

PERFORMANCE PERSPECTIVES

with David Spaulding



VOLUME 5 – ISSUE 4

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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

ATTRIBUTION PRICE EFFECT

We're all familiar with some of the standard effects in attribution. For example, with equities we typically see selection, allocation, and interaction; on the fixed income side, it's common to see treasury or duration effect, spread effect, selection effect, as well as others.

One challenge many firms face, especially in "bond land," is price differences between the index and the portfolio. This can arise because of the often less liquid nature of this market (e.g., municipal bonds are often a problem because issues trade so infrequently) and differences in FX rates. As a result, the index provider may use a source that's different from the manager. How does one deal with this?

At one time I was told that firms were to do *nothing* with these differences; that is, to simply use the different prices which would contribute to, of all things, residual. I think there are some huge problems with an apparent ambivalent attitude about the price differences.

During a recent software search for one of our clients, we met with two vendors, both of whom referenced their "price effect," which they use to capture the price differences. I haven't seen anything formally written on this and hope to gather details in the coming weeks, which I'll provide here. In the mean time, if you have any ideas or insights, please pass them along.

INTERACTION BLACK BOX

I've begun to work on an article, which I hope will be published in the Spring issue of *The Journal of Performance Measurement*, on an "Interaction Black Box" idea. The interaction effect is a rather confusing and controversial one. There are generally two camps:

Camp #1 – show it

Camp #2 – hide it.

When it's hidden, it often is included with the selection effect, although some vendors give you the option to include it with allocation. I happen to favor showing it but also understand that it can be confusing to recipients, especially when it's large.

For some time I've discussed the concept of *attributing interaction* in our training classes; that is, to figure out *where* it *should* go, and putting it there. In some cases, the answer is pretty easy. For example, if we use the Brinson-Fachler model and the manager significantly underweights an outperforming sector (relative to the overall return), the interaction will be a large negative number. If the selection decision was a wise one, it will be negatively impacted. The accompanying table provides an example. If you apply the formula you'll find that the allocation effect is -0.03%, selection is 0.10%, while interaction is -0.05 percent.

<http://www.SpauldingGrp.com>

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Performance Measurement for Pension Funds

– *Auke Plantinga,
University of Groningen*

Multi-currency Attribution – Part 1

– *Carl Bacon CIPM,
StatPro Group plc.*

A Hierarchy of Methods for Calculating Rates of Return

– *Yuri Shestopaloff, Ph.D.
and Alex Shestopaloff,
SegmentSoft Inc.*

Analysis of Ranking Factors for a Risk Averse Investor in a Non-Gaussian World

– *Massimo Di Pierro, Ph.D.,
School of Computer Science
Telecommunications and
Information Systems at DePaul
University and Jack Mosevich,
Ph.D., Merrill Lynch*

A Brinson Model Alternative: an Equity Attribution Model with Orthogonal Risk Contributions

– *Andrew Colin, Ph.D.,
StatPro Group plc.*

The Journal Interview

– *Jonathan Boersma, CFA,
The CFA Institute*

	Portfolio		Index	
	Weight	Return	Weight	Return
Sector	5%	3%	10%	2%
Total		2.5%		1.5%

In this case, lumping interaction with selection seems unfair, doesn't it? After all, it was the poor allocation decision that caused the result. My proposal is to have a "black box" that had logic built into it that would decide *where* to assign the effect. In some cases, it would all go to allocation, in some cases all to selection, and in some cases, split. The box would be a set of rules to properly assign the interaction effect.

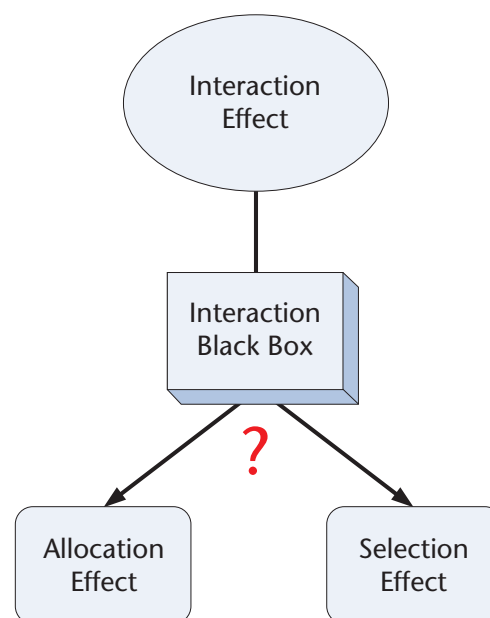


Figure 1 - Interaction Black Box

More details will be in the forthcoming article. In the mean time, if you want to share your thoughts on this idea, please do. Thanks!

SIGNIFICANT VS. LARGE

If you review the GIPS standards, you'll come across these terms in relationship to cash flows. What's the difference?

"Significant" cash flows have to do with the receipt or delivery of external flows which will result in a potentially deleterious effect on the portfolio, because the manager must take time to invest the new money or create cash in the case of a delivery. The standards permit the temporary removal of portfolios from composites in the case of significant cash flows; there's even a guidance statement that provides details on this option.

"Large" has to do with the impact that large flows have on the calculation when an approximation method (such as Modified Dietz or Modified BAI) is used. This has nothing to do with the ability to invest or create the money; rather, it has to do with the impact that large flows have on approximation methods.

KEEP THOSE CARDS & LETTERS COMING

We appreciate the occasional e-mail we get regarding our newsletter. Occasionally, we hear positive feedback while at other times, we hear opposition to what we suggest. That's fine. We can take it. And more important, we encourage the dialogue. We see this newsletter as one way to communicate ideas and want to hear your thoughts.

The standards currently state that compliant firms will be required to revalue their portfolios when large cash flows occur, effective January 2010. The firm gets to decide what “large” means, but we generally expect it to be 5% or 10% of the beginning market value.

There's some confusion about whether or not the Modified Dietz or Modified BAI will be permitted after this date. They will! As long as they're being applied when small flows occur. Imagine, for example, that in a month you have a flow but it doesn't pass the “large” test you've established (i.e., it falls below the size you've defined to constitute “large”). You will therefore *not* be required to revalue and you can apply the approximation formula that weights the flow (recall that effective January 2005, the mid-point methods (e.g., Original Dietz) are no longer allowed; you must weight the cash flows based on when they occur during the period).

Well, what happens if both a large and a small flow occur in a month? For the small flow you can use the Modified Dietz, for example, but you'd be expected to revalue for the second. The result: you'll have two returns for the month, one based on the approximation method and one based on exact; you'd then link these returns. **Figure 2** gives you an idea how this would occur.

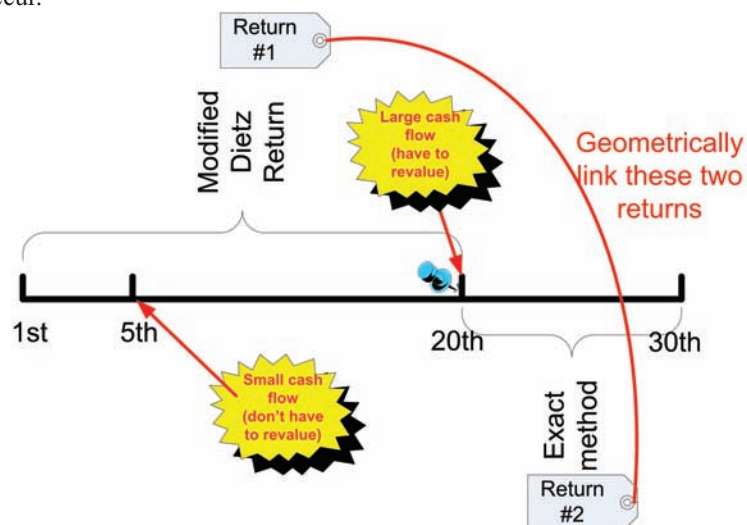


Figure 2 – Dealing with large and small flows

THE CHEESE STANDS ALONE

Well, perhaps not alone, but we received two comments about my thoughts on handling mutual fund fees (see our October newsletter) and neither agree with my position. The first appeared in the November issue; here's the second:

In actuality, most of my clients DO disclose that mutual funds are included but are careful NOT to give the name of the fund, for the very reason you discuss. If you have a one-account composite, consisting of a mutual fund – now THAT'S a quandary!

*Herbert M. Chain
Partner
Deloitte & Touche LLP*

Save the Date...



Reminder!

The Spaulding Group is currently conducting a survey on the Performance Measurement Professional. Please visit our website at:

<http://www.spauldinggrp.com/PMProfessionalsurvey2007.htm>

to download your copy today. All participants will receive a copy of the completed report and be eligible for discounts on future trainings and conferences.

My mother taught me to respect my elders, but I don't necessarily always agree with them. In this case, my friend Herb and I respectfully disagree...I tend to take the more conservative view on how to interpret the SEC rules. I think we both would agree that we prefer gross-of-fee returns, as these avoid confusion with returns, but the SEC has some rules on these too, so you're often obligated to show net-of-fee. As with much of the standards, some interpretation is necessary and we often see disagreement. So, *you* decide how you wish to handle this situation! And consult your GIPS advisor or your attorney.

A READER OFFERS AN ALTERNATIVE APPROACH FOR HANDLING MUTUAL FUNDS

We also received these comments:

Hi David,

I read your October issue of Performance Perspectives and wanted to comment on the section titled, "A QUANDARY? PERHAPS." I believe there exists the misperception that a mutual fund can only be reported net of all expenses. I don't believe this to be true. A solution to presenting a net of fee composite that includes mutual fund total net performance (inclusive of all Operating Expenses – the majority not applicable to institutional separate account investors) is to present a return net of management fees only. An institutional advisor that manages a mutual fund for its parent holding company or an unaffiliated distributor (or anyone else for that matter) can pay to have this performance calculated for them for the sole purpose of including it as part of their GIPS presentation. I believe any firm using a model or actual fee approach when calculating a net of fee composite return is significant skewing their net returns (also may cause higher dispersion of net results when combined with separate accounts since management fees for funds are generally much lower) and putting themselves at a competitive disadvantage against peers when including the total net performance of their fund within a composite. As the former Head of Performance for multiple advisors in the past, I have seen this situation more often than not and have succeeded in convincing compliance, legal staff and outside verifiers that this method is an acceptable one. I urge others to consider making this change and to consult with their compliance, legal and outside verifier for their mutual endorsement.

When considering the change, you may decide to restate historical net performance, or change the net methodology on a go-forward basis. I don't see revising net history an issue as you will be revising the returns upward (a downward historical revision could result in a lawsuit since past clients may have hired you based on better net numbers). You may want to consider a model fee approach since actual may be too onerous. Clearly when making the change in net methodology, one must also disclose the old and new methods along with the effective date of the change.

Feel free to share.

Regards,

Dan

*Daniel Sokolski, VP
State Street Analytics*

Excellent point. We're aware of several firms who do this and believe it's perfectly acceptable; this way, you avoid having to deal with the extraneous fees. Thanks, Dan!

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.

YEAR-END PROMOTIONS

We wish to announce a few promotions which recently took place at our firm:

Christopher Spaulding to *Senior Vice President*

John D. Simpson to *Senior Vice President*

Susan Kneller to *Vice President*

Douglas Spaulding to *Assistant Vice President*

Jaime Puerschner to *Assistant Vice President*

Our firm's success relies a great deal on the contributions of the wonderful team of professionals we've assembled and it's a pleasure to be able to acknowledge a few of them.

A CALL FOR PAPERS

We are planning to publish a "Handbook" on risk measurement and are seeking authors to contribute to this volume. If you're interested, please send your subject and contact details to me. Thanks! (DSpaulding@SpauldingGrp.com)

THE SPAULDING GROUP'S 2008 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
January 15-16	Introduction to Performance Measurement Training	Chicago, IL (USA)
January 17-18	Performance Measurement Attribution Training	Chicago, IL (USA)
February 12-13	Introduction to Performance Measurement Training	San Francisco, CA (USA)
February 14-15	Performance Measurement Attribution Training	San Francisco, CA (USA)
March 3-4	CIPM Principles Prep Class	New Brunswick, NJ (USA)
March 5-7	CIPM Expert Prep Class	New Brunswick, NJ (USA)
March 11-12	Introduction to Performance Measurement Training	Boston, MA (USA)
March 13-14	Performance Measurement Attribution Training	Boston, MA (USA)
April 15-16	Introduction to Performance Measurement Training	New York, NY (USA)
April 17-18	Performance Measurement Attribution Training	New York, NY (USA)
April 24-25	Performance Measurement Forum (North America)	San Francisco, CA (USA)
May 6-7	Introduction to Performance Measurement Training	Los Angeles, CA (USA)
May 8-9	Performance Measurement Attribution Training	Los Angeles, CA (USA)
May 21-22	Performance Measurement, Attribution, & Risk (PMAR) Conference	Philadelphia, PA (USA)
June 3-4	Introduction to Performance Measurement Training	Baltimore, MD (USA)
June 5-6	Performance Measurement Attribution Training	Baltimore, MD (USA)
June 12-13	Performance Measurement Forum (Europe)	Paris, France
July 14-18	Performance Measurement Boot Camp	New Brunswick, NJ (USA)
August 25-26	CIPM Principles Prep Class	New Brunswick, NJ (USA)
August 27-29	CIPM Expert Prep Class	New Brunswick, NJ (USA)
October 7-8	Introduction to Performance Measurement Training	New York, NY (USA)
October 9-10	Performance Measurement Attribution Training	New York, NY (USA)
October 7-8	Introduction to Performance Measurement Training	San Francisco, CA (USA)
October 9-10	Performance Measurement Attribution Training	San Francisco, CA (USA)
October 22	Trends in Attribution Symposium (TIA)	Philadelphia, PA (USA)
November 4-5	Introduction to Performance Measurement Training	Boston, MA (USA)
November 6-7	Performance Measurement Attribution Training	Boston, MA (USA)
November 13-14	Performance Measurement Forum (Europe)	Amsterdam, The Netherlands
December 4-5	Performance Measurement Forum (North America)	Orlando, FL (USA)
December 9-10	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 11-12	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2008 events, please contact Christopher Spaulding at 732-873-5700

TRAINING...

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

TO REGISTER:

Phone: 1-732-873-5700

Fax: 1-732-873-3997

E-mail: info@SpauldingGrp.com



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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:

January 15-16, 2008 – Chicago, IL	June 3-4, 2008 – Baltimore, MD
February 12-13, 2008 – San Francisco, CA	October 7-8, 2008 – New York, NY
March 11-12, 2008 – Boston, MA	October 7-8, 2008 – San Francisco, CA
April 15-16, 2008 – New York, NY	November 4-5, 2008 – Boston, MA
May 6-7, 2008 – Los Angeles, CA	December 9-10, 2008 – 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:

January 17-18, 2008 – Chicago, IL	June 5-6, 2008 – Baltimore, MD
February 14-15, 2008 – San Francisco, CA	October 9-10, 2008 – New York, NY
March 13-14, 2008 – Boston, MA	October 9-10, 2008 – San Francisco, CA
April 17-18, 2008 – New York, NY	November 6-7, 2008 – Boston, MA
May 8-9, 2008 – Los Angeles, CA	December 11-12, 2008 – New Brunswick, NJ

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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.