

PERFORMANCE PERSPECTIVES

with David Spaulding



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DERIVING COMPOSITE NET-OF-FEE RETURNS

While the GIPS® standards (Global Investment Performance Standards) don't specifically require net- or gross-of-fee returns (that is, compliant firms can choose which to show; many report both in their composite presentations), a fair amount is written about each. What isn't clearly stated is *how to calculate them*. I wrote an article¹ for the CFA Institute some time ago that went through specific formulas to derive returns with actual fees; but what about "model fees"?

To begin, I have asked this question a few times, **what is a model fee?** The term isn't defined anywhere in the GIPS standards, though it was added with the most recent version. I guess it means "anything but actual." Okay, and so "how do we calculate them?"

The Fee Guidance Statement² (GS) actually shows examples.³ And, the math is quite simple. We've replicated the table that appears in the GS here (see Table 1), so you can see what's proposed.

Calculation of Scenarios A - E					
	Scenario A	Scenario B	Scenario C	Scenario D	Scenario E
Return on investments	8.00%	8.00%	8.00%	8.00%	8.00%
- Trading expenses	0.20%	1.70%	0.20%	0.70%	0.20%
= Gross-of-fees return	7.80%	6.30%	7.80%	7.30%	7.80%
- Investment management fees	1.00%	na	1.00%	1.00%	1.50%
= Net-of-fees return	6.80%	6.30%	6.80%	6.30%	6.30%
- Administrative fees	0.50%	na	0.50%	na	na
= Client return*	6.30%	6.30%	6.30%	6.30%	6.30%

Table 1: Methodology to derive NOF returns from GIPS Fee Guidance Statement

And what do we see? The GS derives the NOF result by simply **deducting the annual fee** (in these cases, 1.00%, zero, or 1.50%) **from the gross return**. And, I will confess that I have often remarked to clients and students that this *can* be a way to derive them. BUT, is this the "best way"? Since the guidance statements are, by definition, "best practice," one would conclude that in fact it must be. But is it really? That's the question.

The challenge to calculating net-of-fee (NOF) returns for shorter periods is that fees don't compound; that is:

- if we take a series of monthly returns
- deduct the monthly fee
- geometrically link the quarterly and monthly returns to produce annual
- the difference between the returns will only equal the annual fee if the return for each month is zero percent!⁴

1 See <http://www.cfapubs.org/doi/full/10.2469/ipmn.v2011.n1.1>.

2 See http://gipsstandards.org/standards/guidance/develop/pdf/gs_fees_clean.pdf.

3 I want to thank my friend, David Yuska, president of CAPS and chair of the USIPC, for reminding me of this.

4 Actually, they don't match then, either. Why not? **Send in your answer: the first one to give the right answer will win a prize!** We'll announce the answer and winner (if there is anyone) in our March issue.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Risk Management for Hedge Funds

– John Longo

Expanding Our Market Vocabulary

– Timothy P. Ryan

On the Stability of Performance Measures Over Time: An Empirical Study

– Francesco Lisi and
Giovana Menardi

Geometric and Arithmetic Approaches to Attribution Linking Are Equivalent

– Andrei Reztsov

A Measurement-Based Performance Management Model

– Herbert Baum

This issue came up recently, while I was conducting a GIPS verification⁵ for a client, who followed the GS. And so, how can I say they're doing it wrong? Well, technically, they are not *doing it wrong*, but I think *they could be doing it better!* I discussed this with my colleagues, John Simpson, CIPM and Jed Schneider, CIPM, FRM, and we are in agreement that this approach is probably *not* ideal, despite its appearance in the GS.

And so, what *should* firms do? Arguably, calculate their “model” NOF returns either monthly or quarterly, and geometrically link them to derive their annual results. Essentially, the same as they would if they were using *actual* fees.

In Table 2 I've taken two of the examples shown in the GS (as the first two scenarios). I added three more: the negatives of these two examples (scenarios 3 and 4) and one where we have a zero return. And what do we see?

Well first, we can see that the differences between the linked monthly or linked quarterly gross and net-of-fee returns do not equal the annual fees. Even in the case where we have zero returns for each period, we're off a bit (as I said we would be). We're close though, right? In Scenario #1, the fee is 1.00% and we're off by six (monthly) and five (quarterly) basis point. And we're off in Scenario #2 by nine (monthly) and seven bps (quarterly). In Scenario 4 we're off a bit more (12 (monthly) and 10 (quarterly)).

I will confess (once again) that I am not a fan of net-of-fee returns, as they don't provide a lot of value, in many, and perhaps, most cases. That being said, many firms show them, and many use the highest fee to derive them. And so, if you're going to do it, shouldn't you be as accurate as possible?

Aren't the values that are derived from quarterly the true results (if we're deducting fees quarterly)? And since the Standards recommend that one *accrue* fees, then monthly would (in theory) be better, though I happen to believe that the extra work isn't worth it, plus it's techni-cally not what the client is getting, since fees are coming out quarterly, not monthly.

	Scenario #1		Scenario #2		Scenario #3		Scenario #4		Scenario #5	
Annual Fee	1.00%		1.50%		1.00%		1.50%		1.50%	
Monthly	0.08295381%		0.12414877%		0.08295381%		0.12414877%		0.12414877%	
	GOF	NOF	GOF	NOF	GOF	NOF	GOF	NOF	GOF	NOF
Jan	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Feb	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Mar	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Apr	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
May	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Jun	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Jul	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Aug	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Sep	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Oct	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Nov	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Dec	0.63%	0.54%	0.63%	0.50%	-0.63%	-0.71%	-0.63%	-0.75%	0.00%	-0.12%
Year	7.80%	6.74%	7.80%	6.21%	-7.28%	-8.20%	-7.28%	-8.68%	0.00%	-1.48%
Difference	1.06%		1.59%		0.92%		1.38%		1.48%	
Quarterly	0.2490679314%		0.3729088938%		0.2490679314%		0.3729088938%		0.3729088938%	
	GOF	NOF	GOF	NOF	GOF	NOF	GOF	NOF	GOF	NOF
1Q	1.90%	1.65%	1.90%	1.52%	-1.87%	-2.12%	-1.87%	-2.24%	0.00%	-0.37%
2Q	1.90%	1.65%	1.90%	1.52%	-1.87%	-2.12%	-1.87%	-2.24%	0.00%	-0.37%
3Q	1.90%	1.65%	1.90%	1.52%	-1.87%	-2.12%	-1.87%	-2.24%	0.00%	-0.37%
4Q	1.90%	1.65%	1.90%	1.52%	-1.87%	-2.12%	-1.87%	-2.24%	0.00%	-0.37%
Year	7.80%	6.75%	7.80%	6.23%	-7.28%	-8.22%	-7.28%	-8.68%	0.00%	-1.48%
Difference	1.05%		1.57%		0.94%		1.40%		1.48%	

Table 2: Calculating net-of-fee returns monthly and quarterly

5 To learn more about our verification services (GIPS and non-GIPS), please contact Christopher Spaulding (Cspaulding@SpauldingGrp.com) or David Mory (Dmory@SpauldingGrp.com).

Upcoming Events: First Rate 2012 Performance Conference

March 26-27, 2012

Four Seasons Resort and
Club Dallas – Irving, Texas

Conference Website:
<http://www.firstrate.com/investmentperformanceconference2012>

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I want to again state that for years (probably decades!) I've been telling clients that it's okay to take the annual GOF and deduct the annual fee to arrive at the annual NOF return; but, this is a *quick and dirty* approach, which can be improved upon, as shown above.

If you use this method, there is *clearly nothing wrong* with you continuing, other than the reality that *it can be more accurate*. And since GIPS has been trying to get returns to be more accurate, replacing annual deduction of fees with quarterly is yet another way to accomplish this.

Have other thoughts you want to share? Please let us know!

FROM OUR READERS

We heard from two of the leading figures in performance and risk measurement regarding last month's discussion on negative Sharpe ratios.



From Steve Campisi, CFA:

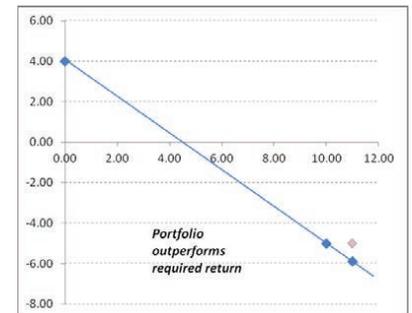
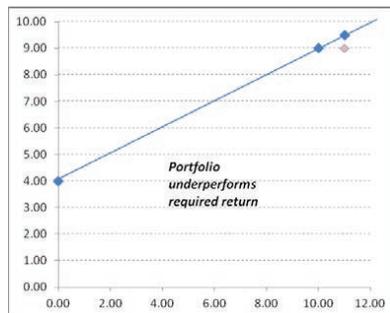
David:

I'm not sure why the idea of negative Sharpe ratios presents any confusion to performance analysts, since it's a straightforward concept. Your explanation is helpful because it provides the link that might not be apparent to most analysts: "Sharpe ratio should be evaluated on a relative basis - compare a manager to the benchmark or to another active manager." Perhaps there's an even simpler explanation: "Higher Sharpe ratios are better." This is true for either positive or negative Sharpe ratios. As you indicate, sometimes the market rewards you for taking risk; at other times it penalizes you with a negative return. Having a less negative return per unit of risk is better; this produces a less negative Sharpe ratio, or on a relative basis a higher Sharpe ratio.

My only request would be that you change your charts so that risk is represented on the horizontal axis and return is on the vertical axis. This is a standard presentation format that analysts expect to see. (We are all creatures of habit.) Also, I found it helpful that you presented your analysis using the highly intuitive "differential return" which is calculated using the required return for the manager's actual level of risk. This is clearly better than

	Return	Risk	Sharpe
Portfolio	9.00	11.00	0.45
Benchmark	9.00	10.00	0.50
Cash	4.00	0.00	
Required	9.50	11.00	

	Return	Risk	Sharpe
Portfolio	9.00	11.00	0.45
Benchmark	9.00	10.00	0.50
Cash	4.00	0.00	
Required	9.50	11.00	



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using the M-squared method, which would analyze the manager's relative return using the hypothetical return, as if the manager had the same risk as the benchmark. This is presented in the charts below, which illustrate your scenarios, the first of which demonstrates an underperforming manager in a good market (positive market risk premium) and an outperforming manager in a bad market (negative market risk premium.)

Interpretations of Negative Sharpe Ratios

1) Market loses money for taking risk (negative risk premium)

2) More negative Sharpe ratio is worse

* You lose more per unit of risk

[And, Carl Bacon, CIPM](#)

David,

Absolutely, negative Sharpe ratios make sense (just like negative information ratios). You can also use the standard graph, return in the vertical and risk in the horizontal – a negative Sharpe ratio is just in the bottom right quadrant and positive Sharpe top right. (nothing on the left because of cause you can't have negative risk or negative standard deviation). Basically when you have a negative return you are better off being inconsistently negative (i.e., higher standard deviation) rather than consistently negative (lower standard deviation). Put it this way and nobody disagrees – by the way fit the numbers into a M squared calculation and that makes sense as well.

Best regards

Carl

I thank Carl and Steve for sharing their thoughts. You may have noticed that I posted a blog entry, citing their remarks and borrowing a bit from them.⁶ This remains an interesting topic; one which I continue to struggle with, as far as being able to communicate effectively why the numbers do, in fact, make sense.

By the way, in last month's issue I referenced a table, which was omitted. Actually, to better represent the dilemma, there are two:

Risk free rate	1%		
	Return	Std Dev	Sharpe Ratio
Portfolio	10%	4%	2.25
Benchmark	10%	2%	4.5

Risk free rate	1%		
	Return	Std Dev	Sharpe Ratio
Portfolio	-10%	4%	-2.75
Benchmark	-10%	2%	-5.5

The first shows what happens when returns are identical and positive, but where the portfolio has a higher standard deviation: as expected, its Share ratio falls below that of the benchmark. The second shows the case where returns are both negative and identical; again, the portfolio has a higher standard deviation, but now has a lower Sharpe ratio. I've used this example in the past, as it serves to demonstrate the challenge many have with this issue. Hopefully it's beginning to make some sense. Again, thanks to Carl and Steve for their remarks and insights.

The Journal of Performance Measurement is beginning a series on performance measurement professionals, and we need your help to identify the folks we should include. We plan to focus on one or two people in each issue, but want the list to be driven by input from other PMPs.

And so, please contact our editor, Doug Spaulding (732-873-5700) with your suggestions.

⁶ <http://investmentperformanceguy.blogspot.com/2012/02/m-squareds-view-of-negative-sharpe.html>.

THE SPAULDING GROUP'S 2012 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
March 13-14, 2012	Fundamentals of Performance Measurement Training	Boston, MA (USA)
March 15-16, 2012	Performance Measurement Attribution Training	Boston, MA (USA)
March 19-20, 2012	CIPM Principles Prep Class	Chicago, IL (USA)
March 21-23, 2012	CIPM Expert Prep Class	Chicago, IL (USA)
April 17-18, 2012	Fundamentals of Performance Measurement Training	Toronto, Canada
April 19-20, 2012	Performance Measurement Attribution Training	Toronto, Canada
April 26-27, 2012	Performance Measurement Forum	Atlanta, GA (USA)
May 21-22, 2012	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
May 22, 2012	GIPS® Workshop	Philadelphia, PA (USA)
May 23-24, 2012	Performance Measurement, Attribution & Risk Conference (PMAR)	Philadelphia, PA (USA)
June 11, 2012	GIPS® Workshop	London, England
June 12-13, 2012	Performance Measurement, Attribution & Risk Conference (PMAR Europe)	London, England
June 14, 2012	Fundamentals of Performance Measurement Workshop	London, England
June 21-22, 2012	Performance Measurement Forum	Dublin, Ireland

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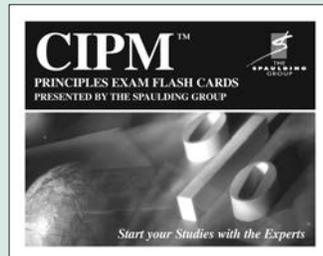
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