PERFORMANCE PERSPECTIVES

with David Spaulding

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CARVE-OUTS…I'M SO CONFUSED

What's the future of carve-outs? Some have suggested that they're going away, but are they?

Recall that a carve-out allows a GIPS®-compliant firm to include a portion of an account in a composite. While a typical example would be the inclusion of the equity portion of a balanced portfolio, some firms carve-out non-asset class segments, although a basic rule is that what you carve-out should be managed as if it was a single account. If, for example, you wanted to carve out the technology sector of your equities, this grouping should match a portfolio that only invested in this sector. While some firms do employ such strategies, it's rare. So going down to such levels is generally not a good idea.[1]

Because accounts in composites must include cash, we run into a challenge with carve-outs. Since the early days (circa 1993) of the presentation standards, firms have had two options: exact cash management (typically done with either sub-portfolios or separate "cash buckets") or cash allocation. Because the notion of allocating cash has been greeted with something less than an enthusiastic response by some, the standards will change in January 1, 2010: effective this date, firms that wish to continue with carve-outs must manage cash separately (i.e., the exact method). This is what the standards say today.

I'm aware that the GIPS Executive Committee is discussing the GIPS 2010 edition and that the future of carve-outs might change further, but as the standards read today, carve-outs continue. I guess we should "stay tuned" for any breaking news.

BRINSON FACHLER VS. BRINSON-HOOD-BEEBOWER

"Un bon croquis vaut mieux qu'un long discours"
– Napoleon Bonaparte

Having just returned from a week in Paris, I can be excused for using a quote in French to introduce this section. It translates as "a good sketch is better than a long speech" and is arguably equivalent to the proverb "a picture is worth a thousand words."

I like pictures and believe they are great aids to convey ideas. In trying to distinguish between the two "Brinson models," I have used a particular series of sketches for years in our training courses. I recently combined them for a talk I was giving and thought it worthwhile to show them here, too.

Recall that the sole difference between these models is the allocation effect:

1 An alternative, and perhaps more meaningful approach when trying to reflect performance at the sector level, for example, would be to do this as supplemental information.

The Journal of Performance Measurement®:

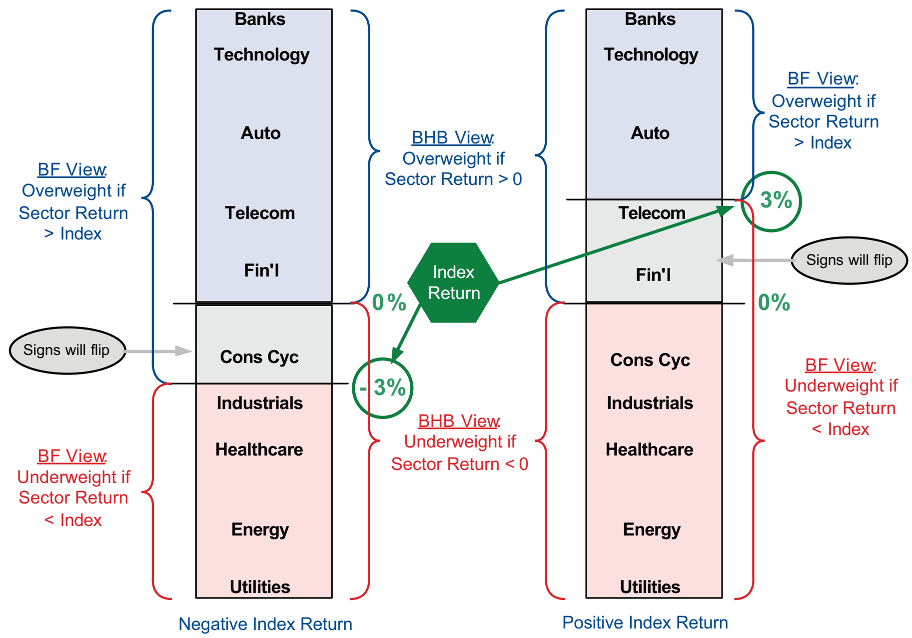
$$Allocation_{BHB} = (w_{P_i} - w_{B_i}) \times r_{B_i}$$

$$Allocation_{BF} = (w_{P_i} - w_{B_i}) \times (r_{B_i} - R_B)$$

where

w_B = benchmark weight
w_P = portfolio weight
r_B = benchmark sector return
R_B = overall benchmark return

In case it isn't obvious, the difference is what we multiply the weight difference (i.e., the allocation difference) by.



In the case of the Brinson-Hood-Beebower (BHB) model, we multiply by the benchmark sector return. We can interpret this as a suggestion that we should overweight positively performing sectors and underweight negatively performing ones.

For the Brinson-Fachler (BF) model, we multiply the weight differences by a relative return: the benchmark's sector return minus the overall benchmark return. Thus, having a positively performing sector isn't enough information: we need to know how the sector did relative to the overall benchmark return. We want to overweight those sectors that outperform the overall benchmark and underweight those that underperform. This sketch attempts to convey the differences. As you can hopefully see, we can have a "gray area" where we'll actually observe a "sign flip (change)" between the two models, where one penalizes and the other rewards the manager's decisions. We hope this helps.

RISK MEASUREMENT CHALLENGES

When it comes to the subject of risk, I've been a collector of quotes. So many demonstrate the difficulties with measuring risk. One of my favorites comes from David Swensen,

> *"Quantitative measures of risk for individual portfolios leave much to be desired."*

Nobel prize laureate Bill Sharpe has had a lot to say about risk, including:

"Measuring risk is the hallmark of accurate performance evaluations."

But now let's contrast this with a quote by Bill Sharpe that Peter Bernstein cited in *Capital Ideas Evolving*:

"It's dangerous, at least in general, to think of risk as a number...The problem we all face is that there are many scenarios that can unfold in the future...The issue is: Do you have similar outcomes in the scenarios, or do you have diverse outcomes?"

Wow!

Many folks seem to be looking at risk and some of the assumptions that have been made. I referenced *The Black Swan* in a recent issue and Bernstein's book quotes several individuals who now challenge some of the assumptions that have been made to develop models. These *fly in the face* of a quote by Milton Friedman which is referenced in *The Black Swan*:

"models do not have to have realistic assumptions to be valid."

A few years ago the Leverage & Derivatives Subcommittee of the GIPS Investment Performance Council considered requiring both tracking error and value at risk to be reported for firms engaged in leverage and derivatives. I was rather vocal in my opposition (as were several others) and this idea was dropped. While I'm aware that the subject of risk and the standards continues to be discussed, I wouldn't look favorably upon any specific measures being required, as they virtually all have detractors. The subject of risk is a complex one and only made more so because of the lack of consensus about what risk is as well as how to measure it, along with challenges about the assumptions which are made.

SURVEYS

The results from our recent "Performance Measurement Professional" survey will be made available shortly. Plus, we're about to launch our seventh survey on the presentation standards. This one is significant for three reasons:

- it's the first since the introduction of the latest edition of the standards
- it's the first without any reference to the country versions (which no longer exist)
- it's the first in advance of the next edition of the standards.

Our surveys have always engendered a great deal of interest and we look forward to your participation. We're editing the questions and hope to have it out shortly. This survey's cosponsors (to date) are:

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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.

NECESSARY DISCLOSURE…

I failed in my April and May newsletters to indicate that the comments regarding GIPS were my own and not necessarily official doctrine. I apologize if my statements appeared as oracles. These are simply my views and guidance. And, this applies to this issue, too!

PERFORMANCEJOBS.COM WEBSITE

We're pleased to announce that our new website is now available for PerformanceJobs.com. Take a visit and you'll also see that we already have jobs posted. We're very excited with the initial interest this new venture has caused and look forward to it becoming the major resource for individuals seeking employment as well as firms looking to hire. If you know of someone who is looking for a career in investment performance, please direct them to our site and encourage them to submit their resume today.

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

DATE	EVENT	LOCATION
June 12-13	Performance Measurement Forum (Europe)	Paris, France
August 25-26	CIPM Principles Prep Class	New Brunswick, NJ (USA)
August 27-29	CIPM Expert Prep Class	New Brunswick, NJ (USA)
September 22-23	Introduction to Performance Measurement Training	Boston, MA (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 13-14	Introduction to Performance Measurement Training	London, England
October 15-16	Performance Measurement Attribution Training	London, England
October 21-22	Introduction to Performance Measurement Training	Chicago, IL (USA)
October 23-44	Performance Measurement Attribution Training	Chicago, IL (USA)
November 13-14	Performance Measurement Forum (Europe)	Amsterdam, The Netherlands
November 19	Trends in Attribution Symposium (TIA)	Philadelphia, PA (USA)
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

Save the Date!

The Journal of Performance Measurement®
Second Annual International

TIA

Trends In Attribution

SYMPOSIUM

November 19, 2008

TRAINING…

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

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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:

September 22-23, 2008 – Boston, MA

October 7-8, 2008 – New York, NY

October 7-8, 2008 – San Francisco, CA

October 13-14, 2008 – London, England

October 21-22, 2008 – Chicago, IL

December 9-10, 2008 – 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 9-10, 2008 – New York, NY

October 9-10, 2008 – San Francisco, CA

October 15-16, 2008 – London, England

October 23-24, 2008 – Chicago, IL

December 11-12, 2008 – 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, over 2,000 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.