PERFORMANCE PERSPECTIVES
with David Spaulding

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WILL IT NEVER END?

At last month's Performance Measurement, Attribution and Risk (PMAR™) conference, Donna Glass of Deloitte and Tom Peters of Kreischer Miller spoke on the topic *Verifying the Verifiers*. There was general agreement that ***something*** is necessary, although what it will be is unclear.

I suggested in our March newsletter that something is needed.[1] GIPS® is a critically important standard; so important that some firms will do almost anything to be able to claim compliance. But verifiers should serve as an independent agent to insure, as much as possible, that the firm is actually compliant.

Unfortunately, there are many firms who know that their verifier has done a poor job but continue to have that verifier do the work for them; and, even when they know they're not compliant, will still claim compliance! But why and how can this be? There are probably several reasons:

- Reputation risk: the head of performance picked or recommended the verifier; to now say to his or her boss that they made a mistake and worse, that the firm actually isn't in compliance, is something a lot of folks don't want to confess. No matter how many mea culpas they may utter, the risk to their livelihood is such that they'll continue with the status quo; even if it means their firm is at risk.
- Cost: to switch from a poor performing verifier to a good one often means an increase in cost — "why spend more money when the verifier, no matter how poor they may be, is giving us what we want: an attestation letter saying we're okay?"
- Risk assessment: what is the probability of us getting caught? And, if we ***are*** caught, what's the worse thing that will happen to us? The cost to change verifiers and get our house in order doesn't justify the risks.
- They like dealing with a firm that isn't too demanding. One that tells them what they want to hear.

1 The comments I express here are my own and do not necessarily reflect the opinions of any of the GIPS working groups or committees on which I serve. I was criticized for an earlier newsletter where I voiced strong opposition to mandatory verification, in light of my position on several committees and working groups. While I never hold myself out in this newsletter as being on any of these groups, to avoid any confusion, I've decided to include this disclaimer. Look for it in future issues when I offer similar GIPS-related comments.

The Journal of Performance Measurement®:

We're sure there are other reasons why firms are willingly continuing to claim compliance, even if they're not compliant. But this is unfortunate. It also doesn't make the industry look very good.

Since we run into this fairly often we have concluded that many heads of performance and compliance officers are willing to *bury their heads in the sand* and hope that the problem will either go away on its own or won't ever really surface. They may feel that they're ultimately immune to any criticism if it turns out they're not compliant because after all, they brought in an independent outsider who attested to their compliance. They fail to realize, however, that the responsibility ultimately lies with them. While they may criticize the vendor if, for example, the SEC comes in and finds them to be noncompliant and therefore violating the anti-fraud provisions of the securities regulations, they still are responsible. This is especially true with compliance officers.

ARITHMETIC VS. GEOMETRIC ATTRIBUTION…SHEDDING SOME LIGHT ON A COMPLEX TOPIC

We have just completed our third survey on performance attribution and will shortly be holding luncheon presentations in London and New York on the results. In years past, I was a bit perplexed by the results of the survey vis-a-vis the issue of Arithmetic vs. Geometric attribution. I'm fully aware that most firms use arithmetic and believe that it's much easier to interpret. However, the results didn't make sense to me. Take the 2002 survey when we asked "Which do you prefer, Arithmetic or Geometric?" the responses were:[2]

	Total	U.S. / Canada	Europe	Australia
Arithmetic	28%	27%	25%	50%
Geometric	72%	73%	75%	50%

Table 1: 2002 Survey

How could this be? But when we spoke with some of the participants we found that many were actually confused by the term "geometric." Many equated it with "geometric linking," which isn't correct, as we've discussed in prior issues. So, when we repeated the survey in 2004 we decided to briefly explain the difference. Well, the results seemed a bit better but they were still surprising, especially in the U.S. and Canada, where we know there's a lot more use of arithmetic than geometric.

	Total	U.S. / Canada	Europe	Australia
Arithmetic	49%	43%	62%	40%
Geometric	51%	57%	38%	60%

Table 2: 2004 Survey

2 I've adjusted the percentages to exclude those who either didn't know or didn't have a preference.

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MATERIALS TO BE RECEIVED:

- ★ The Handbook of Investment Performance, by David Spaulding, CIPM
- ★ Readings in Fixed Income Attribution, edited by Stephen Campisi, CFA and David Spaulding, CIPM
- ★ Pension Funds: Measuring Investment Performance, by Peter Dietz
- ★ A one-year subscription to *The Journal of Performance Measurement*
- ★ Formula Reference Guide
- ★ GIPS Standards (February 2005)
- ★ GIPS Handbook (Second Edition, 2006)
- ★ A calculator
- ★ Excel sheet with examples to take away
- ★ A handbook with all the PowerPoint slides

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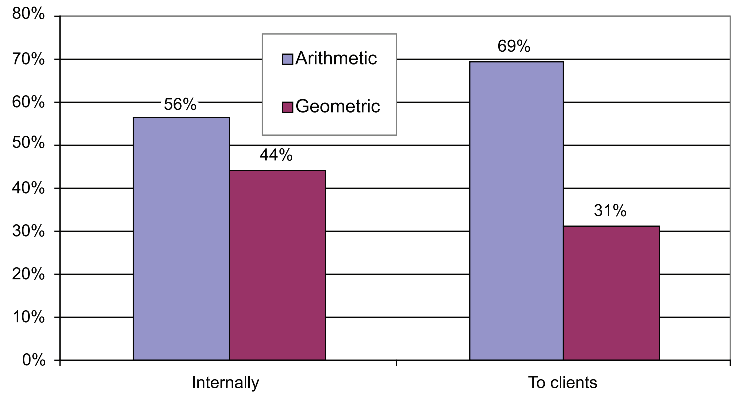
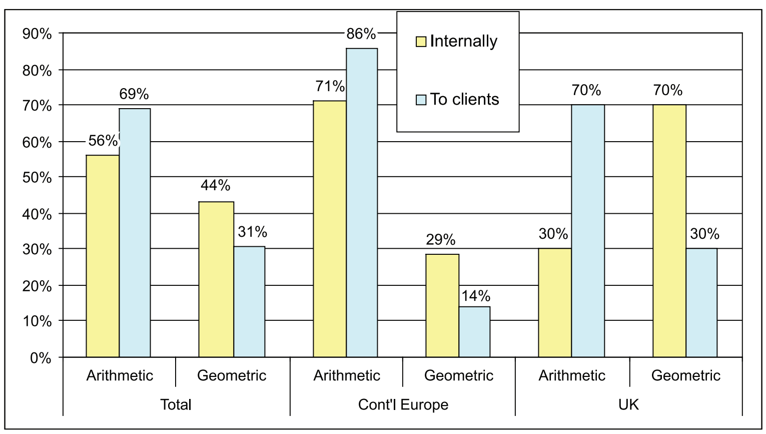
We then discovered that many firms use a geometric model for the calculations, but then present the results arithmetically. While some might disagree with this because they'd argue that it eliminates the "benefits" of geometric-stated results (i.e., ones that reconcile to a geometric excess return),

So, to help gain some greater insights, in the 2007 survey we didn't stop with one question ...we explored this further. We believe the results are quite interesting. For example, to the questions, which method do you prefer for reporting results internally and which to clients, the results made much more sense.



We've always been surprised by the apparent differences between the UK and continental Europe on this subject. Here the results were also more in line with what we would have expected:



It's interesting that for both clients and for internal purposes, most firms prefer to report the results arithmetically, which is an obvious contradiction with the responses to "what method do you prefer." It's especially interesting, we think, how in the UK, there's a huge shift between reporting internally, where geometric is preferred, and for clients, where arithmetic is used. Even there, the appeal of numbers that are arguably more intuitive wins out.

If you participated in our survey, your copy of the results should hopefully be sent to you around the end of July. If you didn't participate but would like to purchase a copy, you can contact our office (732-873-5700), e-mail us (info@SpauldingGrp.com), or visit our website for details (www.SpauldingGrp.com). We want to thank everyone who did participate...the result are quite enlightening, and having the benefit of two prior surveys helps in seeing the trends.

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.

COMMENTS FROM A READER

Todd Juillerat of Invesco sent the following regarding last month's newsletter:

You raise a great point about statistics (alpha, tracking error, information ratio, etc.) being based on net-of-fee versus gross-of-fee within advertisements. I'd honestly never thought of it, nor do expect many people have. Once again, you're ahead of the curve!!

I'm not sure I agree with your assessment of time-weighted versus money-weighted. Within the example you cite, if the pension fund is comparing themselves against other funds (whom I presume use multiple managers since they're "large" and also whom control the cash flows to/from those managers and strategies), wouldn't they be better served to consider their money-weighted returns versus their other plan sponsor competitors? If they want to determine if they've done a better job of choosing managers than other plan sponsors, I'd agree that time-weighted returns (by manager/style) is the more appropriate comparison, and if that's what you meant then I think I just misinterpreted.

Finally, great catch regarding the Significant Cash Flow disclosure requirement (which isn't listed as a required disclosure)!

We obviously appreciate the accolades and thank Todd for sending them our way. We also appreciate the disagreement regarding the suggestion that there's room for using time-weighting for plan sponsor comparisons. Todd's point is excellent and I think worthy of consideration, especially in light of my general preference for money-weighting. We'll be taking the topic of TWRR v. MWRR up again in July.

THE SPAULDING GROUP'S 2007 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
July 23-27	Investment Performance Measurement Boot Camp	New Brunswick, NJ (USA)
August 20-21	CIPM Principles Exam Preparation	Boston, MA (USA)
August 22-24	CIPM Expert Exam Preparation	Boston, MA (USA)
August 27-28	CIPM Principles Exam Preparation	Los Angeles, CA (USA)
August 29-31	CIPM Expert Exam Preparation	Los Angeles, CA (USA)
September 17-18	Introduction to Performance Measurement Training	Los Angeles, CA (USA)
October 8-9	Introduction to Performance Measurement Training	Boston, MA (USA)
October 10-11	Performance Measurement Attribution Training	Boston, MA (USA)
October 15-16	Advanced Performance Measurement Training	San Francisco, CA (USA)
October 23-24	Introduction to Performance Measurement Training	New York, NY (USA)
October 25-26	Performance Measurement Attribution Training	New York, NY (USA)
November 8-9	Performance Measurement Forum	Athens, Greece
November 29-30	Performance Measurement Forum	Orlando, FL (USA)
December 3-4	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 5-6	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For Additional information on any of our 2007 events, please contact Christopher Spaulding at 732-873-5700

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Experience a full week of intensive, real world training, designed to saturate new hires and staff in various situations and arm them with the tools of the performance trade. The Spaulding Group, Inc. invites you to attend Investment Performance Measurement on this date:

July 23-27, 2007 – New Brunswick, NJ

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:

September 17-18, 2007 – Los Angeles, CA
October 8-9, 2007 – Boston, MA
October 23-24, 2007 – New York, NY
December 3-4, 2007 – New Brunswick, NJ

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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:

October 10-11, 2007 – Boston, MA
October 25-26, 2007 – New York, NY
December 5-6, 2007 – New Brunswick, NJ

CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

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ADVANCE PERFORMANCE MEASUREMENT

October 15-16, 2007 – San Francisco, CA

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.