PERFORMANCE PERSPECTIVES

with David Spaulding

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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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OUR 6TH YEAR...WHO WOULD HAVE FIGURED

This issue marks the start of the sixth year of our newsletter. We greatly appreciate the comments we receive. We're able to track the number of individuals who access the site and it typically numbers in excess of 1,000; we're very pleased that many find it of value. We appreciate the occasional e-mails and comments. If you're aware of others who might enjoy reading our newsletter, either give us their contact information or ask them to contact PFowler@SpauldingGrp.com to sign up. Thanks!

WHEN IS A PROSPECT A PROSPECT (FROM A GIPS PERSPECTIVE)

A question has recently surfaced regarding the question of when a prospect is a prospect for GIPS® purposes. Recall that "firms must make every reasonable effort to provide a compliant presentation to all prospective clients."[1] But who's a prospect?

To me, a prospect is anyone you're dealing with directly; i.e., that you're not accessing through an intermediary. This is probably a bit too broad, so I'll cite some examples:

- in most cases, a mutual fund client (shareholder) would not be considered a prospect for GIPS purposes as the mutual fund is the "account" that is included in a composite. In the U.S., the SEC regulates what must be given to such a prospect. We don't composite (as a verb) shareholder accounts, except when they're individuals for whom we're managing money for directly, and for whom we've established a broader discretionary account.[2]
- in most cases, a wrap fee account isn't a prospect; rather, the sponsor of the wrap fee program is the client. The only exception would be when the asset manager has established their own wrap fee program, in which case they're the sponsor and arguably the individuals they're marketing to are their prospects.
- a partner in a private equity partnership isn't a prospect; rather, the partnership is the prospect or, more correctly, the client. The risk or challenge here is that we might be forced to provide details of private deals which is problematic; as with mutual fund shareholders, prospective partners will be shareholders of the fund (partnership).

I believe there's a precedence for my position: the wrap fee guidance, which allows a compliant firm to consider the sponsor the client, thus negating the need to "composite" every participant. Wrap fee clients typically receive reports from the sponsor and don't have direct access to the manager. Ironically, there's probably more justification for the pooled vehicles being considered the "client," as there is no individual management going on in these cases, as there is with wrap fee accounts. If an individual considering

1 Para 0.A.11. *Global Investment Performance Standards*. February 2005.

2 By this I mean the case where a manager invests client assets in various mutual funds rather than, or in addition to, individual securities. They are therefore offering expertise in allocating their client's assets as well as in selecting appropriate funds. These should be composited.

The Journal of Performance Measurement®:

a mutual fund or partnership is a "prospect" for GIPS purposes, then if they become a "client," shouldn't they then be in a composite? Well, they are not in one as an individual but rather they're their as part of the fund or partnership.

Nothing official has yet been offered regarding this topic, but I'm hopeful that it will be, and I'm also hopeful that it will match what I've provided here. **I want to emphasize that this is my opinion and that it's not one that is shared by everyone. Like much of what we do, there's some controversy here.** As always we welcome your thoughts and ideas.[3]

VERIFIER CORNER

Filling the gaps

We had an interesting question passed to us recently by another verification firm. They have a new client who had been previously verified where the following situation occurred: a wrap fee composite experienced a three month break in performance when their only wrap client had left. To fill the gap, they brought in a non-wrap account.

While the GIPS wrap fee guidance statement permits a firm to initially use non-wrap accounts in order to get their wrap fee composite going (in advance of bringing actual wrap fee accounts on), it doesn't address the introduction of such accounts after the composite has wrap fee accounts. So, was this action permitted?

I would say "no." To permit a firm to introduce non-wrap accounts simply to avoid gaps is problematic from a few perspectives. First, could they introduce such accounts at any time after the composite has been established with wrap accounts? If so, they could "juice" their return when this would prove advantageous. Second, is it possible that some "cherry picking" might occur in order to make the gap look better than it would otherwise have been? Third, the fact that there's a gap might be of interest to a prospective client and smoothing it out with a non-wrap account might be misleading. And fourth, if this were permitted in this case, why wouldn't it be for non-wrap composites (bringing in accounts from other composites in order to avoid gaps).

The absence of a prohibition doesn't mean it's permitted.

Gaps are problematic, no doubt. But this approach to solving it is, in my opinion, not a good idea and I would argue not permitted.

SMA vs. Wrap ... same? Different?

EF Hutton is credited with coming up with the first "wrap fee" program; this occurred (I believe) in the early-to-mid 1980s. The idea behind it is that clients pay a single fixed fee, which includes all the services they receive, including brokerage, custody, and advisory. The idea caught on and is now extremely popular, with many thousands of individuals investing, numerous managers participating, and quite a number of sponsors offering such programs.

3 I want to again emphasize that these are strictly my opinions; at present, the standards do not speak to this topic. I am hopeful that the standards will offer details at some point in the future. I have discussed this topic with two colleagues: one who shares my views and another who disagrees. As noted above, I'm hopeful that this position will prevail. But since they are not official doctrine, you will bear any risks associated with abiding by these ideas. You may want to ask your verifier, consultant, and/or compliance officer for their opinion before making a decision.

Performance Measurement is our Passion™

The Spaulding Group can address any issue that you may come across in the field of investment performance measurement

OUR PRODUCTS AND SERVICES

We help clients address performance measurement in a variety of ways, for example:

Consulting

TSG helps firms evaluate the broader areas of performance to include calculations (which to use and when), reporting (for internal use, for prospects, and for clients), system issues, data issues, GIPS® Compliance (the why and how), as well as other areas.

Verification/Certification

We offer GIPS verification. And, if you are not claiming GIPS compliance but need your numbers certified, we can do that, too!

Training

We offer a variety of training classes including, Introduction to Performance Measurement, Performance Measurement Attribution, Advanced Performance Measurement, Performance Measurement for Plan Sponsors and Consultants, and our Performance Measurement Boot Camp. We also offer prep courses for the CIPM certification. Our classes are also available in-house at a significant discount.

Research

We survey the industry annually on a variety of topics including Performance Technology, Attribution, GIPS, and The Performance Measurement Professional. Our research services are also available on a proprietary basis.

Publishing

We publish *The Journal of Performance Measurement®* as well as the Spaulding Series of books, our *Formula Reference Guide*, among other publications.

Conferences/Forum

TSG hosts the annual Performance Measurement, Attribution and Risk (PMAR™) Conference each May. PMAR IV drew 160 attendees. We also host the Trends In Attribution (TIA) Symposium. The Performance Measurement Forum is a membership group which meets twice a year in the United States and twice a year in Europe.

At some point, someone decided that the term "wrap" should be replaced with the more elegant "SMA" term, which means "separately managed account." This is lovely, except that we've used the term "separately managed account" for quite some time and not necessarily to represent wrap fee accounts.

We have a client that was distinguishing between "SMA" and "wrap," when in reality they were all the same; that is, they were all wrap; the only difference was that some were sponsored by an affiliate while the others were sponsored by third parties.

As with much of what we do, terminology counts. If we use a term that has multiple meanings, clarity is probably in order. It's unfortunate (I think) that this new term was introduced. When using the term SMA, don't be surprised if someone asks you to clarify what you mean; it's just another example of words meaning more than one thing.

MORE ON VERIFIER INDEPENDENCE

In our last issue we briefly addressed the issue of verifier independence. I cited a case of a verifier who's established a relationship with a firm in South Korea. I failed to mention that this "bundled service" includes pricing of securities. This puts the verifier smack in the middle of assisting with the creation of returns, which is the critical part of the presentations. I suggest that independence is compromised when a verifier extends their services to such a level. I would hope that something definitive would be offered from either the Verifier / Practitioner Committee or the GIPS Executive Committee.

Again, I can see why these bundled services might be attractive to asset managers, but the problem with losing independence creates potential issues with the verifier's report. For years we've come across firms that like to use the same firm that helped them become compliant do their verification; this is fine, as long as the "help" the verifier provides doesn't "cross the line" and result in a conflict. Both the verifier and client must be aware of this possibility.

The standards remain a very important component of our industry, but we must assure that the quality of compliance and verifications is high, otherwise its value will be lost.

THANKS FROM FR. RAY

Last year, the Performance Measurement Forum held its Spring meeting in New Orleans; the city was selected as a way to show them support after the devastation from Hurricane Katrina. In advance of the meeting we arranged to work in the community; my Church developed a relationship with a parish in the city, so we approached their pastor, Fr. Ray Baumgardener, to see how we could help. He had a need himself: a community service area had been damaged and as a result, they were unable to provide the services that were very much needed. And so, several members of the forum as well as a couple friends of Patrick Fowler (who happen to be professional contractors) went and spent three days rebuilding this facility. Quite a lot of work was accomplished as a result of our efforts.

Fr. Ray is being transferred to Baltimore and paid a visit to my parish this month to offer his thanks (our Church has contributed to his community in many ways since the hurricane and continues to offer support). I was surprised and pleased when during his homily, he also named our group for the work we did. While none of us went there for any recognition, but simply as a way to help, it's still very nice to receive praise for our efforts. We again thank all of our associates who lent a hand.

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If you have two to five years experience and are looking for career advancing opportunities submit your resumes to PerformanceJobs.com.

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 view more images from our New Orleans trip, please visit our website at http://www.spauldinggrp.com/neworleanspictures2007.htm

INDUSTRY NEWS

With the start of our sixth year of publishing this newsletter, we decided to introduce two new sections: Industry News and TSG News. The Industry News section will summarize information we feel would be of interest and value to our readers. This will include the movement of various individuals within the industry as well as recent software acquisition decisions we learn of. Feel free to send us notices you'd like included.[4]

Todd Juillerat recently joined State Street Global Advisors as a Managing Director. Recall that Todd also serves as the North American representative to the GIPS Executive Committee and also serves as a member of the advisory board of *The Journal of Performance Measurement*®.

We also want to congratulate Carl Bacon, the new chair of the GIPS Verifier/Practitioner committee and Iain McAra, the new chair of the USIPC. And congratulations to Neil Riddles, who steps down as chair of the USIPC and assumes the role of chair of the GIPS Country Council.

September is not usually quite such an exciting month: October usually is when we see huge drops in the market. With the announcements of Lehman's bankruptcy, AIG's rescue by the Feds, and Bank of America's takeover of Merrill, many are wondering what the future holds. One question relative to Lehman is "what will happen with their index family?" Many rely on these indexes; they've been a staple of the industry for many years. We would expect that they will eventually be bought by someone, but only time will tell. The same holds for their analytics package: someone will no doubt want to acquire it. As per an update from Lehman to all POINT users titled, "Plans for Index and POINT Continuity – Update (September 15, 2008)" "As outlined earlier, Lehman Brothers will continue to calculate returns and publish indices on an ongoing basis, with September 15, 2008 index returns to be published as scheduled."

4 As you might expect, we have the right to decide what items to include and may edit messages provided.

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.

TSG NEWS

Our verification business continues to grow: we recently added three new clients:

- UMB Investment Advisors
- Fried Asset Management, Inc.
- Opus Investment Management, Inc.

FROM OUR READERS

Hi David,

As with many others, I always enjoy reading your newsletter. I have been involved with performance measurement and management for over 5 years now. Here are some thoughts on the topic of ratios.

To me, the traditional "Sharpe ratio" is useful only when comparing beta return to other beta return over long periods of time. In this case you are simply comparing the risk-return profile of different markets or asset classes. But most of the time, institutional investors are monitoring value added. For this the Sharpe ratio does little. Same applies to Sortino and Treynor. Another negative point of these is that over 3y cycles, the risk-free return will impact these ratios and therefore make them highly period dependent and not cross comparable.

The "Information ratio" is better as it compares relative return to relative risk. However, I don't know why some use average monthly return of the product minus average monthly return of the index, annualized. I always use the annualized returns of the product minus the annualized return of the index which gives the annualized alpha.

However, something is still missing from the equation. Although we look for relative performance, absolute risk still matters. This is simplified but based on a real example which caused me to think about this. Assuming same calculation and same time horizon. Manager A has an annualized alpha of 2% and a tracking error of 4% which gives us an Information ratio of .50. Manager B has an annualized alpha of 2% with a tracking error of 3% for an information ratio of .67. From that perspective, Manager B seems for interesting. However, now lets add that Manager A has a standard deviation of 8% while the index is at 10% and Manager B has a standard deviation of 14% while the index is at 10%. As an institutional investor, I am looking for alpha, but the overall volatility of the portfolio still matters. In light of this, wouldn't Manager A be a better choice? Some say the Jensen's Alpha ratio helps. But Jensen's Alpha is also dependent on the risk free rate and does not work well when the beta return is negative.

So my solution for a comprehensive ratio is to divide the information ratio by the excess standard deviation or the beta of the product. With our example above, Manager A would have a comprehensive ratio of .625 while Manager B would have a ratio of .478. Manager A would rightfully be highlighted as the desired manager. I think in general institutional investors pay too little attention to "excess absolute risk."

Let me know what you think.

Thanks & Best regards,
Dominic

Dominic Blais, CMA, Portfolio Manager, Public Assets, Our friend and associate Ron Surz has a newsletter too and asked us to let you know about it.

Performance evaluators use tracking error as a central risk measure. Asset allocation advisors use style boxes to diversify. Both of these practices favor index funds and index huggers, who are quantitative. This may be OK if it weren't for a continuing client demand for active non-quantitative managers. Consultants try to give clients what they want, but have decided to leave the talent filters unchanged. These filters built for index huggers don't work on liberated non-index-huggers. Newsletter readers can find the article at http://www.ppca-inc.com/pdf/Bass_Ackwards-20080904.pdf

THE SPAULDING GROUP'S 2008 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
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 21-22	Introduction to Performance Measurement Training	Chicago, IL (USA)
October 23-44	Performance Measurement Attribution Training	Chicago, IL (USA)
November 13-14	Performance Measurement Forum (Europe)	Amsterdam, The Netherlands
November 19	Trends in Attribution Symposium (TIA)	Philadelphia, PA (USA)
December 4-5	Performance Measurement Forum (North America)	Orlando, FL (USA)
December 8-9	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 10-11	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2008 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:

October 7-8, 2008 – New York, NY
October 7-8, 2008 – San Francisco, CA
October 21-22, 2008 – Chicago, IL
December 8-9, 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 9-10, 2008 – New York, NY
October 9-10, 2008 – San Francisco, CA
October 23-24, 2008 – Chicago, IL
December 10-11, 2008 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

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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.