



Performance Perspectives

with David Spaulding

**Volume 2- Issue 2
November 2004**

New Guidance Statements

There are now five new guidance statements for your review and comment on the CFA Institute website (http://www.cfainstitute.org/standards/pps/gips_status.html).

They all deserve your attention, so please take the time to review them. And, be mindful that the comment dates for some expire at year-end, so please make sure that those that most affect you are addressed by the deadlines.

In this issue of our newsletter, I will share with you some of my thoughts on two of these items: verifier independence and leverage & derivatives.

Draft Guidance Statement – Verifier Independence

Ever since the Enron case, public accounting firms have been under greater pressure to insure that they avoid conflicts of interest and insure independence when conducting audits. Some have felt that the same guidelines should carry over to the wonderful world of verification. Neil Riddles of Hansberger Global Investors and I penned a letter-to-the-editor to Pensions & Investments¹ in early 2003, which expressed our thoughts. For example:

“The notion that a verifier that helps a client become compliant, can then be independent when they come back in to do the verification, is quite a stretch.

“We have always advocated that the two parties should be separate to insure independence.”

We also expressed our disappointment “that AIMR hasn’t addressed this sooner.”

But now it is being addressed in this guidance statement. There are four major topical areas that the guidance touches on:

1. Can a verifier provide business advisory services (consulting) to a verification client prior to performing the verification?
2. Can a verifier provide other non-performance-related services to a verification client?
3. Can a verifier provide other performance-related services to a verification client?
4. Are there other issues a verifier should consider when determining their status with regard to independence?

¹ Spaulding, David and Neil Riddles. “AIMR rule needs reform.” *Pensions & Investments*. March 17, 2003: page 12.

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, we focus on the money management industry.

Our involvement with the industry isn’t limited to consulting. We’re actively involved as members of the Association for Investment Management & Research (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.

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I suspect that these can actually be separated into two major categories:

1. Those functions the verifier performs relative to performance and compliance with the standards
2. Those other activities, which, because of their magnitude, may create a conflict.

In the first case, if the verifier is overly involved with the performance measurement and compliance functions, their independence can be challenged, because they've been part of the process. And in the second case, because the client provides a fair amount of revenue to the verifier's firm, might this impact their objectivity.

The document rightly points out that "Defining the term 'independent' is not a simple process." It goes on to suggest that we should "view independence as a continuum. At one extreme is a verifier who provides no other service to their verification client. At the other extreme is a verifier who provides a wide range of other services which might be perceived as creating a conflict of interest with regard to verification services."



Before I comment further, I want to cite a recent event where I felt the verifier had *crossed the line* of independence. We were helping a client with a software search and I asked if they would want their composite system to automatically produce the disclosure materials for their compliance with the AIMR-PPS®. Their response shocked me; they said they don't need this because their verifier provides these materials. Later, I found out that this is not unique – that a few verifiers offer this service. But, not all verifiers agree that it's acceptable.

The guidance statement lists as one of the items that "might create an independence conflict" as "Preparing compliant presentations." However, in the Q&A section of the guidance statement, it allows a verifier to do this if they're "Simply performing word processing and duplication functions." Why would a firm pay their verifier to do word processing?

Since the standards require a compliant firm to have presentation materials, and since a firm isn't supposed to have a verification done until they're compliant (or believe they're compliant), why would a verifier prepare the materials? Paragraph G of the verification section of GIPS® states "Verifiers must review a sample of composite presentations to ensure that the presentations include the information and disclosures required by GIPS." Well, doesn't this mean that if the verifier prepared the materials, they'll be checking their own work? And this isn't a conflict? Give me a break.

One phrase that is occasionally used in this document, when trying to determine whether or not an action by the verifier crosses the line is "as long as the client assumes full responsibility." This appears to serve as a *litmus test* when determining independence. But I find this expression to be way too forgiving. What does a client's willingness to "assume full responsibility" have to do with independence?

We know of a verifier who made the decision for their client that certain accounts were non-discretionary. When I asked the client "why are they nondiscretionary" they didn't know. I'd say this is decidedly over the line. However, what if the firm "assumes full responsibility"?

When I posed this scenario to one verifier, who had referred to this catch phrase when justifying his firm's practice of creating presentation materials for their clients, he quickly responded that this act (where the verifier determines discretion) wouldn't be permitted. But why not? After all, if the client is willing to "accept full responsibility"; why shouldn't this be permitted?

To use this expression as a litmus test of independence is a huge mistake, in my opinion. We shouldn't judge independence on a client's willingness to "assume full responsibility." This will totally cloud the issue and add further confusion when determining independence.

As you might expect, I will be offering my thoughts on this guidance statement and I encourage you to do the same. You have until 28 February 2005.

Draft Guidance Statement – Leverage & Derivatives

Two years ago, the IPC L&D subcommittee offered draft standards for leverage and derivatives. To say that this was met with a less than enthusiastic response is putting it mildly. I, along with several others, was critical of much of what was offered. My main gripe had to do with the requirement for firms engaged in leverage to provide both Value at Risk (VaR) and Tracking Error (TE) statistics as part of their GIPS presentations. The added cost to procure a system to calculate VaR was, in my opinion, unfounded. And, to suggest that VaR and TE have achieved such a lofty level of acceptance that they will accurately provide the insights on risk is, in my opinion, debatable. And further, to mandate specific calculations runs contrary to the way the standards had previously been developed.

Others were critical of the specific definition that was offered of leverage, which some felt was too broad.

Because of the overwhelming opposition to what was proposed, the subcommittee was asked to reconsider what they had offered. And, at the spring meeting of the IPC, this group was asked to develop a *guidance statement*, instead of formal standards. And this, they have done.

This is a much-improved document, which I fully support. It provides many original calculations, which should be well received. I encourage you to become familiar with this document, especially if your firm is engaged in these types of investments. Your comments are welcome until the end of this year.

Common areas of confusion - the standards

I had the pleasure of delivering the luncheon talk at Financial Models' recent user conference in Toronto, and gave a talk on the *3 Cs of Performance Measurement* (confusion, controversy, and change). The standards continue to be confusing, as well as controversial and

changing.

Let's talk briefly about one of those confusing items – the requirement to include a fee schedule.² It's not unusual to find in the States, instead of the fee schedule, a reference to the firm's ADV Part II.³ Some verifiers allow this.⁴ But, it's not acceptable. The wording, as it appears in the AIMR-PPS, is: "4.A.16. *The AIMR-PPS standards require firms to disclose the firm's fee schedule(s) appropriate to the presentation.*" If a reference is sufficient, why couldn't the firm use such a practice for many of the other disclosures?

Well, the fact of the matter is that a fee schedule is required and that a reference is not sufficient. While I've been stating this for quite some time, I recently got this opinion in writing from the AIMR-PPS help desk, and if you want to see it, just e-mail me (DSpaulding@SpauldingGrp.com) and I'll forward you a copy.

Certification Program

A year ago, we launched an initiative to develop a formal certification program for performance measurement professionals. The *Certified Investment Performance Analyst* (CIPA) program was to fall under the domain of a nonprofit corporation we formed: The Foundation of Investment Performance Professionals. We had created a board of directors for the foundation (Patrick Fowler, Sabina Hastings, John Simpson, Carl Bacon, Neil Riddles, and me), and a phenomenal team of professionals (our Blue Ribbon Committee, or BRC) to develop the examination (Ian Thompson, Darren Crowley, Jean Burylo, Grant Strang, Martin Schlieman, Carl Bacon, Jean-Pierre Mittaz, Paul Johnson, Neil Riddles, Lucy Schwartzman, Jennifer Cahill, Todd Juillerat, Sandra Hahn Colbert, Cecilia Wong, Claude Giguere, John Simpson, Craig Weitz, Bruce Feibel, Sabina Hastings, Brian Thompson, and Ron Surz, with Patrick Fowler serving as our coordinator. We planned to host the first examination in November 2005.

² This is currently a requirement in the AIMR-PPS and is expected to be mandatory in GIPS.

³ A required document for any SEC registered investment advisory firm.

⁴ In fact, in the case I cited earlier, where the verifier prepared the disclosure materials for their client, they had this reference instead of the actual fee schedule.

But alas, our initiative has been terminated, because we recently learned that the CFA Institute is developing a similar program. While we do not as yet know the name they've picked for their certification, we know that the test will significantly overlap what we were working on. And, not wanting to compete with the CFA Institute, and knowing that the industry doesn't need two such programs, we have decided to halt what we were doing.

We have reached agreement with the head of the CFA Institute's program, Philip Lawton, to turn over our work product, which they will review for possible inclusion in their program. In addition, many of our BRC members have expressed interest in supporting the CFA Institute's program, as they have done with ours. We are confident that Philip and the CFA Institute will develop a program that will be widely accepted and recognized by the industry.

We greatly appreciate the many hours of work that our board and BRC have put in. These volunteers are dedicated to the

development of a much-needed program to further the professionalism of those serving in this important and exciting area of the investment industry. We are grateful for their contributions.

The Spaulding Group would like to announce that it has published a revised edition of its hugely popular and successful, **Performance, Attribution, and Risk Measurement Reference Guide**.

The earlier edition recently sold out. This new edition includes additional material as well as some formula revisions. It is available for purchase on our website, www.SpauldingGrp.com.

This newsletter is produced by TSG Publications. It is written and edited by Dave Spaulding. The opinions expressed are his and are a result of his own industry experience.
Content layout by Sabina T. Hastings.

The Journal of Performance Measurement

Fourth Annual Awards Presentation

and the presentation of the

Dietz Award for Performance Measurement Literature

Honorable Mention Awards:

A Case for Money-weighted Performance Attribution

Stephen Campisi, Intuitive Performance Solutions (*Vol.8 Issue #3*)

When the Green Zone Could Land You in the Red Zone

Arun Muralidhar, Ph.D. Fx Concepts (*Vol. 8 Issue # 4*)

Errors in Transaction-based Performance Attribution

Jose Menchero Ph.D., CFA, and Junmin Hu, Ph.D., Thompson Vestek (*Vol. 8 Issue #1*)

Dietz Award 2004

Performance Attribution with Consistency and Depth

Timothy P. Ryan, Fidelity Management and Research Co. (*Vol. 8 Issue #2*)

UPCOMING TRAINING DATES

INTRODUCTION TO PERFORMANCE MEASUREMENT

<u>LOCATION</u>	<u>DATES</u>
Chicago, IL	January 11 - 12, 2005
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Boston, MA	March 10 - 11, 2005
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