at least one other composite. To close the composite, the firm would set an "end date," and document this, along with the names of the composites that replaced it, within the disclosures; something like "the mid-cap composite was closed August 31, 2007. The succeeding composites are the 'mid-cap value' and 'mid-cap growth' composites." The composite would continue to be on the firm's list of composites for five years.

Is there any harm in this? Your thoughts?

VERIFICATION – MINIMUM TIME PERIOD

I was teaching a GIPS class for the CFA Institute recently in Atlanta and someone asked the question, "what's the minimum period for which a verification can be performed." If we look at paragraph III.A.3 of the 2005 edition of GIPS we read: "The initial minimum period for which verification can be performed is 1 year of a firm's presented

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Single Currency Return Attribution

– *Bob Kopprasch, Ph.D.,
Gijs Treimanis*

Morningstar® Investor Return: Capturing the Collective Investor Experience

– *Catherine Sanders,
Julie Austin, CFA, and
Michelle Swartzentruber*

Fixed Income Attribution with Minimum Raw Material

– *Andrew Colin, Ph.D.*

Risk-Adjusted Performance Attribution Based on the Information Ratio

– *Jose Menchero, Ph.D., CFA*

Fixed Income Attribution: A Unified Framework Part 2

– *Bernard Murira, CFA and
Hector Sierra, Ph.D., CFA*

The Journal Interview

– *Todd Juillerat, CFA, Invesco*

performance.” Pretty clear, yes? But it begs the question, “why?” If a firm begins business on March 1, 2006, why can’t they have their record verified at the end of 2006?

I recall that we discussed this in the Investment Performance Council Interpretations Subcommittee a couple years ago, but don’t believe that anything has been formally published on it. And so, I reached out to Karyn Vincent, who is the current chair of this committee. Her response: “The one year minimum applies only if there is more than one year of history. The assumption is that a firm presents annual returns. For example, if a firm has five years of history, then a full year must be verified. If a firm has just started and has a April 1 inception date, and therefore has a nine month track record ended 12/31, the firm can be verified for the first partial year. The firm does not need to wait a full year.”

Makes sense to me and hopefully to you, too! I expect that this will be turned into a “Q&A” and be on the GIPS website at some point in the near future.

GEOMETRIC OR ARITHMETIC ATTRIBUTION...YOUR PREFERENCE?

We are in the process of completing our third survey on performance attribution. We typically ask the question, which method is preferred, geometric or arithmetic. We’ve often been surprised by the responses since geometric wins out. But how can this be, since we have enough interaction with people to know that arithmetic is preferred, both here and in Europe (the one exception seems to be the U.K., but recall that they still drive on the left side of the road, too). (It’s a joke...please don’t be offended). Seriously, we are often perplexed when we see more people choosing geometric. But a possible reason was given to us some time ago: some firms use a geometric model to do the math, but then convert the result to arithmetic! (See Figure 1).

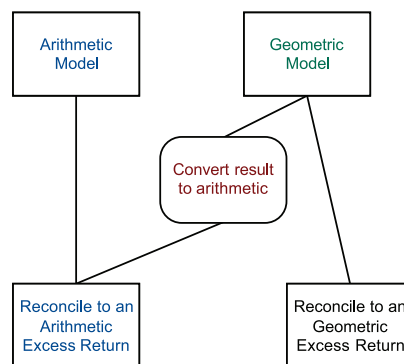


Figure 1

Recall that the goal of relative attribution is to explain the sources of the excess return (see Figure 2). When we speak about geometric vs. arithmetic, we’re speaking about the way we define excess return, thus we need a model that will reconcile to it.

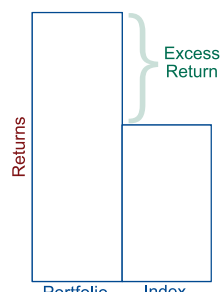


Figure 2

The Spaulding Group (TSG) can address any of these common problem areas

Types of Assignments

General Performance Measurement Issues

TSG assists firms in evaluating the broader areas of performance to include calculations (which to use and when), reporting (for internal use, for prospects, and for clients), systems issues, and other areas.

Verification/Certification

We also offer GIPS® verification, and if you are not claiming compliance but need your numbers certified, we can assist with that as well.

GIPS Compliance

Many firms need assistance understanding the GIPS standards and determining whether they should comply. Also, many need help developing a strategy to become compliant or remain compliant. Often, in just a day or two, TSG can help you address the opportunities, benefits, and tasks to be tackled in order to comply.

System Design

TSG can support you in the design and development of your performance system. We can also assist in documentation and testing.

Software Searches

TSG can help you decide which software product best meets your firm's needs, and we also support the implementation process.

Operational/Control Issues

TSG can assist you in dealing with a host of operational challenges including data integrity, reconciliation, policies and procedures, and much more.

Arithmetic models reconcile to an excess return defined as:

$$\text{Excess Return}_{\text{Arithmetic}} = R - \bar{R}$$

while geometric models reconcile to an excess return defined as:

$$\text{Excess Return}_{\text{Geometric}} = \frac{R + 1}{\bar{R} + 1} - 1$$

where:

R = Portfolio Return

\bar{R} = Index Return.

For example, if our portfolio had a return of 7% while the index has a return of 5%, the arithmetic excess return will be 2% while the geometric will be 1.9 percent. This is what a lot of people find confusing. And so, if we convert our result from a geometric model to arithmetic, we will now reconcile to the arithmetic excess return. But why do people do this? Because they find some benefits in using a geometric model but want the results to be expressed arithmetically. Confused? You're not alone.

Reminder: in case you haven't completed the survey yet, please do so (it's on our website: www.SpauldingGrp.com). Participants will receive a complimentary copy of the results.

COMMUNITY SERVICE IN NEW ORLEANS

The Performance Measurement Forum¹ is having its Spring 2007 North America meeting in New Orleans this month. We chose New Orleans to show support for the region following the devastation of Hurricane Katrina. And, in addition, we decided to do some work here.

Patrick Fowler arranged our work project with Fr. Ray Bomberger, who I'm familiar with because our Church established a relationship with him and his parish following the storm. We spent three days working in his Church as well as at a home of a parishioner. The work in the Church was critically important so they could resume support of the poor, which has been curtailed since the damage.

The volunteers for this effort were:

- Diann Martin of the World Bank
- Debi Deyo Rossi of Turner Investment Partners
- Valarie Lamana of Goldman Sachs
- Ann Putallaz of Munder Capital Management
- Joe McDonagh of Eagle Investment Systems
- Patrick Fowler, John Simpson, and Christopher Spaulding of The Spaulding Group.

In addition, I participated as well as Kenny Soltis and Mike McKenna, two friends of Patrick who are general contractors.

We were very pleased to be able to provide some assistance and thank everyone for joining us. They exercised what some refer to as "stewardship": giving of their time, talent, and treasure to be here.

We will include some photos from our efforts in the May issue.

¹ The Performance Measurement Forum is a membership group, made up of approximately 50 firms, that meets twice a year in Europe and twice a year in North America. It's an interactive group that addresses various issues the industry faces.

THE SPAULDING GROUP'S 2007 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

| DATE | EVENT | LOCATION |
|-----------------|--|-------------------------|
| May 8-9 | Introduction to Performance Measurement Training | Chicago, IL (USA) |
| May 10-11 | Performance Measurement Attribution Training | Chicago, IL (USA) |
| May 15-16 | PMAR Conference | Philadelphia, PA (USA) |
| June 4-5 | Advanced Performance Measurement Training | New Brunswick, NJ (USA) |
| June 14-15 | Performance Measurement Forum | Helsinki, Finland |
| July 23-27 | Investment Performance Measurement Boot Camp | New Brunswick, NJ (USA) |
| August 20-21 | CIPM Principles Exam Preparation | Boston, MA (USA) |
| August 22-24 | CIPM Expert Exam Preparation | Boston, MA (USA) |
| August 27-28 | CIPM Principles Exam Preparation | Los Angeles, CA (USA) |
| August 29-31 | CIPM Expert Exam Preparation | Los Angeles, CA (USA) |
| September 17-18 | Introduction to Performance Measurement Training | Los Angeles, CA (USA) |
| October 8-9 | Introduction to Performance Measurement Training | Boston, MA (USA) |
| October 10-11 | Performance Measurement Attribution Training | Boston, MA (USA) |
| October 15-16 | Advanced Performance Measurement Training | San Francisco, CA (USA) |
| October 23-24 | Introduction to Performance Measurement Training | New York, NY (USA) |
| October 25-26 | Performance Measurement Attribution Training | New York, NY (USA) |
| November 8-9 | Performance Measurement Forum | Athens, Greece |
| November 29-30 | Performance Measurement Forum | Orlando, FL (USA) |
| December 3-4 | Introduction to Performance Measurement Training | New Brunswick, NJ (USA) |
| December 5-6 | Performance Measurement Attribution Training | New Brunswick, NJ (USA) |

*For Additional information on any of our 2007 events,
please contact Christopher Spaulding at 732-873-5700*

Register Today!

The Journal of Performance Measurement®
Fifth Annual International

PMAR

Performance Measurement,
Attribution & Risk

Conference

May 15th - 16th, 2007

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INTRODUCTION TO PERFORMANCE MEASUREMENT

A unique introduction to Performance Measurement specially designed for those individuals who require a solid grounding in all aspects of performance measurement. The Spaulding Group, Inc. invites you to attend Introduction to Performance Measurement on these dates:

May 8-9, 2007 – Chicago, IL

September 17-18, 2007 – Los Angeles, CA

October 8-9, 2007 – Boston, MA

October 23-24, 2007 – New York, NY

December 3-4, 2007 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

The Spaulding Group is registered with CFA Institute as an Approved Provider of professional development programs. This program is eligible for 12 PD credit hours as granted by CFA Institute.



PERFORMANCE MEASUREMENT ATTRIBUTION

Two full days devoted to this increasingly important topic. The Spaulding Group, Inc. invites you to attend Performance Measurement Attribution on these dates:

May 10-11, 2007 – Chicago, IL

October 10-11, 2007 – Boston, MA

October 25-26, 2007 – New York, NY

December 5-6, 2007 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

The Spaulding Group is registered with CFA Institute as an Approved Provider of professional development programs. This program is eligible for 10 PD credit hours as granted by CFA Institute.



ADVANCE PERFORMANCE MEASUREMENT

June 4-5, 2007 – New Brunswick, NJ

October 15-16, 2007 – San Francisco, CA

IN-HOUSE TRAINING

The Spaulding Group has offered in-house training to our clients since 1995. Beginning in 1998, we formalized our training, first with our Introduction to Performance Measurement class and later with our Performance Measurement Attribution class. We now also offer training for the CIPM program. To date, over 1,500 individuals have participated in our training programs, with numbers increasing monthly.

We were quite pleased when so many firms asked us to continue to provide in-house training. This saves our clients the cost transporting their staff to our training location and limits their time away from the office. And, because we discount the tuition for in-house training, it saves them even more! We can teach the same class we conduct to the general market, or we can develop a class that's suited specifically to meet your needs.

The two-day introductory class is based on David Spaulding's book, *Measuring Investment Performance* (McGraw-Hill, 1997). The attribution class draws from David's second book *Investment Performance Attribution* (McGraw-Hill, 2003). The two-day Advanced Performance Measurement Class combines elements from both classes and expands on them.