

# 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](mailto:CSpaulding@SpauldingGrp.com)

## CROSSING TIME ZONES

Let's say that you're a manager of a fund domiciled in North America, that uses a benchmark that has its official close at 4 PM London time. There are two things that will occur:

- 1) You've got a few more hours, so the pricing of your securities will differ from what the index has
- 2) The FX rates will differ.



What to do?

Options:

- 1) Accept the differences: no reason to fret ... live with it.
- 2) Override the index: that is, adjust the index with prices and FX rates that coincide with what you use
- 3) Override the fund: i.e., use the index's prices and FX rates.

The problem with the first option is that not only will there be differences in returns attributable to pricing and FX differences, but other measures may suffer (e.g., your tracking error will be affected by FX differences, as well as pricing differences, which will result in higher results).

With the second, your index won't match what is published. Someone may wonder why.

With the third, your fund will technically be mispriced.

What to do?

I am open to suggestions on this one. A "best practice" approach should be achievable. Virtually all global managers face this challenge. I'll give you my current thinking (subject to change<sup>1</sup>).

I would actually go with the #1 option: that is, to have the differences. I'd include disclosures to explain the differences, and be prepared to offer an adjusted index and/or portfolio, so that they align, but the REAL numbers are *what they are*. What about tracking error? I'd adjust the portfolio's pricing and FX rates to align with the index; it's unfair for the portfolio to be penalized because of differences.

What do YOU think? Please let me know.

<sup>1</sup> Just as when I decided to change from being a Denver fan to a Seattle fan during the fourth quarter of the Superbowl!

# The Journal of Performance Measurement®

## UPCOMING ARTICLES

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**Operational and IT  
Consequences of  
Performance Reporting**  
– *Bruce Russell*

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**Measuring Performance  
in the Presence of Deposits  
and Withdrawals**  
– *Thomas Becker*

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**The Journal Interview**  
– *Richard Mitchell*

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**Cumulative Frongello-  
Equivalent Attribution**  
– *Tim Svenson*

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**Milestone – Risk-Adjusted  
Performance Attribution**  
– *Jose Menchero*

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**A Simplified Fixed Income  
Attribution Model**  
– *Peter Simmons,  
Anton Karadakov*

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## MISSION ACCOMPLISHED

Almost seven years ago, I started a quest for a doctorate: this had been a goal/dream of mine for a few decades. However, finding a part-time program wasn't easy. But once I learned that Pace University in Manhattan had a program, and that it allowed me to concentrate in Finance, I was hooked! And so, I took the GMATs and applied.



The program is designed for full time professionals who wish to obtain a doctorate (which, for many, is a “terminal degree”<sup>2</sup>). We began the program with 17 candidates; roughly eight completed the course work, and so far only four of us have successfully obtained our degree. The challenges are several, as you might expect:

- Going to school while holding down a full time job. I earned both my masters’ degrees while working, so this wasn’t new to me (although it had been many years since I completed my MBA).
- Reading. You’re required to read a lot of articles, some of which are pretty boring. To me, this was an opportunity to learn how to read research articles (which can run many pages). Once this skill was learned, it wasn’t as difficult.
- Writing. Students must write at various times. For many, writing isn’t something they regularly do. Fortunately, I’ve been a serious writer for a long time, so this wasn’t difficult for me.

Perhaps the most difficult thing with any doctoral program is the dissertation. Many make it to the ABD (all but dissertation) stage, meaning they’ve completed the course work, but a relatively small percentage actually get the dissertation done. This is partly because of the challenge in coming up with a topic, but also the need to gather data and do the research. While we’re encouraged to pick a topic where data is readily available, this isn’t always the case, and wasn’t for me. While getting historical security prices is fairly easy, index data had to be purchased, so this was an added expense. I also had to create some of the data that were used in the analysis.

My topic is performance attribution. I was blessed to be able to do research in an area that I truly appreciate. The title of the paper is “The Predictability of Holdings-Based Residuals As a Result of Trading Turnover and Other Market Factors.” And so, what does this mean? Well, I’ve been aware of the long standing debate as to which method (holdings or transaction) is better, but have never seen any empirical evidence to justify anyone’s position. While some would share anecdotal evidence, this is hardly enough to properly determine which approach is better.

For some time I’ve been encouraging an objective assessment of the two approaches, but there seemed little interest. And so, I decided to make this my topic. I explored what the causes were of residuals, and found some interesting information, that I will share in a couple upcoming papers.

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2 A terminal degree is the highest academic degree in a given field of study.

## DST ARTICLE: FIXED INCOME ATTRIBUTION – EXPERT ROUND UP

Global demand for fixed income products has grown precipitously due to the diversification benefits that this asset class provides. Yet, many asset managers, wealth managers and service providers lack a clear understanding of the factors influencing portfolio performance due to a lack of uniform industry standards and methodologies for measuring attribution. In this article, key industry experts convene to offer their thoughts on fixed income attribution models and solutions and offer suggestions for how to better measure these instruments.

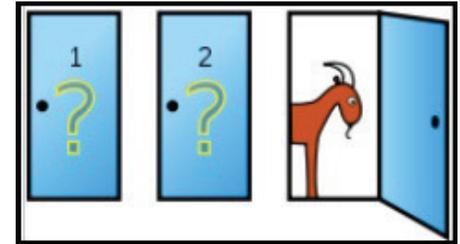
Click [here](#) for the article.

I have had a couple inquiries for copies of my dissertation, and so we are looking into the best way of making it available. Because there is a cost associated with this, we want to ensure it's done in the most efficient manner. If you'd like a copy, please send me a note, and we'll let you know the details once we've decided. I can tell you with certainty that the cost will be no more than \$50 a copy.

### PUZZLE TIME

#### January Puzzle

Last month's puzzle is often referred to as the "Monty Hall Problem." He was the host of the television game show, "Let's Make a Deal." Contestants have the opportunity to win a "grand prize," which is hidden behind one of three doors, and the contestant is asked to select one of the doors. Often, Monty would then have one of the doors opened, revealing something other than the "grand prize" the contestant is seeking. He would then ask the contestant if they would like to switch doors, swapping the one he/she picked with the one that is still closed.



The question: should the person make the switch? Why or why not?

This evokes what Daniel Kahneman's *Thinking, Fast and Slow* discusses. The "fast" way is essentially our gut feeling, with no analysis involved, while the "slow" is more analytical. Well, this question requires us to use the "slow" form, but as Kahneman explains, our "slow" (what he refers to as "system two") is often lazy. Let's consider an example:

You're the contestant, and you pick door number 1. Monty opens up door #3 and we see a goat; hardly our "grand prize," and asks if you'd like to switch to #2. If you're like me, your initial thought is that this is a 50/50 choice: there are two doors, 1 and 2; you picked 1, so why switch? What's to be gained? That's the slow thinking. To me, this is completely intuitive: two doors, you pick one, to switch gains you no advantage.

However, that's not the whole story; we need to invoke our slower thinking process.

When we picked door number one, we have only two possibilities: the prize is either behind door #1, or behind doors #2 or #3. This means we have a one-third probability of being correct, and a two-thirds probability of being wrong. When Monty opens door #3, he's revealing what's behind one of the two doors that are in the two-thirds group. Clearly, the prize cannot be behind both doors, and so he's merely showing you a door that the prize isn't behind. While it may appear we have a 50/50 choice, what we actually have is a choice to increase our odds to two-thirds.

- Our door #1 = 1/3 probability
- Doors #2 and #3 = 2/3 probability.

By us switching doors, we are merely walking across to the two-thirds group.

Let's walk through the math to show how this works to our advantage. There are only three possible scenarios:

## KEEP THOSE CARDS & LETTERS COMING

*We appreciate the emails we receive regarding our newsletter. Mostly, 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.*

Scenario	Door #1	Door #2	Door #3	Keep #1	Switch
A	Grand Prize	Nothing	Nothing	We Win	We Lose
B	Nothing	Grand Prize	Nothing	We Lose	We Win
C	Nothing	Nothing	Grand Prize	We Lose	We Win

We pick Door #1.

In scenario A, when Door #2 is opened to reveal that the prize isn't there, we can either keep our door or switch. If we switch to Door #3, we lose; by keeping the door, we win.

In scenarios B and C, Monty reveals what is behind the doors that do not have the prize; if we switch, we win in both cases; if we keep our original door, we win.

And so, we see that if we retain our original door, we will win one-third of the time, which is our expectation (given that the prize can only be behind one of the three doors); however, by switching, we've adopted the "two door" alternative, meaning we have increased our odds of winning to two-thirds.

David Plantamura was one of those who successfully answered our puzzle, and provided the following, which we wanted to share with you:

Michael Director	USA
Anthony Howland	UK
Neil Riddles	USA
Carlos Leute	Puerto Rico
David Plantamura	USA
Tom Stapleton	UK
Brett Bloemendaal	USA
Gerard van Breukelen	Netherlands
Tom Anderson	USA
Hans Braker	Netherlands

*Wow this brings back memories. In my high school statistics class, back in 1973 or 1974, my instructor, John Sieg, gave us this problem. The math coordinator David Clayman was a roommate at Harvard of Dr. An Wang of Wang Labs. Dr. Wang gave Methuen High School some of the first personal computers Wang Labs developed. In return David Clayman wrote some training documentation for these computers. John Sieg used one of the computers to run a Monte Carlo simulation to prove to the class that you should always switch doors.*

*I just Googled John Sieg, and found out that he went on to teach at the University of Massachusetts in Lowell and that he unexpectedly passed away in 2006 at the age of 53. There is a picture of him and he looks the same at age 53 as he did when I had him as an instructor. He had just graduated from Dartmouth, had the same moustache, and must have been 21 at the time. He was a good instructor and I guess everyone was watching "Let's Make a Deal" at the time. I also Googled David Clayman and found out he passed away in 2011 at age 93.*

*Thanks for bringing back this memory.*

It's interesting that a Monte Carlo<sup>3</sup> simulation was done; granted, it's probably a bit more robust than my simple example, but we end up in the same place: an unexpected and perhaps non-intuitive or counter intuitive one for many "slow System two" thinkers, but the correct one, nonetheless.

<sup>3</sup> A bit of trivia that I learned from this month's book review, but that I'm sure can easily be discovered on Wikipedia, too. The Monte Carlo simulation method was developed in the 1940s at the Manhattan Project, to predict the outcome of nuclear chain reactions. The physics behind chain reactions is too complicated for a precise calculation; instead, they calculated what would happen in many trials, and then aggregated the results. The scientists, John von Neumann and Stanislas Ulman decided to name their method after the Monte Carlo casino in Monaco, with its famous roulette wheel.

# YOUR MISSION: Attend PMAR 2014



Will you accept this mission?  
Do you have what it takes  
to be a Special Agent of  
Performance Measurement?



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## February Puzzle

A taxi cab hits a pedestrian at a busy intersection during evening rush hour. The cab flees the scene. A witness says the cab is one of the blue cabs that operate in the city. Of the taxis in this city, 15% are blue, and 85% are green. The witness has good vision, and tests establish that in evening light she can identify the color of the taxicab correctly 80% of the time. If she testifies that the cab was blue, what's the probability that she is correct?

## **ERRORS!**

Oops! I goofed. In last month's issue I had some errors which my friends, Tricia Bailey and Andre Mirabelli, pointed out to me.

In the "Order Dependency in Attribution Linking" piece, we find:

$$((1.10+1.10)-1) \times 100 = 21.00$$

Should be

$$((1.10 \times 1.10)-1) \times 100 = 21.00$$

$$(5 + 1.10) + 4 = 9.5$$

Should be

$$(5 \times 1.10) + 4 = 9.5$$

I thank Tricia and Andre, and apologize for not catching these in the editing process.

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

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

## Diana Merenda

### Bio:

A recognized process improvement expert in the areas of client service and marketing support, Diana Merenda has extensive experience in asset management including tenures at Lazard Asset Management and Deutsche Asset Management. Diana speaks frequently at industry conferences on the subjects of client service and reporting, data management and marketing. Diana is co-founder of Client Lifecycle Support, a consultancy focusing on best practice workflows as well as offering software for client onboarding, change management, new product development among other areas. Diana has implemented training programs, been published in FUNDfire and other publications, serves on the Financial Women Association's Leadership Council and is a member of the National Society of Compliance Professionals. Diana holds the Claritas® Investment Certificate, CFA Institute ID #6916469; an undergraduate degree in communications from Hunter College, an MBA in management from Baruch College and has successfully completed project management and entrepreneurship courses at Hofstra University. She has also served in local elected public office for seven years, most recently as a two-term Mayor of the Village of Plandome Heights, NY.



## CLIENT'S CORNER

### *1. How long have you been involved in performance?*

I have been involved in performance from the AIMR days of the early '90s! I still have that first handbook, very thin, simple white cover. My goodness how times have changed. Once I learned the importance of composite construction and its relevance for marketing, which was my speciality, there was no going back. I was hooked!

### *2. What do you enjoy most about it?*

I love composite construction because to me, it is the very core of what makes GIPS the authentic methodology for sincere marketing of mandate performance. For this reason, I believe that client onboarding is a critical element for pristine policies and procedures as it relates to composite construction, because having that crucial 'heads up' that a portfolio is going to be ready to become part of a composite in 30 or 45 or 60 days is does so much for risk mitigation on every level.

### *3. What role does The Spaulding Group play at your firm?*

When I introduced The Spaulding Group to one of the firms I was with TSG did a fantastic job of keeping the COO abreast of trends, challenges, areas of interest that had a real impact on the business. In addition, the education workshops that TSG arranged to conduct on premises gave us a competitive edge with respect to fixed income attribution. TSG became a key element of our GIPS program, integral to its success at the firm.

**THE SPAULDING GROUP'S 2014  
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS**

DATE	EVENT	LOCATION
March 24-25	CIPM Principles Prep Class	New Brunswick, NJ (USA)
March 26-28	CIPM Expert Prep Class	New Brunswick, NJ (USA)
April 14	Performance Measurement for Asset Owners	New York, NY (USA)
April 15	Performance Measurement for the Non-Performance Professionals	New York, NY (USA)
April 16	Portfolio Risk Class	New York, NY (USA)
April 24-25	Performance Measurement Forum – North American Forum	Montreal, QE (Canada)
May 19-20	Fundamentals of Performance Measurement	New Brunswick, NJ (USA)
May 20	Fundamentals of GIPS Workshop	Philadelphia, PA (USA)
May 21-22	PMAR XII North America Westin Philadelphia	Philadelphia, PA (USA)
June 10-11	PMAR V Europe America Square Conference Centre	London, England
June 17-18	Fundamentals of Performance Measurement	Chicago, IL (USA)
June 19-20	Performance Measurement Attribution	Chicago, IL (USA)
June 19-20	Performance Measurement Forum – EMEA Forum	Berlin, Germany
July 15-16	Fundamentals of Performance Measurement	San Francisco, CA (USA)
July 15-16	Fundamentals of Performance Measurement	Sydney, Australia
July 17-18	Performance Measurement Attribution	San Francisco, CA (USA)
July 17-18	Performance Measurement Attribution	Sydney, Australia
July 22-23	Fundamentals of Performance Measurement	New York, NY (USA)
July 22-23	Fundamentals of Performance Measurement	Hong Kong
July 24-25	Performance Measurement Attribution	New York, NY (USA)
July 24-25	Performance Measurement Attribution	Hong Kong
August 18-19	CIPM Principles Prep Class	Chicago, IL (USA)
August 20-22	CIPM Expert Prep Class	Chicago, IL (USA)
September 17	Portfolio Risk Class	Boston, MA (USA)
September 23-24	Fundamentals of Performance Measurement	Los Angeles, CA (USA)
September 25-26	Performance Measurement Attribution	Los Angeles, CA (USA)
October 14-15	Fundamentals of Performance Measurement	Chicago, IL (USA)
October 16-17	Performance Measurement Attribution	Chicago, IL (USA)
November 11-12	Fundamentals of Performance Measurement	Dallas, TX (USA)
November 13-14	Performance Measurement Attribution	Dallas, TX (USA)
December 9-10	Fundamentals of Performance Measurement	New Brunswick, NJ (USA)
December 11-12	Performance Measurement Attribution	New Brunswick, NJ (USA)

*For additional information on any of our 2014 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](mailto:info@SpauldingGrp.com)**



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### FUNDAMENTALS OF 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 Fundamentals of Performance Measurement on these dates:

May 19-20, 2014 – New Brunswick, NJ

June 17-18, 2014 – Chicago, IL

July 15-16, 2014 – San Francisco, CA

July 15-16, 2014 – Sydney, Australia

July 22-23, 2014 – New York, NY

July 22-23, 2014 – Hong Kong

September 23-24, 2014 – Los Angeles, CA

October 14-15, 2014 – Chicago, IL

November 11-12, 2014 – Dallas, TX

December 9-10, 2014 – New Brunswick, NJ

#### 15 CPE & 12 PD Credits upon course completion

CFA Institute has approved this program, offered by The Spaulding Group, for 12 CE credit hours. If you are a CFA Institute member, CE credit for your participation in this program will be automatically recorded in your CE tracking tool.



### 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:

June 19-20, 2014 – Chicago, IL

July 17-18, 2014 – San Francisco, CA

July 17-18, 2014 – Sydney, Australia

July 24-25, 2014 – New York, NY

July 24-25, 2014 – Hong Kong

September 25-26, 2014 – Los Angeles, CA

October 16-17, 2014 – Chicago, IL

November 13-14, 2014 – Dallas, TX

December 11-12, 2014 – 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, close to 3,000 individuals have participated in our training programs, with numbers increasing monthly.

**CIPM PREP TRAINING:** March 24-25, 2014 – Principles Level–New Brunswick, NJ  
 March 26-28, 2014 – Expert Level–New Brunswick, NJ  
 August 18-19, 2014 – Principles Level–Chicago, IL  
 August 20-22, 2014 – Expert Level–Chicago, IL

**UPDATED CIPM Principles and Expert Flash cards are now available on our web store. Please visit [www.SpgShop.com](http://www.SpgShop.com) today to order your set.**

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