Performance Perspectives

with Dave Spaulding

Volume 1- Issue2
October 2003

Software searches

I recently learned a lesson (or, perhaps more correctly, was reminded of a lesson): don't assume that the person who completes the RFP knows everything they're talking about. This doesn't mean "don't trust what is said." While I'm aware that some vendors resort to hyperbole when they respond to questions, I am referring to the accuracy of what is shared.

We recently were engaged by a client to help them with a search for an attribution system. In our Attribution class, I mention how this type of a search is more complex because it requires you to give some thought to the model attributes [sorry about the pun]. But when you ask a question, such as "does your system support the Brinson-Fachler model," you tend to expect the vendor to give you a correct answer. Well, this didn't happen all the time.

To this question, for example, one vendor responded "no." Well, had they said "yes," we might want to insure that they actually are able to support this model, but a response of "no" should require no validation. Well, this particular vendor did warrant such a check, as I was pretty sure that they did support this model. So, I reached out to someone other than the sales person (someone who actually works with the design of the system) to check, and I was told "That's a funny response to the RFP question (indicating somebody here doesn't know what Brinson Fachler is!). To answer your question: Yes, we do use Brinson-Fachler, with the interaction effect thrown into the stock selection."

We asked the vendors if they provide arithmetic (additive) or geometric (multiplicative) attribution. One firm responded "geometric." Since I wasn't that familiar with their system, I initially accepted this response. And, because I felt that our client would prefer arithmetic, was considering excluding them from further consideration. But, to make sure I sent an e-mail: "I want to confirm that you only provide a geometric approach, not arithmetic."

Their response to this question left it unclear, so to make sure we were talking apples-to-apples, I sent another e-mail, stating "A key difference between the two is how you view excess return; with arithmetic, it's Rp-Rb (portfolio return minus benchmark return); w/geometric, it's [(Rp+1)/(Rb+1)]-1," and again asked "Does your system calculate the excess returns geometrically?"

Now, we got to the truth: "Perhaps I confused the issue. I spoke with some colleagues to make sure I wasn't mixing terms and I guess I was. One colleague, cleared things up a bit. The system name, like most of our well-known domestic competitors, applies an Arithmetic method for calculating excess returns, based on the definition you provide. I used the term 'geometric,' perhaps confusingly, to describe how we link multiple period returns."

This individual, unfortunately, isn't alone when it comes to confusing "geometric attribution" with "geometric linking." However, we would generally expect the vendor to know the difference, wouldn't we?

There's always the fear that a vendor will stretch the truth, exaggerate, or even use some hyperbole when they market their system. However, when a vendor provides erroneous information because of their own ignorance or

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.

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

lack of familiarity with either terminology or their systems, that complicates things in a whole different way.

How can you guard against this? It's difficult. Knowing *when* a vendor may be making a mistake (even unintentionally) is quite a challenge. I guess it reinforces the need to rely not just on the vendor responses, but also on your own familiarity with the product, as a result of input you get from others in the industry, conference exhibits, etc. If a response doesn't jibe (i.e., agree) with your expectations, then confirmation is needed.

Technology Survey

This being said, we are in the process of gaining some insight into the current status of money management firms' use of performance systems. We did this survey two years ago and found it quite insightful. We plan to make this a biannual event, as the subject of technology is extremely important.

We found in our '2001 survey that most firms rely on their portfolio accounting system to handle portfolio-level returns. Many firms still utilize spreadsheets to a large degree for composite returns. And, attribution is very much dominated by specialized software. While this is probably what one would predict, getting the hard facts is reassuring.

This survey is a bit different then its predecessor, in that we are also asking about spending plans. These past 2+ years have been a challenge for many of us and so spending has often been cut. On the vendor side, this has resulted in many layoffs. The vendors (along with just about everyone else) are looking for a turnaround in the market and a resulting increase in discretionary revenue. And one indication of a true turnaround will be increased spending on technology.

Performance measurement used to just mean rates of return. It now means much more. And, as we learned in our first technology survey, the sources for providing the needs of this area will vary. Rates of return are typically handled out of the portfolio accounting system. Composite software (for firms complying with GIPS® or the AIMR-PPS®) is often handled by spreadsheets, which we deem to be generally less than ideal. More and more firms are discovering that software packages are much better. And attribution software is generally handled by specialized software.

While some vendors can handle all of these areas, many investment firms prefer to go with the *best of breed* approach. This, too, is an area that we're exploring in the survey.

So please, if you haven't completed a survey, visit our website (www.SpauldingGrp.com) and participate! You'll be helping with this important research effort and will be rewarded with a complimentary copy of the results.

Fixed Income Attribution

And, further on the technology front, we are pleased with the significant increase in "true" fixed income attribution systems. Here are a few of the vendors who now have such systems: Alphai, Financial Models, Wilshire, SAMS, Statpro, SunGard. A more complete list will be available with our vendor technology survey (the counterpart to the user survey), which is in process.

The good news is that there are now a variety of these "true" fixed income attribution systems (as opposed to equity systems being re-labeled as fixed income). Firms will continue to have the opportunity to use fixed income analytical systems (such as CMS/Bondedge and Salomon Brothers' Yield Book) which include an attribution module, but these specialized packages are much welcome, indeed.

The bad news is that given the complexity of the fixed income approach, there are no standard models, of yet. And, even if there were, we would expect investment firms to select a module which best matches their investment process. How easy is this? Not very. But, we're at least moving in the right direction.

Unlike the equity side of attribution, you'll find that most (if not all) vendors that offer fixed income attribution will have only a single model. This is a tremendous improvement over just two years ago, but it would be nice if, like the equity side, we had a choice within a single vendor as to what model(s) we wanted to employ. But, that time will surely come.

The IPC

The Investment Performance Council (IPC), which oversees GIPS and therefore has significant influence over the AIMR-PPS (as well as other Country Versions of GIPS) is meeting this month (September) in Sydney. There are several significant items on the agenda, including the approval of various guidance statements and a review of the draft Gold GIPS.

In November, I will report to you some of the results of the meeting and how they might impact your compliance.

A little about politics

As I mentioned in my last newsletter, my term as mayor is coming to a conclusion and will officially end on 31 December. These four years, coupled with the prior two years as a councilman (one as council president) were very rewarding for me. I have always enjoyed politics, although I never envisioned getting involved at the local level.

We recently adopted our fourth budget during my term as mayor (we're on a fiscal year basis, with our year beginning 1 July). Enhancing our finances is an area that I'm probably most proud of. During the four years, our property tax rate has only gone up by one tax point, this in spite of reductions in state aid and increases in many expense areas.

Our finance officer presented the budget to our residents via a PowerPoint presentation, which is available at our township's website, if you have interest in learning more about our local government.

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.

Something new has been added to our website.

www.SpauldingGrp.com/Resources

Our new Resources Center, will find supply you with some recommended reading material on all areas of performance, but we also have a ***GIPS Tips*** section that contains information to help with the transition from AIMR-PPS to GOLD GIPS.

Here is a sample of what you will find:

What firms should have policies and procedures for:

1. How you calculate performance (your formula(s); how you handle cash flows (start-of-day; end-of-day); if overrides are permitted) (this is applicable for both portfolio returns as well as composite returns).

2. Composite Construction (the rules to create composites; who makes the decision; who reviews these decisions; what happens if you discover a portfolio was in the wrong composite) .

3. Process for handling new accounts (who makes the decisions as to what composite(s) they go into).

4. Process for termination/portfolios (what occurs when a relationship ends; tracking; removal from composites).

5. Change in styles/ strategy (how handled when a client requests a change; timing).

6. Discretion (your rules for discretion).

7. Minimum Account Size (if one exists, what happens when an account falls below / goes above).

8. How you calculate Gross of Fee returns (what is your formula).

9. How you calculate Net of Fee returns (what is your formula; how you handle if the fees are paid externally).

10. Pricing procedures/ sources (this is more important w/non-US investing, but worth touching on for domestic, too; also, for FX rates - again, for non-US; includes sources of pricing, and rates, as well as the timing you use for pricing; also, if there are known differences between these and the composite's associated benchmark).

11 Treatment of cash flows (how you handle them from a return perspective (touched on in #1, above - start-of-day, end-of-day) as well as temporary removal (#12 below).

12. Temporary removal of portfolios (circumstances that would warrant removal; include, if appropriate, for large flows (criteria; timing).

13. Policy on reporting (what you give to clients, prospects; how handle special situations).

14. How you handle as-of adjustments to returns (e.g., when a situation arises that may require a change in the originally published number(s); we're actually in the process of publishing an article on this topic -- should be in the Summer issue of JPM; deals w/timing, circumstances when adjustments would be made; who you communicate to, etc.).

15. Portability issues -- how were mergers/acquisitions handled (where applicable).

16. Corporate action processing -- how handled. This can be an issue when, for example, there's a spin-off and you don't have all of the details for some time, meaning you may have to revisit a previously processed action.

17. Carve-outs -- if you use them, how you do the carving out (what method you employ; if it's changed over time).

18. Measure(s) of dispersion -- what measure(s) is(are) used; under what circumstances you might use one (e.g., standard deviation) rather than another (e.g., high/low).

19. Initial Composite Construction (the process that was used to create the composites).

UPCOMING TRAINING DATES

INTRODUCTION TO PERFORMANCE MEASUREMENT

LOCATION	DATES	VENUE
Boston, MA	October 28 - 29, 2003	Boston Sheraton
San Diego, CA	December 16 - 17, 2003	TBA

Receive 15 CPE Credits for attending this Two-day class!

PERFORMANCE MEASUREMENT ATTRIBUTION

LOCATION	DATES	VENUE
Boston, MA	October 30 - 31, 2003	Boston Sheraton
San Diego, CA	December 18 - 19, 2003	TBA

Receive 11 CPE Credits for attending this One and a Half day class!

These programs may qualify for AIMR Professional Development credit. If you are an AIMR member, please refer to the AIMR Web site to determine whether this program meets the criteria for AIMR PDP credit, to calculate credit hours, and to verify documentation requirements.
(www.aimr.org/memservices/continuinged/ceprogram)

2003
Performance Measurement Forum Schedule

March 20-21, 2003 - San Francisco, CA
June 11-12, 2003 - Warsaw, Poland
November 12-13, 2003 - Lisbon, Portugal
December 8-9, 2003 - New York, NY