PERFORMANCE PERSPECTIVES

with David Spaulding

VOLUME 5 – ISSUE 2 OCTOBER 2007

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

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A QUANDARY? PERHAPS.

Paragraph 4.A.16 of the 2005 edition of the GIPS® standards states, "When presenting net-of-fee returns, firms must disclose if any other fees are deducted in addition to the investment management fee and direct trading expenses." Someone recently asked about the situation where a mutual fund is included; mutual fund returns typically reflect the deduction of additional expenses. Therefore, shouldn't these be disclosed?

If we look at page 7 of the SEC no-action letter addressed to the Association for Investment Management and Research (AIMR), dated December 18, 1986,[1] we find, "In our view, as long as an advertisement for investment advisory services does not include an explicit or implicit reference to a particular fund, it would not be an advertisement for a fund."

The quandary? If you disclose that the net-of-fees return includes the deduction of mutual fund fees, I think you're violating the SEC's restriction about explicitly or implicitly referring to a fund. Okay, we know that, in the words of my friend Herb Chain (of Deloitte), "the SEC trumps GIPS." The override ability of regulators is referenced in 4.A.9, which reads "If the presentation conforms with local laws and regulations that differ from the GIPS requirements, firms must disclose the fact and disclose the manner in which the local laws and regulations conflict with the GIPS standards." But wouldn't the mere referencing of this rule itself also conflict with the SEC's rules? Unless we get official word (from either the SEC (unlikely), the GIPS Executive Committee, or the GIPS help desk), I'd play it safe and "say nothing" about the inclusion of additional fees being deducted.

SEC COMPLIANCE ALERT

I attended the annual GIPS conference last month in Chicago and had the pleasure to hear once again Bill Meck of the Philadelphia office of the SEC. Bill is a great speaker, and I'm not just saying that because I'm under investigation for insider trading and want to get in the good graces of at least one examiner...just kidding. Seriously, he's great! (Bill spoke at PMAR V this past May and will return next May). Anyway, to what Bill spoke about.

You may recall that I commented on the recent SEC Compliance Alert in our August issue and briefly touched on the reference to false claims of compliance. The alert, and more specifically the Performance Sweep from which the results were taken, was the chief topic of Bill's presentation. I took rather copious notes and will share, as best I can, what Bill offered.

The Performance Sweep commenced August 2004 and covered the period 2001 through 2003. It was to measure the accuracy of performance advertising, numbers, disclosures, and compliance. The firms that were asked to submit detailed responses came from the 150 Investment Advisors who were rated highest in various categories by specific ratings services. This group of 150 were further reduced by filters, which included:

1 If you'd like a copy, let me know and I'll send you one.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Performance Measurement for Pension Funds
– *Auke Plantinga, University of Groningen*

Multi-currency Attribution – Part 1
– *Carl Bacon CIPM, StatPro Group plc.*

A Hierarchy of Methods for Calculating Rates of Return
– *Yuri Shestopaloff, Ph.D. and Alex Shestopaloff, SegmentSoft Inc.*

Analysis of Ranking Factors for a Risk Averse Investor in a Non-Gaussian World
– *Massimo Di Pierro, Ph.D., School of Computer Science Telecommunications and Information Systems at DePaul University and Jack Mosevich, Ph.D., Merrill Lynch*

A Brinson Model Alternative: an Equity Attribution Model with Orthogonal Risk Contributions
– *Andrew Colin, Ph.D., StatPro Group plc.*

The Journal Interview

- Similar mutual fund managed by the advisor with the same objective (these were excluded if the reported returns for the separate accounts were similar to the fund returns)
- Investment advisors who had recently been examined by the SEC and given a "clean bill of health" were excluded
- Hedge fund advisors not registered with the SEC were excluded
- Firms whose performance was only slightly better than their peer group were excluded, because it was probable that the returns were accurate.

The sample was reduced to 31 advisors. These advisors had an average AUM of US$13.3 billion, and with the AUM range being from $27 million to $90 billion. These advisors were sent a document with a request for:

- All RFPs
- Consultant questionnaires
- All advertisements used during the 2001-2004 period
- Descriptions of performance calculation process, and written policies and procedures (P&P)
- A copy of the audit and/or verification reports
- Lists of "fair valued" securities.

Of the 31 advisors, 22 were examined offsite; nine were visited. And, of these 31 advisors, 24 maintained websites and 19 included performance on their site.

One of the SEC's conclusions was that the prevalence of third party performance software has increased the accuracy of results, but firms still make mistakes. Some of the cited deficiencies included:

- Failure to advertise net-of-fee and other "Clover" deficiencies (4 occurrences)
- Past specific recommendations[2] (13)
- Inadequately disclosed back-tested performance (1; five firms in total used back-tested results)
- Incorrect figures (12)
- No written P&P (2, and both firms claimed compliance with GIPS)
- Inadequate P&P (5, and all 5 claimed GIPS compliance)
- One firm didn't identify distortions from large cash flows (see below).

Of the 31 firms, 22 claimed compliance with the standards and 21 of these 22 had some "deficiency." Of these, 14 had been verified (the only one that had no deficiencies had also been verified).

2 This has to do with providing, for example, your "top 10" and "bottom 10" holdings for a period. I confirmed with Bill that in spite of the perceived balance of such a report, it's still disallowed.

Verifiers' Corner

We encounter many situations, both when working with clients as well as through classes we teach, conferences we attend, and questions we receive, that need some amplification or clarity. We decided to begin to devote a portion of our newsletter for this very topic. We'll tend to address a single topic each month and be as brief as possible.

A west coast client just sent me an e-mail regarding "creation date." There was some confusion in an earlier document from AIMR that linked creation date to the date the firm began claiming compliance, stating that the earliest date you could have for the composite creation date was the date the firm started claiming compliance, even if the composite had been around for years. Well, this was discussed at length in one of the committees I previously belonged to and we agreed that this was wrong. Creation date = the date the composite was created, with no dependency on the date the firm began claiming compliance.

Bill didn't feel that the results should engender any alarm. He acknowledged that the standards are complicated and that it's quite easy to have some mistakes. Bill, doing a David Letterman impression, offered his "Top 10 Deficiencies" (in reverse order, as is the style of Mr. Letterman):

10 Carve-out disclosures missing

9 Number of portfolios and amount of assets in composite disclosures

8 Fee schedules not included

7 Methods used to allocate cash to carve-outs not explained

6 Availability of a list and description of composites not indicated

5 Total firm assets missing

4 Failure to abide by the rule that all fee-paying accounts be in at least one composite

3 Website claim of compliance needed details

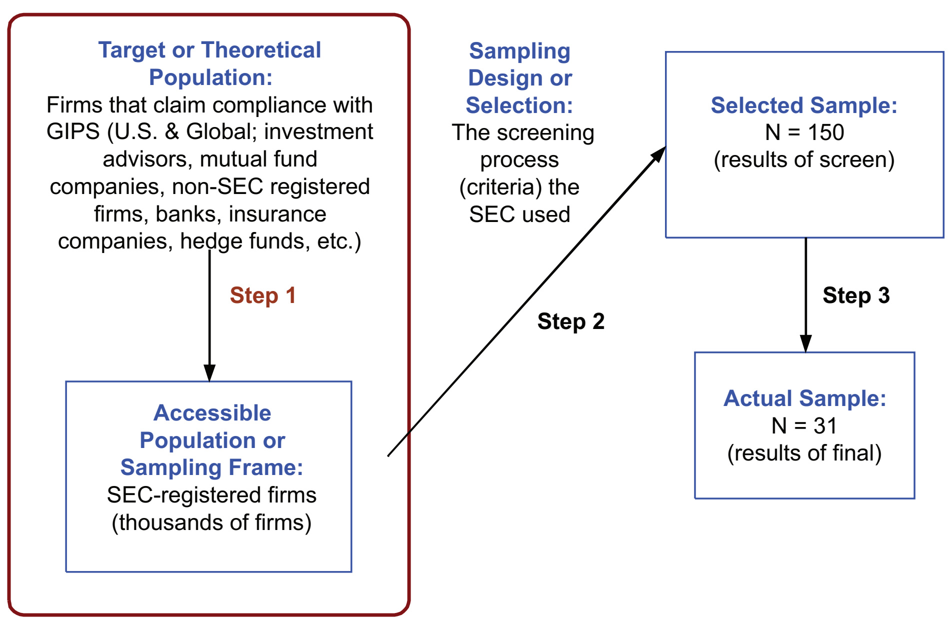
2 Firm claimed compliance in only some advertisements (see below)

1 Insufficient or no P&P.

MY COMMENTS ON THE SEC'S STUDY

The Sample

Now that I'm back in school, I'm getting exposed to some neat stuff. One of the courses I'm taking deals with research methods and included a diagram that addresses a sampling process. I've used it to describe the approach the SEC took to sample.[3]



3 Adapted from Gliner, Jeffrey A. and George A. Morgan (2000). Research Methods in Applied Settings. Page 146.

This is a very biased survey for at least two reasons: first, it excludes many firms in the target population (the broad international population of firms that claim or are eligible to claim GIPS compliance) as it only looks at SEC-registrants; second, the filtering focuses on firms that are more likely to have problems. Therefore, any generalization of the results to the broader market would be of questionable validity or justification.

That being said, we have reason to believe that most firms that have not been verified are most likely deficient in one or more ways. In addition, we believe that many firms that have been verified are also deficient. As Bill noted, the standards are complex and it's easy to fail in one or more ways.

Two of the deficiencies

I took exception to two of the "deficiencies" the SEC found:

1. Failure to identify distortions in cash flows. The standards currently recommend that firms revalue for all large external cash flows (see 2.B.3) and the requirement to revalue doesn't take place until 2010 (see 2.A.2.b). Therefore, firms that claim GIPS compliance are relying on the standards as the basis for their decisions regarding revaluation. In addition, I'd argue that even firms that don't claim compliance might seek to find a "safe harbor" within the standards, as many non-compliant firms still use parts of these rules as the basis for their policies and procedures.

   The industry has sought for many years to improve the accuracy of their returns.[4] But, we recognize that (a) there's a cost associated with this and (b) the availability of good prices (from which valuations are partly derived) aren't always at the level we'd want.

   In addition, I'm unaware of any formal mandate from the SEC that requires such action as revaluing for large flows.

   The SEC apparently expects firms to be aware of the potential for distortion and when they're confronted with the strong possibility that there are distorting effects (as a result of large flows coupled with volatile markets, for example), the advisor should take steps to note the problem in their advertising. The standards now require firms to "disclose that additional information regarding policies for calculating and reporting returns is available upon request (see 4.A.17). Perhaps this will suffice.

   The key "take away" is that SEC-registered firms should be aware that the SEC wants you to be mindful of the potential distortions that can arise from large flows and not simply to ignore them. While there doesn't seem to be a requirement for you to revalue the portfolio, some disclosures may be necessary (and appropriate) to communicate this to your clients and prospects. It may also be prudent to expedite your compliance with the 2010 rule change.

4 I attended a workshop sponsored by the ICAA in 1988 which dealt specifically with this issue; at the time, mid-point weightings for cash flows were quite common.

The Spaulding Group (TSG) can address any of these common problem areas

Types of Assignments

General Performance Measurement Issues

TSG assists firms in evaluating the broader areas of performance to include calculations (which to use and when), reporting (for internal use, for prospects, and for clients), systems issues, and other areas.

Verification/Certification

We also offer GIPS® verification, and if you are not claiming compliance but need your numbers certified, we can assist with that as well.

GIPS Compliance

Many firms need assistance understanding the GIPS standards and determining whether they should comply. Also, many need help developing a strategy to become compliant or remain compliant. Often, in just a day or two, TSG can help you address the opportunities, benefits, and tasks to be tackled in order to comply.

System Design

TSG can support you in the design and development of your performance system. We can also assist in documentation and testing.

Software Searches

TSG can help you decide which software product best meets your firm's needs, and we also support the implementation process.

Operational/Control Issues

TSG can assist you in dealing with a host of operational challenges including data integrity, reconciliation, policies and procedures, and much more.

2. Only claiming compliance in certain advertisements.

   Here, I have reason to believe that the term "advertisement" was being used in a very broad way, to include presentation materials and the failure of some firms to provide such materials to all prospects. Given that the standards require firms to "make every reasonable effort" to provide all prospects with a copy of their presentation (see 0.A.11), one might argue that the need to always provide such materials doesn't exist. However, I believe that this "softer" wording (*i.e.*, rather than mandate 100% compliance, "every reasonable effort" language) was used because of the problem in some locales to be able to comply with full distribution. This shouldn't usually be a problem for SEC-registered firms. Therefore, "a word to the wise": make sure that all prospects receive a fully compliant presentation.

In conclusion, given the bias of the survey sampling, the situation probably isn't as bad as it might first appear. The acknowledgment that the standards ***are*** complex is probably a good thing. While this doesn't give anyone a "free pass" to have deficiencies, it at least helps soften the blow a bit (perhaps). But it also says that firms should be attentive to the details as many of the cited problems shouldn't exist. Due diligence throughout the process and hiring a competent verifier are critically important for firms claiming compliance with the GIPS standards.

RISK MEASUREMENT

In Strategy Safari, Henry Mintzberg *et al.*, provide a variety of views on how strategies are formed. In their opening chapter, they speak of strategy as a plan (intended) and as a pattern (realized). I see a parallel here when we speak of *ex post* and *ex ante* risk. There is great interest today in projecting risk, which is interesting given that we all know that *past performance isn't necessarily an indication of future results*. While we can't project performance, we can project risk.

In The Production of Knowledge, William H. Starbuck challenges much of the practices employed in research today. As often happens when I read non-performance books, I came across a number of ideas that I could relate to our field. From a risk perspective, I hope you can see how his statement "[t]heories that are useful for making statements about the future are different from theories that are useful for making statements about the past. Analysis of past events tend to favor complex and subtle explanations and elegant techniques that make strong assumptions about the properties of data." (Page 51). He goes on to say "complex explanations and elegant techniques have consistently disappointed forecasters. Analytic techniques that promise to extract more information from data tend to mistake noise for information. They perform best for stable situations that contain little random noise." (Page 52). Given that we typically base our risk projections on the past, aren't we too subject to lots of noise? Is there anything less stable than the investment markets? A "computation scheme has no way to distinguish whether an unexpected new event is idiosyncratic or it is the first sign of a changed trend ... predictions of trend changes have nearly always been wrong. Likewise, subtle relationships seen in past data rarely recur with sufficient force to produce discernible effects in future data." (Page 52) And finally, "forecasting methods tend to mistake noise for information, ... A general law seems to be at work: for making statements about the present and future, more complex, subtle, or elegant techniques give no greater accuracy than simple, crude, or naive ones. Complex causal analyses rarely prove to be more accurate than simple extrapolations. Evidently, complex analytic models and complex forecasting techniques try to extract too much information from data." (Pages 122-123)

My guess is that Dr. Starbuck would take exception to the current trend to provide *ex ante* risk. The idea of providing managers and clients with an idea of the risk they're facing is a good one; the question is, how reliable or accurate is it? This is a subject worthy of some research.

TERRA INCOGNITA

If you're not familiar with this term, it means an unknown or unexplored land, region, or subject. It's my contention that performance measurement and risk are loaded with terra incognita (as in my suggestion above about research into *ex ante* risk). We'd like to begin to develop a list of areas that need research and discovery, and therefore solicit your help and ideas. So, please let us know areas that you feel need to be addressed.

A CALL FOR PAPERS

We are planning to publish a "Handbook" on risk measurement and are seeking authors to contribute to this volume. If you're interested, please send your subject and contact details to me. Thanks! (DSpaulding@SpauldingGrp.com)

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 SPAULDING GROUP'S 2007-2008 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
November 8-9	Performance Measurement Forum	Athens, Greece
November 29-30	Performance Measurement Forum	Orlando, FL (USA)
December 3-4	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 5-6	Performance Measurement Attribution Training	New Brunswick, NJ (USA)
January 15-16	Introduction to Performance Measurement Training	Chicago, IL (USA)
January 17-18	Performance Measurement Attribution Training	Chicago, IL (USA)
January 22-23	Introduction to Performance Measurement Training	Reykyavik, Iceland
January 24-25	Performance Measurement Attribution Training	Reykyavik, Iceland
February 12-13	Introduction to Performance Measurement Training	San Francisco, CA (USA)
February 14-15	Performance Measurement Attribution Training	San Francisco, CA (USA)
March 3-4	CIPM Principles Prep Class	New Brunswick, NJ (USA)
March 5-7	CIPM Expert Prep Class	New Brunswick, NJ (USA)
March 11-12	Introduction to Performance Measurement Training	Boston, MA (USA)
March 13-14	Performance Measurement Attribution Training	Boston, MA (USA)
April 15-16	Introduction to Performance Measurement Training	New York, NY (USA)
April 17-18	Performance Measurement Attribution Training	New York, NY (USA)
April 24-25	Performance Measurement Forum (North America)	TBD
May 6-7	Introduction to Performance Measurement Training	Los Angeles, CA (USA)
May 8-9	Performance Measurement Attribution Training	Los Angeles, CA (USA)
May 21-22	Performance Measurement, Attribution, & Risk (PMAR) Conference	Philadelphia, PA (USA)
June 3-4	Introduction to Performance Measurement Training	Baltimore, MD (USA)
June 5-6	Performance Measurement Attribution Training	Baltimore, MD (USA)
June 12-13	Performance Measurement Forum (Europe)	Paris, France
July 14-18	Performance Measurement Boot Camp	New Brunswick, NJ (USA)
August 25-26	CIPM Principles Prep Class	New Brunswick, NJ (USA)
August 27-29	CIPM Expert Prep Class	New Brunswick, NJ (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 22	Trends in Attribution Symposium (TIA)	Philadelphia, PA (USA)
November 4-5	Introduction to Performance Measurement Training	Boston, MA (USA)
November 6-7	Performance Measurement Attribution Training	Boston, MA (USA)
November 13-14	Performance Measurement Forum (Europe)	TBA
December 4-5	Performance Measurement Forum (North America)	TBA
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 2007-2008 events, please contact Christopher Spaulding at 732-873-5700

TRAINING…

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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:

October 8-9, 2007 – Boston, MA
October 23-24, 2007 – New York, NY
December 3-4, 2007 – New Brunswick, NJ
January 15-16, 2008 – Chicago, IL
January 22-23, 2008 – Reykyavik, Iceland
February 12-13, 2008 – San Francisco, CA
March 11-12, 2008 – Boston, MA
April 15-16, 2008 – New York, NY
May 6-7, 2008 – Los Angeles, CA
June 3-4, 2008 – Baltimore, MD
October 7-8, 2008 – New York, NY
October 7-8, 2008 – San Francisco, CA
November 4-5, 2008 – Boston, MA
December 9-10, 2008 – 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:

October 10-11, 2007 – Boston, MA
October 25-26, 2007 – New York, NY
December 5-6, 2007 – New Brunswick, NJ
January 17-18, 2008 – Chicago, IL
January 24-25, 2008 – Reykyavik, Iceland
February 14-15, 2008 – San Francisco, CA
March 13-14, 2008 – Boston, MA
April 17-18, 2008 – New York, NY
May 8-9, 2008 – Los Angeles, CA
June 5-6, 2008 – Baltimore, MD
October 9-10, 2008 – New York, NY
October 9-10, 2008 – San Francisco, CA
November 6-7, 2008 – Boston, MA
December 11-12, 2008 – 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

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 1,500 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.