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, we focus 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

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CGIPS™ SURPRISES

We are finding that a number of people who have signed up for the CGIPS Principles' Exam have learned that the material encompasses more than they expected. As a result, we have begun to give out a pre-class questionnaire listing several subject areas to discern how each student gauges their knowledge, (from a scale from zero (I've never heard of it) to 10 (I could teach a class on this)). Not surprising, topics like Modified Dietz, geometric linking, and annualization tend to receive scores of 7 or higher (although even here we have seen scores as low as four). But when we ask about Macro Attribution, French-Fama's 3-factor model, and Quality Control Charts, it's not unusual to get zeroes.

This has prompted a few to ask, "Can I reschedule my exam to the Fall?" Unfortunately, the answer is, "no".

While we are unaware of how many have signed up for the exam, we know that their experience level varies between a few months to many years. We are also unaware of how the scoring will be conducted. However, we know that the "pass/fail" notices won't go out until sometime after the exams have been fully administered.

Because of this, we have added two more "prep" sessions for March (see schedule on page 6). In addition, we are offering flash cards, which we believe can better prepare you for the exam. John Simpson, who designed our CGIPS training class, has also developed the cards' content, which will be ready to ship by early March.

MIS-CLAIMS OF GIPS® COMPLIANCE

There was a recent article in P&I[1] that commented at length on the habit of some plan sponsors to claim compliance with the GIPS or AIMR-PPS® standards. The author is absolutely correct in saying that this runs in conflict with the standards purpose, which is to provide a set of rules for asset managers to use when presenting their performance to prospective clients. Since plan sponsors don't generally manage other peoples money, they wouldn't need to avail themselves of this.

Well, I couldn't help myself and I penned a response that appears in the February 20th issue. Rather than tell you about what I wrote, here it is:

> Dear Editor:
>
> Brian C. Breidenbach's recent article ("Misleading compliance," January 9, 2006) highlights what has been one of the common problems with the

1 Bridenbach, Brian C. "Misleading compliance." Pensions & Investments. January 9, 2006: page 12.

The Journal of Performance Measurement®:

> AIMR-PPS® and GIPS®, and that's the incorrect use of the "in compliance with" language. Software vendors started this trend in 1992, when they were offering "AIMR-PPS compliant" systems, and it's continued since then. In addition to the examples Breidenbach discusses, custodians, too, are often asked if they're compliant or, even worse, claim that they are.
>
> For plan sponsors, the interest in claiming compliance may not be such a bad thing, as these institutions want to adopt as much of the standards as possible, as they see these rules as "best practices." While in the early days, asset managers chose to comply to gain a marketing advantage, today institutional managers are at a marketing disadvantage if they don't comply. It's important to note that many of these firms have found an additional benefit of compliance: to improve internal controls. Presumably, many plan sponsors (and consultants) want the same thing.
>
> An argument can be made that plan sponsors can comply, and even the Q&A Breidenbach references provides the basis for this: to paraphrase the actual quote, plan sponsors can not make the claim of compliance unless the plan sponsor actually manages the assets to which the compliance is directed. A Plan sponsor could be viewed as a fund-of-funds (which can comply), as they have the right to hire and fire their managers. In addition, many plan sponsors manage some of their assets internally. Consultants, too, could argue that they behave in a fashion similar to a fund-of-funds, and should therefore be able to adopt the standards.
>
> I don't believe plan sponsors claim compliance in order to gain an advantage over anyone else, but rather to state that they find the standards worthwhile and want to abide by them. Consultants may perhaps adopt the standards as a way to demonstrate their skill at manager selection, which appears to be a logical extension of the standards.
>
> Rather than fault such institutions who find the standards worthy of adoption, we should encourage it. The standards have now taken on a global presence with the introduction of the latest version of GIPS, which replaces the AIMR-PPS (as well as other local standards). We should be looking for ways to broaden them further, as they are excellent rules to abide by.

After I pondered this further, it occurred to me that while the standards are simply wonderful, plan sponsors are too bogged down with the false belief that time-weighted returns are the universal way to calculate returns. This is simply wrong. In fact, I'd argue that plan sponsors should be using money-weighted returns as the general rule for seeing how they're doing, and time-weighting only to monitor their managers.[2]

2 And here only if they, the client, controls the cash flows. This would mean that money-weighting is appropriate for (a) private equity / venture capital accounts and (b) sub-portfolio returns, which we've talked about before.

The standards have benefited many firms, by helping them garner new accounts as well as to get their house in order. Well, the latter is an excellent reason for plan sponsors (and even consultants) to adopt the standards – what's the harm?

REVALUING PORTFOLIOS

We were recently asked, "what are the rules on revaluing portfolios for daily performance?". Well, there are none. GIPS requires revaluation for large flows effective January 1, 2010, and we know that many firms are already doing this or are on the way to do it long before this date arrives. But what's the timing? Start-of-day, mid-day, end-of-day?

My general recommendation is start-of-day for inflows, and end-of-day for outflows. This seems to make sense and we've seen a number of firms as well as software vendors adopt it. I'm not a fan of mid-day.

The challenge is to properly handle the flow. That is, if the money contributed to that day's return, then it should be included; if it didn't, it generally shouldn't. Generally, because we could have a situation where the manager (a) knew about the flow, (b) had time to invest it, but (c) decided not to. Well, the flow should still be included. We'll try to come up with something more detailed on this in the future.

CONGRATS!

The CFA Centre for Financial Market Integrity and the Country Sponsors of the GIPS Standards recently announced the inaugural GIPS Executive Committee members. The Executive Committee is comprised of nine seats, four representing key industry stakeholders of the GIPS standards, four seats representing the regions and Country Sponsors of the GIPS standards, and the Director of Investment Performance Standards at the CFA Centre. The members of the GIPS Executive Committee are as follows:

Director — Alecia Licata

Industry stakeholders:

Interpretations seat — Karyn Vincent

Verification/Practitioner seat — Yoh Kuwabara

Investor/Consultant — Carol Kennedy

Investment Manager — Sunette Mulder

Regions / Country Sponsor representatives:

GIPS Council Chair — Hans-Jorg von Euw

Europe, Middle East, Africa RIPS Chair — Stefan Illmer

Asia-Pacific RIPS Chair — Louis Boulanger

Americas RIPS Chair — Todd Juillerat

Congrats to all!

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.

Consulting and Verification Services

The Spaulding Group can address any issue in the field of investment performance measurement.

Our services include consulting, verification, training, research, publishing, conferences and interactive forums. We are recognized globally as the leader in investment performance measurement products and services.

TYPES OF ASSIGNMENTS

We help clients address performance measurement in a variety of ways, for example:

- GIPS® Compliance — the *why* and *how*
- Verification/Certification
- Performance Measurement Needs
- System Design
- Software Searches
- Operational/Control Issues

OUR CLIENTS

TSG has consulted to clients from all areas of the money management industry. We serve investment advisors, banks, mutual fund companies, insurance companies, hedge funds, custodians, broker dealers, investment consulting firms, plan sponsors and software vendors.

For more information on how we can support you and your firm please contact Christopher Spaulding at 732-873-5700 or CSpaulding@SpauldingGrp.com, or visit our website at www.SpauldingGrp.com

COMMENTS FROM A READER

One reader offered the following, in response to last month's commentary on standard deviation:

> Interesting discussion on the standard deviation measure in this Newsletter. Two thoughts came to mind:
>
> a) You did not discuss the difference between using STDEVP and STDEV. Mathematically, the difference is that the former will always be smaller than the latter, because it divides by sqrt(T) rather than sqrt(T-1). Conceptually, the difference is that STDEVP is only appropriate if you have observations on the full population of portfolio returns within the composite. As you showed, that is not the case. So, theoretically, one could argue that STDEV is more appropriate than STDEVP, but for those wanting to minimize their reported dispersion, STDEV is always inferior to STDEVP.
>
> b) You kind of argued against the asset-weighted standard deviation, but if you are interested in minimizing your reported dispersion, then this is superior to the equal-weighted standard deviation. The reason is that large portfolios will, all other things being equal, be closer to the composite return than small portfolios. After all, that's what the weighted average implies. Thus, in calculating a standard deviation, you can reduce it by giving the large portfolios that are close to the composite return a larger weight. The size of the effect of course depends on the variation in portfolio sizes in the composite, but it can be very significant, which provides a good reason to use the asset-weighted vs. the equal-weighted standard deviation.

Excellent clarification of the differences in formulas; I failed to discuss this and am glad this issue was raised. As to whether to use "n" or "-1," we discover some inconsistency as to which has been recommended. The 1993 version of the AIMR-PPS showed the calculation using "n" in the denominator,[3] as did the 1997 edition.[4] But the GIPS handbook shows the denominator with "n-1".[5] Is there any wonder why one might be confused? I tend to use "n," as this has been out there the longest.

And as for asset-weighting of standard deviation, this was encouraged in the AIMR-series of standards, but nary a word can be found within GIPS.

3 "Performance Presentation Standards - 1993." AIMR: Page 38.

4 "AIMR Performance Presentation Standards Handbook 1997." AIMR: Page 97.

5 "Global Investment Performance Standards Handbook." AIMR. 2002. :4-5.A.1(d)Page 1.

THE SPAULDING GROUP'S 2006 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION	DEADLINE
February 14-15	Introduction to Performance Measurement Training	New York, NY (USA)	February 7
February 16-17	Performance Measurement Attribution Training	New York, NY (USA)	February 7
March 9-10	CGIPS Preparatory Training	New Brunswick, NJ	
March 14-15	Introduction to Performance Measurement Training	Boston, MA (USA)	March 7
March 21-22	Introduction to Performance Measurement Training	San Francisco, CA (USA)	March 19
March 23-24	Performance Measurement Attribution Training	San Francisco, CA (USA)	March 19
March 30-31	CGIPS Preparatory Training	San Francisco, CA	
April 18-19	Introduction to Performance Measurement Training	Princeton, NJ (USA)	March 31
April 20-21	Performance Measurement Attribution Training	Princeton, NJ (USA)	March 31
April 27-28	Performance Measurement Forum	Scottsdale, AZ (USA)	April 24
May 9-10	Introduction to Performance Measurement Training	London, England	May 2
May 11-12	Performance Measurement Attribution Training	London, England	May 2
May 22-23	Performance Measurement, Attribution, & Risk Conference	Philadelphia, PA (USA)	May 19
June 15-16	Performance Measurement Forum	Dublin, Ireland	June 9
June 20-21	Introduction to Performance Measurement Training	Vancouver, Canada	June 13
June 22-23	Performance Measurement Attribution Training	Vancouver, Canada	June 13
July 11-12	Introduction to Performance Measurement Training	Chicago, IL (USA)	July 5
July 13-14	Performance Measurement Attribution Training	Chicago, IL (USA)	July 5
September 12-13	Introduction to Performance Measurement Training	Boston, MA (USA)	September 4
September 14-15	Performance Measurement Attribution Training	Boston, MA (USA)	September 4
September 18-19	Introduction to Performance Measurement Training	Los Angeles, CA (USA)	September 11
September 20-21	Performance Measurement Attribution Training	Los Angeles, CA (USA)	September 11
October 9-10	Introduction to Performance Measurement Training	New York, NY (USA)	October 2
October 11-12	Performance Measurement Attribution Training	New York, NY (USA)	October 2
October 18	Fixed Income Attribution Symposium FIA	TBA	October 17
November 9-10	Performance Measurement Forum	Milan, Italy	November 3
Nov. 30 - Dec. 1	Performance Measurement Forum	Orlando, FL (USA)	November 24
December 6-7	Introduction to Performance Measurement Training	Chicago, IL (USA)	December 1
December 8-9	Performance Measurement Attribution Training	Chicago, IL (USA)	December 1

For Additional information on any of our 2006 events, please contact Christopher Spaulding at 732-873-5700

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February 14-15, 2006 – New York, NY
March 14-15, 2006 – Boston, MA
March 21-22, 2006 – San Francisco, CA
April 18-19, 2006 – Princeton, NJ
May 9-10, 2006 – London, England
June 20-21, 2006 – Vancouver, Canada
July 11-12, 2006 – Chicago, IL
September 12-13, 2006 – Boston, MA
September 18-19, 2006 – Los Angeles, CA
October 9-10, 2006 – New York, NY
December 6-7, 2006 – Chicago, IL

15 CPE Credits upon course completion

PERFORMANCE MEASUREMENT ATTRIBUTION

A day and a half devoted to this increasingly important topic. The Spaulding Group, Inc. invites you to attend Performance Measurement Attribution on these dates:

February 16-17, 2006 – New York, NY
March 23-24, 2006 – San Francisco, CA
April 20-21, 2006 – Princeton, NJ
May 11-12, 2006 – London, England
June 22-23, 2006 – Vancouver, Canada
July 13-14, 2006 – Chicago, IL
September 14-15, 2006 – Boston, MA
September 20-21, 2006 – Los Angeles, CA
October 11-12, 2006 – New York, NY
December 8-9, 2006 – Chicago, IL

11 CPE Credits upon course completion

These programs may qualify for the CFA Institute's Professional Development Credit. If you are a member of the CFA Institute, please refer to their website to determine whether this program meets the criteria for CFA Institute PDP credit, to calculate credit hours, and to verify documentation requirements. www.cfainstitute.org/pdprogram

CGIPS PRINCIPLES EXAM PREPARATION

The two-day CGIPS Principles Exam Preparation class will provide you with a solid foundation for your formal study of the CGIPS Principles Exam. It will also help you identify any areas in your performance background that might need reinforcement. The earlier you commit yourself, the greater the probability of success.

March 9-10, 2006 – New Brunswick, NJ
March 30-31, 2006 – San Francisco, CA

Customized In-House Training is also available. Please call or email for additional details.