PERFORMANCE PERSPECTIVES

with David Spaulding

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SOMETHING THAT NEEDS TO BE CLARIFIED

In our last issue I once again addressed GIPS 2010. But in doing so, I apparently caused some confusion, so I wish to set the record straight on this matter.

Last month we had a section titled "What's Missing?" Some folks apparently interpreted what I wrote as saying that the draft documents didn't have all the changes in them or were somehow missing something; this wasn't the case. I pointed out that there are two documents, one that has all of the changes redlined (the "redlined" version) and one that doesn't (what I called the "proposed changes" document). In the "proposed changes" document, we occasionally see questions raised about some of the proposed revisions, but not all of them. Therefore, if you think that by only focusing on the items that are specifically questioned that you're capturing or seeing all of the changes, you are mistaken. While I can understand why the GIPS Executive Committee wouldn't have asked about every single change, by asking about a few it could cause the reader to think that these are the only things that are changing. The alternatives one has are (a) read the "redlined" version, which is arguably somewhat tedious or (b) compare the "proposed changes" document with the current edition of the standards (which would also be a challenge). And therefore, we developed a spreadsheet that summarizes the changes in what we believe is a rather neat table. It has helped me identify the changes, and I believe it can help others, too.

I fear that I both confused and insulted some individuals, and for this I am deeply sorry. This was not my intent. While I try to be sensitive to how my words might be interpreted, I failed in this case. I apologize.

Although there are several items in the draft with which I disagree, for the most part the revised edition improves upon the current version. I know that a lot of work has gone into this project and I applaud, thank, and congratulate those who are involved in it. The inclusion of the "redlined" version, although a bit difficult to read, details every single change that is proposed.

MARKET RECOVERY

I was pleased to hear our new President say that we need to have a change in attitude in order to get out of this market downturn; something I've been saying for almost six months. But there are still detractors out there who'd rather *talk down* whatever good news we have.

I tend to avoid *USA Today*, as I've found its reporting to be extremely negative and biased. I never buy it, and even though most hotels in the U.S. offer it free to guests, I tend to only look at the sports, so as to avoid their negativity.

I'm writing this on Wednesday, March 18th. And the headline in their business section reads "Home-building boom likely a blip." Amazing, isn't it? Here some positive news comes out and they immediately want to talk it down. Continue feeding negative news so people feel badly. Well, not me. I trashed the paper.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Balanced Portfolio Attribution
– *Stephen Campisi, CFA, Intuitive Performance Solutions*

Private Investments and Performance Implications from a Fund Sponsor's Perspective
– *Guy M. Holappa, CFA, BNY Mellon Asset Servicing*

Establishing Benchmarks for Currency; The Disentangling of Currency Returns
– *Eric B. P. Busay, CFA, CalPers*

Value-based Performance Measurement: A Further Explanation
– *Seth Armitage, Ph.D., University of Edinburgh and Gordon Bagot.*

Utility-Adjusted Performance
– *Charles E. Appeadu, Ph.D., CFA, CFA Institute and Luis García-Feijóo, Ph.D., CFA, CFA Institute*

The Journal Interview
– *David Spaulding, CIPM, The Spaulding Group Inc.*

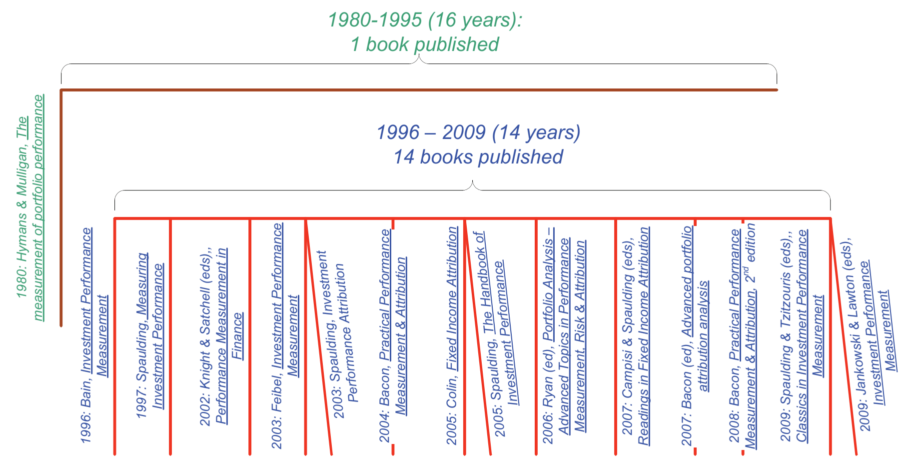
BOOKS AS A METAPHOR

I love metaphors.[1] They often help to explain concepts in an easier way.

I spoke at a conference in Singapore last month and Andrew Colin used cooking as a metaphor for fixed income attribution. It worked quite well.

I'll use books as a way to show how our industry has grown in the past several years.

To begin, from Carl Bacon I learned about a book that was published in 1980: The Measurement of Portfolio Performance, by Hymans & Mulligan. It is arguably the first book published on performance measurement. I distinguish it from Dietz's '66 classic because his was a thesis with a narrow focus; this is actually a book written to teach people about performance. And while Carl credits it with his appreciation for geometric excess return and consequently geometric attribution (a shortcoming he has yet to overcome), I appreciate the authors' obvious appreciation for money-weighted returns, what they call the "true" return!



Okay, now back to my point. So in 1980 we have the first book **on** performance measurement. When does the next one show up? In 1996. So, from 1980 until 1995 (16 years) we have only one book on performance.

And from 1996 until this year how many books have been published? Fourteen, or one book a year![2] To me, this demonstrates how our industry has grown: that it has warranted such growth in book publishing. It wouldn't have happened without the obvious demand, interest, and growth in topics.

NEGATIVE SHARPES

We addressed the issue of negative Sharpe ratios in our August 2008 newsletter.[3] But it seems that at least weekly we're hearing from individuals who are discovering the interesting results one gets when calculating a Sharpe ratio with negative returns.

Suffice it to say, this is a controversial topic. Some (like Sharpe) feel that there's nothing wrong with the results that are produced when the returns are negative; others feel differently.

1 Some say the proper term is "analogies." Perhaps they're right, but I'll continue to say "metaphors."

2 I'm taking a bit of a liberty in including two books which have both been announced and that will shortly appear. Actually, since the second edition of my handbook will be out by mid-summer, the number will actually be at least 15!

3 http://www.spauldinggrp.com/old-site/Aug08NL.pdf

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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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To refresh your memory, the issue is that if we keep the return the same and it's positive, the portfolio with the lower risk has the higher Sharpe ratio (i.e., we're getting more return for the risk we're taking); however, when the return is negative, the results are reversed.

If we think of this in terms of beta rather than standard deviation it might make a bit more sense. With more risk, our returns are supposed to go up faster and down faster; but, if for some reason our return doesn't go down as quickly, is that a good thing? It appears from the Sharpe ratio that it is. While I know that we're using standard deviation, not beta, it's at least one way to try to make sense out of this perplexing situation.

We've attempted to discover if there is a consensus as to how firms are dealing with this situation; so far no luck. Hopefully we'll have something definitive soon. Feel free to opine!

VERIFICATION & FRAUD

With the Madoff situation prominently displayed it's probably not surprising that other fraud cases have also recently surfaced. I suspect that they're surfacing for at least two reasons: (1) like with the Madoff case, the market drop caused many investors to want their funds, putting pressure on many managers to deliver; those who couldn't were found to be doing more with their clients' money than investing it; (2) some investors may have grown suspicious given the Madoff revelations and wanted to make sure they could get to their funds. There also appears to be heightened awareness and scrutiny from regulators. As a result, we've discovered that a few of these firms had been claiming compliance with GIPS. In addition, some have undergone verification. The online news source *Fundfire* has exposed a few of these this month.[4]

So a logical question to ask: should verifiers catch fraud?

The CFA Institute's Jonathan Boersma was quoted in the March 5 article as saying "Verification is not and has never been intended to be a method to detect fraud."

I guess it depends partly on what we mean by "fraud." One of my favorite websites defines it as "deceit, trickery, sharp practice, or breach of confidence, perpetrated for profit or to gain some unfair or dishonest advantage" and "a deception deliberately practiced in order to secure unfair or unlawful gain."[5]

If a firm claims compliance with GIPS but is found to be not in compliance by the verifier, is that firm committing fraud? Well, I won't deal with the technicalities of what they did before they were apprised of what the verifier discovered, but if that firm continues to claim compliance, after learning of their errors, isn't that fraud? We had a very large client (with assets close to $100 billion) a couple years ago who had been claiming compliance for many years. After conducting a review we informed them that in fact they weren't compliant; they chose to continue to claim compliance, however. We chose to discontinue our relationship with that client.

I don't disagree with Jonathan that the level of fraud that some of these firms have gone to are definitely beyond the scope of what a verifier does. In one case we understand that the firm actually created custodial records with Bear Stearns' logos on them, something that requires some work but isn't that difficult given the ability to capture such details off of a firm's website.

4 Johnson, Scott. 2009. "Alleged Fraud Exposes Loophole in GIPS Review." *Fundfire*. March 18. Also, Johnson, Scott. 2009. "Alleged Schemers Passed GIPS Compliance Audit." *Fundfire*. March 5.

5 www.Dictionary.com

Verified, but are you *really* compliant?

Red flags that you may have an unqualified verifier

- Every year they bring in new staff to do your verification, who are often junior-level, and, you get to train them!
- You have to answer the same questions year after year.
- You're aware of problems that the verifier doesn't find.
- Your verifier avoids answering your questions or providing guidance.
- While it's nice to get their verification report saying everything is fine, you are concerned that you may not actually be compliant.

If you're going to make the investment to have your claim of compliance with the Global Investment Performance Standards (GIPS®) verified, doesn't it make sense to select a verifier who will do a quality job and provide you with added assurance that you truly are compliant?

The Spaulding Group is the industry leader in investment performance measurement products and services. We take your firm's claim of compliance very seriously, and we do not offer "rubber stamp" verifications. Our verifiers were chosen to conduct training for the CFA Institute on the GIPS standards and are heavily involved with the standards. We are available for our clients year-round to answer questions and provide support. And if you want to become compliant, we can help you move toward compliance with confidence.

With The Spaulding Group you get

- Senior level professionals conducting your verification.
- Verifications that are conducted on-site.
- Verifications that are done by people, not computers.
- Increased confidence that your firm is truly compliant, not "rubber stamped".
- A firm that's been doing verifications since 1992.
- A firm with a global reputation for excellence.

Whether you are considering a change in verifiers, looking to be verified for the first time, or wanting to become compliant, The Spaulding Group can help. You can be confident that we will provide superior service at a competitive price. For a no obligation quote, please contact Christopher Spaulding at **732-873-5700** or email him at **CSpaulding@SpauldingGrp.com**

While not specifically required by the standards, verifiers typically ask to see outside records during the course of their review; if the firm can't provide them then this should be an indication that there may be problems, which at a minimum should cause the verifier to withhold their verification report.[6]

Another question arises: what should the verifier do in the event they discover fraud?

I think this depends on the gravity of the situation. While a verifier doesn't have the same relationship with their client as a lawyer does (the privileges that such a relationship holds), they are nevertheless a trusted confident and were presumably paid for their counsel. On a scale from one-to-ten, where Madoff-type fraud is a 10, then someone at the lower levels shouldn't result in any action by the verifier other than notifying the client of their errors. However, if someone's at or close to Madoff, then I suspect that regulatory authorities should be notified.

To date there has been no guidance from the GIPS Executive Committee on this; I'm hopeful that given all the attention that's being given to this topic something will be forthcoming. Our firm has never conducted a verification for anyone like the firms identified in the *Fundfire* article (and we hope we don't). If we do, we will seek the advice of the CFA Institute and our attorneys.

WEBINAR SERIES

As a result of the success of this month's webinar on GIPS 2010, we decided to launch a monthly webinar series.

Our next webinar will be Friday, April 24 at 11:00 (AM EST). This two-hour session will deal with Equity Attribution. For more information, please contact Patrick Fowler (PFowler@SpauldingGrp.com). We foresee announcing these sessions at least a quarter in advance, so here are the other planned topics:

- May: GIPS Verification
- June: Risk-adjusted returns.

VERIFIER'S CORNER

A client was recently confused by the terms "large" and "significant" cash flows. Arguably, their synonyms.

- "large" cash flows have to deal with the requirement as stated in ¶ 2.A.2 of the GIPS standards, which requires (effective 1 January 2010) that accounts be revalued for large flows.
- "significant" cash flows have to deal with the option, as laid out in the Guidance Statement on the Treatment of Significant cash Flows, to temporarily remove accounts from portfolios when significant flows occur.

Yes, this stuff gets confusing once-in-awhile; hope this helps!

THE LOSS OF A PERFOMANCE MEASUREMENT GURU

It is with sadness that we announce the recent death of Damien Laker, truely one of our industry's luminaries. Through his software development, writing, publishing, teaching, and consulting Damien impacted the industry to a great extent. We mourn his passing.

6 The document that states that the firm has complied with the GIPS composite construction requirements, and has processes and procedures designed to calculate and present performance results in compliance with the standards.

THE SPAULDING GROUP'S 2009 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
April 20-21, 2009	Introduction to Performance Measurement Training	New York, NY (USA)
May 12-13, 2009	Introduction to Performance Measurement Training	Chicago, IL (USA)
May 14-15, 2009	Performance Measurement Attribution Training	Chicago, IL (USA)
May 20-21, 2009	PMAR VII Conference	Philadelphia, PA (USA)
September 15-16, 2009	Introduction to Performance Measurement Training	Boston, MA (USA)
September 17-18, 2009	Performance Measurement Attribution Training	Boston, MA (USA)
October 20-21, 2009	Introduction to Performance Measurement Training	San Francisco, CA (USA)
October 22-23, 2009	Performance Measurement Attribution Training	San Francisco, CA (USA)
November 18, 2009	Trends in Attribution Symposium (TIA III)	Philadelphia, PA (USA)
December 8-9, 2009	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 9-10, 2009	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2009 events, please contact Christopher Spaulding at 732-873-5700

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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:

April 20-21, 2009 – New York, NY
May 12-13, 2009 – Chicago, IL
September 15-16, 2009 – Boston, MA
October 20-21, 2009 – San Francisco, CA
December 7-8, 2009 – New Brunswick, NJ

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.

CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

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:

May 14-15, 2009 – Chicago, IL
September 17-18, 2009 – Boston, MA
October 22-23, 2009 – San Francisco, CA
December 9-10, 2009 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

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CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

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.