

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

UNSUPERVISED ASSETS...THERE'S MORE THAN MEETS THE EYES

Many moons ago, when we first had the AIMR-PPS®, AIMR put out a handy booklet (“Answers to Common Questions About AIMR’s Performance Presentation Standards”). In it we read the following “Q&A”:

“How does one handle partial discretion, in which a block of stock is earmarked and not part of the investment management process?”

Answer

“The remainder of the portfolio should be included, if possible, in its appropriate composite if the holdings are representative of the composite’s strategy. If the earmarked block of stock affects the way the rest of the portfolio is managed, then the entire portfolio is considered nondiscretionary and is not included in any composite.”

This is something many people wrestle with, sometimes thinking that if a client has “restricted” or “unsupervised” assets in their portfolio, then the portfolio should immediately be deemed nondiscretionary. As noted in the above, this should only occur if the manager can’t manage the balance like the other portfolios in the composite. Most accounting systems allow you to flag securities as “non-supervised” or “restricted,” so they will be excluded.

Two questions:

1) What about the income? Your client has a large position in a dividend-paying stock. How should the income be handled?

I’d say it should be a cash flow, as it wasn’t generated from a managed asset. While I suspect that most people aren’t mindful of this and simply take the income in, the result would be an overstatement of performance.

2) What about assets under management? Should the values of these assets be included?

Ideally, I’d say “no.” These are non-managed assets. They are, in essence, non-discretionary from a “legal” standpoint (you can’t sell them). Therefore, they’re not under management. Again, I suspect that most people include them and in most cases the impact is de minimis. This is one reason I suspect that there has never been any “official” comment on it. Also, the accounting of it might be a challenge. But, technically, I’d say exclude them.

BALANCED PORTFOLIOS...HOW TIMES CHANGE

We also find in this handy Q&A book (from the AIMR-PPS days) the following:

“If the client dictates the asset allocation in a balanced portfolio – e.g., 40% equities, 60% fixed income – how should the portfolio returns be reported?”

<http://www.SpauldingGrp.com>

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Multi-currency Attribution – Part 2 – Factoring in Interest Rate Differentials

– *Carl Bacon, CIPM,
StatPro Group*

Performance Attribution Against Transient Buckets

– *Timothy P. Ryan,
Hartford Investment
Management Company*

Derivative Products in Performance Attribution

– *Mathieu Cubilié, StatPro Group*

Evaluating Target Date Lifecycle Funds

– *Ronald J. Surz, PPCA, Inc.,
and Craig L. Israelsen, Ph.D.,
Brigham Young University*

The Role of Conceptual Context in Finding the Rate of Return

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

The Journal Interview

– *Douglas Lempereur CFA, CIPM,
FRA, Franklin Templeton*

Answer

“If the client dictates the mix, then this portfolio is not a balanced portfolio, because the manager does not have discretion over asset allocation, which is a main component of return for this strategy. The Standards recommend that these segment returns be included in equity-only and fixed-income-only composites, with cash accurately allocated.”

In the GIPS® handbook (2nd edition) we read “Composites should be constructed according to strategic ranges of asset mixes provided in the client investment guidelines, not according to the tactical percentage of assets invested in the different asset classes.” (Page 102). While this may seem to contradict the earlier statement, I think that this is actually enhancing what we previously had. In reality, most firms don’t distinguish between cases where the client specifies the range and when the manager handles the allocation. And, in most cases, the client provides some buffer, within which the manager has discretion to alter the allocation.

When the AIMR-PPS was first introduced, many firms lumped all of their balanced accounts together, regardless of the variation in the asset allocations. The second edition went to some length to clarify this (see pages ix-x of the 1997 edition), suggesting that multiple composites are warranted in many cases.

Firms should avoid having ranges too wide as the results will (a) not be very meaningful and (b) be quite disparate.

ASSUMING IT’S RIGHT

Often we assume that what comes out of a software package is, in fact, correct. However, this isn’t always the case. I can think of three occasions when I was involved with verifications where the software vendor had errors in their figures. In one case, the composite return formula was incorrect; in another case, there was a problem in how to interpret a formula and the vendor got it wrong. And most recently, a vendor consolidated the cash flows to a single date in the Modified Dietz formula; unfortunately, while the logic works sometimes, it doesn’t always work, meaning errors can result. Ironically, in this case, the documentation was in error and the vendor apparently had learned of the mistake in the logic and had corrected the code but hadn’t adjusted the documentation... not a horrible problem, but a bit misleading.

I also saw a classic case where parallel testing was done on a system to validate that the results matched the prior system...well, they did! Unfortunately, they were both wrong. I recall this being discussed 25 years ago as a flaw in the typical practice to validate results of a new system by comparing them with the old system; one of my associates suggested that this was fine, as long as the old system got it right. Well, they don’t always and this was a real example of how the practice isn’t failsafe.

Bottom line: you can’t always rely on the software (or, apparently the documentation, either).

ATTRIBUTION...ART OR SCIENCE?

We find varying opinions as to the merits of the different approaches to doing attribution, from different models to the question of arithmetic vs. geometric: from deciding whether

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.

transaction or holdings-based is better or if you should be doing security or sector level attribution.

While in the past I attributed this to the “fact” that attribution is an art, not a science, I am now rethinking this view and questioning whether or not it truly is a “fact.” What, pray tell, is science? A quick visit to www.dictionary.com provides us with:

- a branch of knowledge or study dealing with a body of facts or truths systematically arranged and showing the operation of general laws
- knowledge, as of facts or principles; knowledge gained by systematic study
- a particular branch of knowledge

and for art:

- the quality, production, expression, or realm, according to aesthetic principles, of what is beautiful, appealing, or of more than ordinary significance
- the class of objects subject to aesthetic criteria
- a branch of learning or university study, esp. one of the fine arts or the humanities, as music, philosophy, or literature

Kuhn states that “the term ‘science’ is reserved for fields that do not progress in obvious ways. Can a definition tell a man whether he is a scientist or not?...Inevitably one suspects that the issue is more fundamental...Why does my field fail to move ahead in the way that, say, physics does? What changes in technique or method or ideology would enable it to do so?”¹ He goes on: “we tend to see as science any field in which progress is marked.” But, “Does a field make progress because it is a science, or is it a science because it makes progress?”²

He continues, “Normally, the members of a mature scientific community work from a single paradigm or from a closely related set. Very rarely do different scientific communities investigate the same problems. In those exceptional cases the groups hold several major paradigms in common.”³

While I don’t advocate a single paradigm, if paradigm would mean model and method, I do believe we should have some universally agreed-upon beliefs about the way attribution should be done (e.g., that the model should tie into the management approach). That being said, we welcome your thoughts.

CARVE-OUTS...WILL IT BE A PROBLEM?

The GIPS standards are on their way to eliminating the ability for firms to allocate cash for carve-outs: they’re scheduled to be disallowed effective January 1, 2010.⁴ That being said, some of us oppose this idea and would like the date shifted by one or two centuries...by then, I’ll most likely be gone and won’t care any longer.

¹ Kuhn, Thomas S. (1996) *The Structure of Scientific Revolutions*. Page 160.

² Kuhn (1996). Page 162.

³ Kuhn (1996). Page 162.

⁴ See paragraph 3.A.7, *Global Investment Performance Standards*. February 2005.

⁵ See paragraph 4.A.11. GIPS (2005).

Save
the
Date...



Seriously, I strongly question the need to disallow this long-established and often-adopted way to create carve-outs. Since it can't be "gamed" (i.e., one can't come up with an allocation scheme that will always favor them), what's the harm? Okay, could it be more accurate? Yes. But if a company is okay with the drop in accuracy, why should it matter? The firm is required to disclose the methodology they use to do the allocation,⁵ so the prospect has the ability to question the returns if they so choose.

We're still about a year away from seeing a draft of the 2010 edition, but now is a good time to start to *rally the troops* who oppose this change. So, I invite you to let us know if (a) this will impact you or (b) whether you oppose the change, regardless of its potential impact on you. Please e-mail me (DSpaulding@SpauldingGrp.com) with your thoughts.

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)

Reminder!

The Spaulding Group is currently conducting a survey on the Performance Measurement Professional.

Please visit our website at:

<http://www.spauldinggrp.com/PMProfessionalsurvey2008.htm>

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

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

DATE	EVENT	LOCATION
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 17-18	Introduction to Performance Measurement Training	Boston, MA (USA)
March 19-20	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:

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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:

February 12-13, 2008 – San Francisco, CA	October 7-8, 2008 – New York, NY
March 17-18, 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
June 3-4, 2008 – Baltimore, MD	

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:

February 14-15, 2008 – San Francisco, CA	October 9-10, 2008 – New York, NY
March 19-20, 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
June 5-6, 2008 – Baltimore, MD	

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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.