VOLUME 10 – ISSUE 2 OCTOBER 2012

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

http://www.SpauldingGrp.com

RANKING THE WAYS TO PRESENT PERFORMANCE

With the existence of the GIPS® standards, one would perhaps think that *everything that's been said about presenting performance to prospects has been*. However, this isn't the case, and for several reasons.

First, not all firms choose to or are able to comply with the Global Investment Performance Standards. Second, even if a firm *does* comply, there are times when they may want to show performance in a manner other than what's required by GIPS. And third, as I have stated in the past, I have some issues with the way GIPS requires returns to be calculated; for example:

- The use of asset-weighted composite returns; I, along with many others, believe equal-weighted results are better
- As I have also often commented on, the aggregate method, in my view, can produce flawed and misleading returns.

And so, there can be a variety of ways firms may produce, publish, and present returns to prospective clients. These can vary from returns with actual accounts (using composites, "rep" accounts, and hypothetical strategies) to ones without real accounts (e.g., model or back-tested)

One rule should be followed, regardless of whether the firm presents returns in accordance with GIPS or not: do not mix results of real and non-real accounts. To do so can (intentionally or otherwise) mislead the reader.

Since we have a plethora of ways to present performance, we should have a system to rank them, from best to worse, from "best practice" to "not so best practice" (worse practice, possibly?).

The accompanying graphic is my attempt to rank; this is clearly *my* opinion, which may not jive with that of others. Surely it wouldn't conform to the thinking of many involved with the GIPS standards, such as some (though possibly not all) members of the Executive Committee, because I rank composite returns derived from equal-weighting above those from asset-weighting. My rationale is quite simple: asset-weighted returns are subject to skewing of large accounts that can, in essence, dominate the composite return. I have seen cases where the composite return is the return of a single large account, and yet is a distance from that of the remaining accounts (that are simply not represented in the result). Equal-weighting treats all accounts the same, and the result is, in my view, the best representation.

Asset-weighted results are further divided into three subcategories:

- Using beginning values, plus weighted cash flows
- Using beginning values only
- Using the aggregate method.

The Journal of Performance Measurement®

UPCOMING ARTICLES

Venture and Private Equity Performance Update: One Cheer for FAS157
– Susan Woodward

A New Choice in Multi-period Investment Performance Attribution: Effective Return versus Geometric Smoothing
– Ronald J. Surz

Analyzing Diversification Effects, Sector Allocations, Market Conditions, and Factor Tilts in Advanced Equity Beta Strategies: The Case of Efficient Indices
– Felix Goltz and Dev Sahos

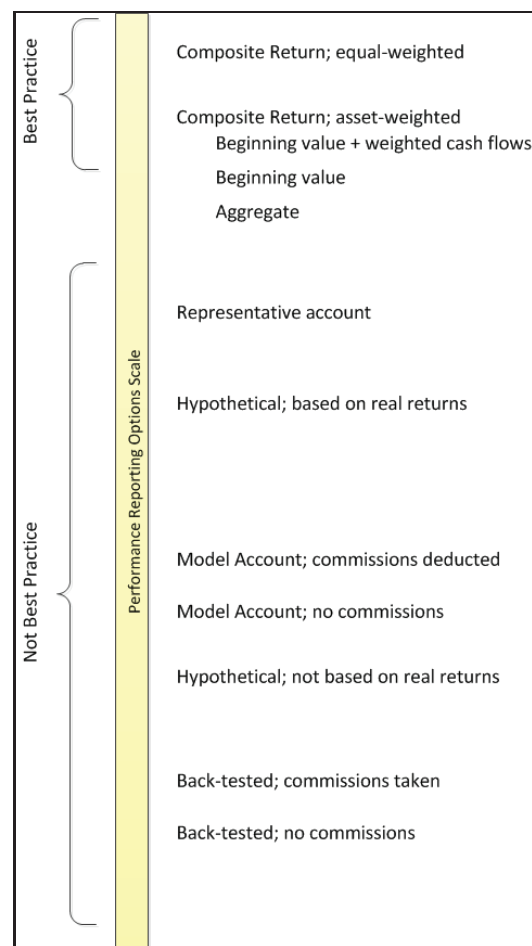
Flows and Woes: The True Cost of Spot Trading Policy
– Matthew Lyberg and Alexander Dunegan

Rethinking Portfolio Risk in Asset Management
– Charles T. Hage

I have been for some time an opponent of the aggregate method, and have elaborated at length in prior writings as to why. Essentially it's because it fails to do as the composite return is supposed to (as defined within GIPS), and that is to provide an asset weighted average of the accounts within the composite; instead, it gives us the composite's return, which has limited value. In addition, it can at times be nonsensical and misleading. And so, these are ranked in their value.

I would propose a quantitative scoring for the various options. Perhaps the following:

- Equal-weighted composite returns: a 10 or 9.9
- Asset-weighting using beginning values plus weighted flows: 9.5
- Asset-weighting using beginning values: 9.3
- Asset-weighting using the aggregate method: 9.1, 9.0, 8.9?
- Rep accounts: 6.5
- Hypothetical, based on real returns: 5.5
- Model account; commissions deducted: 4.0
- Model account; no commissions: 3.5
- Hypothetical; not based on real returns: 3.0
- Back-tested; commissions deducted: 2.5
- Back-tested; no commissions: 2.0.



Another rule should be that anything short of composite returns should carry a disclosure; a warning, if you will, that let's the prospect understand the shortcomings of what they're seeing. Regardless of the method, a disclosure is warranted so that the recipients understand what they're seeing. GIPS compliant firms do not require such a disclosure, since compliance carries with it the expectation that returns are presented in a certain manner. That being said, I would advocate indicating which of the three formulatic approaches was used.

As for suggested disclosures, you can expect to see these in the upcoming Universal Advisor Performance Standards (UAPS), so stay tuned!

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.

WHAT IS HAPPENING TO GIPS PROTOCOL AND TRADITION?

We are anxiously awaiting the publication of the new GIPS® (Global Investment Performance Standards) Handbook (the latest word is it should be out by year-end): the 2006 edition dealt with the 2005 version of the Standards, and so is essentially obsolete and possibly misleading.

It was apparently decided to allow one firm the ability to introduce parts of what we'll see in this book. A better means would be either through the GIPS website, newsletter, or the CFA Institute's magazine. To grant one firm this right is unfair and improper, and makes it look like that firm's newsletter has some *de facto* official status.

As to what is being revealed, we learned that rule changes are being made as part of the editing of the Handbook. Why am I classifying it as "editing"? Because what we're seeing cannot be found in the Standards themselves, guidance statements, or Q&As. This raises a lot of questions, such as (a) did the full GIPS Executive Committee agree on these changes, (b) were they passed by the Interpretations committee, or (c) were they crafted by just a few folks, without the benefit of discussion and different opinions?

I am particularly disturbed by the change regarding a compliant firm's implementation of the Significant Cash Flow policy. The earlier version of the SCF guidance has the following:

> It is important to note that if all of a composite's portfolios were removed during one or more periods due to Significant Cash Flows, there would be a break in the composite performance record. Firms that have composites with only a few portfolios should strongly consider either defining the measure of significance at a very high level or possibly determining that a Significant Cash Flows policy is not appropriate for that composite. If a composite loses all of its member portfolios (whether that is due to Significant Cash Flows, portfolio termination, or some other reason), the performance record stops. If portfolios are later added to that composite, the two periods cannot be linked.

The highlighted text was removed (for an unknown reason) from the current version. Clearly, it was the framers' intent to encourage firms to be sensitive to the number of portfolios a composite might have, as the broad implementation of an SCF policy might, unintentionally, lead to breaks in a composite's history. However, it now appears that firms will be prohibited from tying their SCF policy to a composite's number of portfolios. Why? What is the basis for this?

I addressed this matter in a recent blog post,[1] and I encourage you to read that if you'd like to see examples of what will now be prohibited. While I strongly disagree with this new rule, my primary objection is to the *method* employed to deliver it.

1 http://www.investmentperformanceguy.blogspot.com/2012/10/a-new-gips-rule-being-introduced-in-non.html

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.

The decision was made in the early stages of GIPS to publish new versions every five years,[2] so as to avoid compliant firms having to constantly adapt to new rules: great idea! What we can see in the interim is interpretations of existing rules; clearly, this is no interpretation, as there is nothing to hang the prohibition on; no paragraph can be cited to justify it.

Sadly, this is not the first occurrence of such a process. You may recall that we were recently told that firms can no longer introduce or remove accounts into or from composites within a month. Granted, most firms never did do this, but some did. A change was made, without the benefit of public comment, and with no effective date. The suggestion was that this was the "original intent" of the Standards. Really? What sentence or two can we point to that shows this? None![3]

The Standards have, from the early days, had a tradition of allowing and encouraging public comment, on revisions to the Standards themselves, as well as guidance statements. But this seems to have been cast aside, at least at times.

Recall that the Error Correction GS, a subject which often causes my heart's pace to pick up a tad, introduced a rule change when it was revised. Granted, the original document DID get public comment, but the revision to it, that introduced rules that were not part of the original document, did not. Even GIPS 2010 introduced rule changes that were not part of the draft, but rather added as the document was being finalized.

The benefits of public comment are many; for example:

1. Sometimes the public objects strongly to what is being proposed, and their objections cause disharmony and lack of support for the Standards.
2. Sometimes, what is being proposed is confusing, and the public's comments allow for those responsible for their drafting to alter or enhance what is being promulgated.[4]
3. On occasion, the feedback causes those who wrote the draft to realize that their ideas lacked merit, and could be problematic if they were enacted.

Just consider the rule changes introduced in the Error Correction GS. No one (other than members of the GIPS EC, and perhaps a few others) knew about them. But, when the draft of the 2010 edition of the Standards was circulated, we learned of these new rules, and the public responded in unison that the ideas were not welcome. I won't bother to go into all that occurred as a result of this chorus of objections, but it created challenges and confusion. Had the draft GS been circulated with the rule changes, this could have all been avoided.

2 Actually, there is no requirement that new versions be introduced every five years, but changes would be considered, and so far this has been the schedule.

3 Personally, I have no problem with the change; my issue is with the manner in which it was introduced. The suggestion that it wasn't a "change" is ridiculous. It was I who pointed out the problems that can occur with the aggregate method when accounts are introduced or removed within a month, so I would have supported the change (although I'd prefer to see the abandoning of the aggregate method). But, I, as well as no one else in the public, had the opportunity to comment.

4 The opposition to the Leverage & Derivatives guidance several years ago resulted in the document being pulled back completely. And, you may recall that an earlier draft of the wrap fee rules (under the AIMR-PPS®) were totally altered in response to the massive amount of disdain for what was being suggested.

RISK week

November 12-16, 2012

An online conference event

AGENDA:

A Framework for Risk Management of Hedge Funds
John Longo, Ph.D., CFA
Rutgers University

Risk Adjusted Measures
John D. Simpson, CIPM
The Spaulding Group

Value at Risk
Ben Sopranzetti, Ph.D., CPA
Rutgers University

A Client's Perspective on Risk
Stephen Campisi, CFA
US Trust

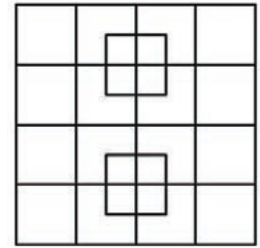
Risk Attribution
Philippe Gregoire, Ph.D.
Orfival

Now, we are seeing new rules introduced as the Handbook is being edited, without the benefit of, or deference to, the public. This is unfortunate. Everyone involved with the Standards should find this objectionable. Will anyone read the full handbook to try to cull out rule changes? Handbooks are often seen as reference tools, just like dictionaries, that one calls upon when needed. And yet, these changes will be lurking within a fairly thick document, until they are discovered. But that may be too late, for a firm may be violating them and completely unaware of these changes.

Note that there is NO REQUIREMENT for firms to abide by the Handbook, *per se*. This was in the original draft language, but was removed. And so, firms must abide by (a) the Standards, (b) guidance statements, and (c) Q&As. Or, are we now to learn that the Handbook itself carries similar authority?

This is all confusing, disturbing, frustrating, disappointing, anxiety creating, and upsetting (probably a few more words can be added, but I'll stop here). Am I alone in my total objection to what is occurring within our industry? I hope not.

PUZZLE OF THE MONTH



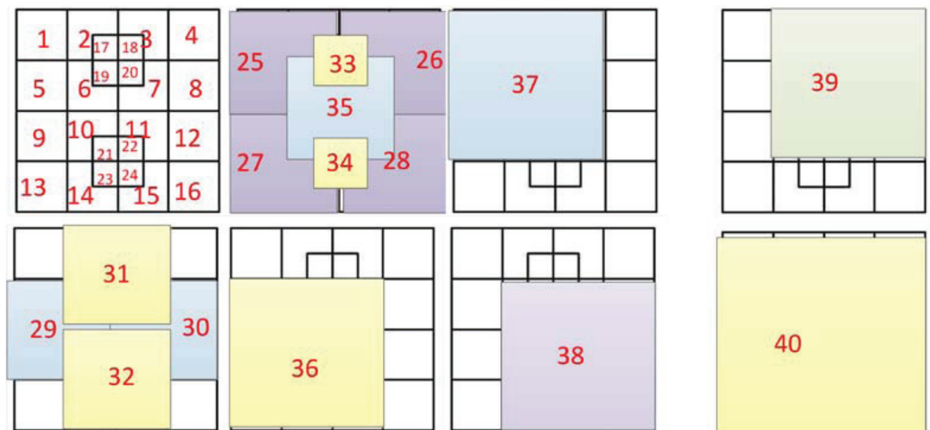
Last month we introduced this new section. The question posed: how many squares are there in this figure:

Twenty-seven participants got the right answer!

Andrew Durkin	UK	James Brewer	USA	Ashish Jacob	USA
John Ly	Canada	Steve Campisi	USA	Jean Dziedzinski	USA
Matthey Rayner	UK	Helene McElmurray	USA	Cindy Yim	Canada
Tommy Cronin	Ireland	Frank Holmberg	Denmark	Gerard van Breukelen	Netherlands
Phil Butler	UK	Sheila S	India	Salil Natu	USA
Andrew Peakman	Switzerland	Bernhard Payer	Switzerland	Eva Lee	USA
David Plantamura	USA	Terri Gloecker	USA	Mary Arndt	USA
Carolyn Falini	USA	Sandra Hahn-Colbert	USA	Joe Dabny	USA
Craig Wietz	USA	Anthony Howland	UK	Sandra Ross	USA

And that answer is "40." I'll confess that when I first encountered it, it took me three attempts to get the right answer. It's fairly easy to get the first several, but then one must realize that combining squares creates additional squares.

I created this series of graphics to help explain where the squares come from:



PERFORMANCE MEASUREMENT HALL OF FAME

The recently published Summer issue of *The Journal of Performance Measurement®* announces that we are seeking nominations for the Performance Measurement Hall of Fame. We credit our friend and colleague, Tim Ryan, for this suggestion.

Please submit names to Douglas Spaulding (DougSpaulding@SpauldingGrp.com), the Journal's editor. The Journal's advisory board will vote on membership. We expect the "inaugural class" to consist of five to ten names. The inductees will be announced in our Winter issue.

We thank Tim for thinking of this idea and for suggesting that we create the Hall.

Your suggestions and ideas are also invited.

This month's puzzle was submitted by my colleague, Jed Schneider, CIPM, FRM:

You are a prisoner. There are two doors.Behind one is a man-eating tiger, and behind the other is freedom. A guard stands in front of each door. One guard always lies while the other always tells the truth. You must choose one door to exit. You are allowed to ask one and only one question to one of the guards (both guards know what's behind each door).

What question do you ask to guarantee choosing the door to freedom?

As with last month, send me your answer in the next three weeks or so (DSpaulding@SpauldingGrp.com).

Have a favorite puzzle or two? Please send them along!

FACT OF THE MONTH

Jack Treynor denies authorship of the Treynor ratio.

Several years ago I was conducting a review of a firm's performance system, and had the need to check certain formulas. I had reviewed Treynor's 1965 HBR article, "How to Rate Management of Investment Funds," but couldn't clearly confirm certain details of the formula, so reached out to Jack via email. He quickly responded that the formula that carries his name is not his and that he didn't know its source, but that he disagreed with using beta in the denominator.

Recall the formula:

$$TR = \frac{\bar{r}_p - \bar{r}_F}{\beta}$$

which is the equity risk premium (average portfolio return minus average risk free rate) divided by beta.

If Treynor didn't come up with this, who did?

Bill Sharpe's 1966 *Journal of Business* article, "Mutual Fund Performance," shows Treynor's formula with a "B" in the denominator (the "B" is meant to represent beta). Bill acknowledged to me that he had always thought that Treynor referenced beta in his article. Since Sharpe's article has been cited by countless other articles, it's not surprising that the above formula has remained. Sharpe referred to Treynor's formula as the "Treynor Index," and his own as the "reward-to-variability ratio."[5] In rereading Treynor's article, I agree with Sharpe.

2 Treynor's is also sometimes referred to as the "reward to volatility ratio."

THE SPAULDING GROUP'S 2012 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
November 8-9, 2012	Performance Measurement Forum	Istanbul, Turkey
November 12-16, 2012	Risk Week – An Online Conference Event	
November 29-30, 2012	Performance Measurement Forum	San Francisco, CA (USA)
December 4-5, 2012	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
December 6-7, 2012	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2012 events, please contact Christopher Spaulding at 732-873-5700

Save the dates!

The Journal of Performance Measurement®
Eleventh Annual International
PMAR
Performance Measurement, Attribution & Risk
Conference
May 16th - 17th, 2013

The Journal of Performance Measurement®
In Association with RIMES Technologies
PMAR III
Performance Measurement, Attribution & Risk Conference
EUROPE
11 - 12 June 2013 – London

TRAINING...

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

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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:

December 4-5, 2012 – 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.

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:

December 6-7, 2012 – 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.

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.

We were quite pleased when so many firms asked us to continue to provide in-house training. This saves our clients the cost of transporting their staff to our training location and limits their time away from the office. With the discounted 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).

UPDATED CIPM Principles and Expert Flash cards are now available on our web store. Please visit www.SpgShop.com today to order your set.

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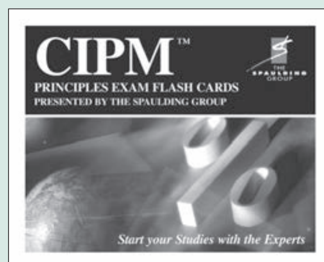

Benefits of Flash Cards:

- Work at your own pace
- Immediate feedback
- Strengthen and reinforce core CIPM principles

These cards are a ***must have*** for anyone preparing to take the CIPM Exams.