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AN UNADDRESSED FUNDAMENTAL ISSUE

I have written extensively[1] over the past year on the subject of the aggregate method to derive composite returns. And when we speak of composites, we aren't limiting ourselves to GIPS® (Global Investment Performance Standards), since the concept of compositing or grouping accounts isn't limited to the Standards. Family accounts, for example, are composites.[2]

I was recently engaged in a fairly lengthy email discussion with someone who holds the belief that the aggregate method is, in fact, the superior way to derive composite returns, while the other methods (the beginning market value (BMV) and beginning market value plus weighted cash flows (BMV+WCF)) are inferior. I was taken aback by this, especially given the example I derived that showed a composite's account returns having identical results (4.00%) while the composite itself had a very different result (4.48%). I wondered, "How on earth could anyone conclude this?"

As I was in the process of responding to the latest email, I had an epiphany: what does the composite return represent?[3] Sadly, and perhaps ironically, the standards don't provide a definition for "composite return." We can find lots of terms defined in the glossary, but this very important value was overlooked. Perhaps there was a belief that everyone would know what it means, but this isn't the case. And so this begs the question, "what does 'composite return' mean?" I urge you to pause for a moment, and come up with your own definition before proceeding.

In reality, there are two possible definitions for this term, depending upon which method you use to derive it:

- If you use either the BMV or BMV+WCF approach, the composite return represents the *asset-weighted average experience of the accounts that were present in the composite during the given time period.* However,
- If you use the aggregate method, the composite return represents *the return of the composite, as if it was an account itself.*

Without actually saying it, those individuals who believe that the aggregate method is superior hold to the second definition, while folks like me find its results to sometimes be nonsensical.

1 See, for example, the July 2010 edition of this newsletter (http://tinyurl.com/3reorhr), several blog posts, including December 20, 2010 (http://tinyurl.com/3trwuku), July 6, 2010 (http://tinyurl.com/42lqpbz), and July 7, 2010 (http://tinyurl.com/3brtxlg). I also wrote an article on this topic which appeared in the Winter 2010/2011 issue of *The Journal of Performance Measurement*® ("An Analysis of the Aggregate Method to Calculate Composite Returns").

2 It was as a result of doing analysis for Bear Stearns more than five years ago on how they were deriving their family account returns that I first realized there was a problem with the aggregate method.

3 In reality I have both thought about and commented on this before, but this moment was a bit more focused on this single issue, in light of those who celebrate the aggregate method's results.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Thus, the argument becomes not whether the aggregate method should be permitted, but rather, what the composite return is supposed to represent? This is hugely fundamental, and yet appears nowhere in the GIPS materials.

The GIPS standards resulted from the Association for Investment Management and Research's Performance Presentation Standards (AIMR-PPS®). If you look at its first edition (1993), you will only see the BMV method offered as a way to derive the composite's return. Here, too, there is no attempt to define what exactly this return represents, but it is clear that it is intended to provide us with the asset-weighted average experience of the accounts that are present in the composite. The second edition (1997) introduced the BMV+WCF, which is simply a refinement of the BMV method, as well as the aggregate formula. At the instant this formula was permitted, we see (though not explicitly stated) a second, and completely different, definition for composite return surfaced, where it now treats the composite as a single account. What are the ramifications of this?[4]

Well, I pointed out several times that the results can appear odd, but apparently only to those of us who think the return should provide us with the average result of the accounts in the composite.

ADDING ACCOUNTS WITHIN THE MONTH

Recall that what caused me to pursue this topic was the issue of accounts being added to a composite within a month.[5] Well, let's spend a few moments on this.

Consider the first definition in light of the question about adding accounts within a period: in general, is it possible to take an average where all of the underlying members aren't present for the full period? In general, the answer is "yes." For example, if we want to know the attendance of students in a class, where there are 10 students in total, but a few were present for only part of the year; could we include them in our statistic? Of course! We simply weight their number of days (present or absent, depending on the approach we wish to take) by a fraction of the year, while we weight the others by the full period. Please refer to Table 1.

Student ID	Days absent	Portion of year enrolled
1	0	100%
2	4	100%
3	2	100%
4	0	100%
5	0	100%
6	1	100%
7	8	100%
8	0	50%
9	1	50%
10	2	25%
Average days absent =		1.6

Table 1

4 Did the members of the AIMR-PPS Implementation Committee give this any thought? Did anyone mention that a second definition was now being introduced? I have no way of knowing.

5 While this isn't the only time the aggregate method can produce some strange results, it is definitely a leading contender.

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.

And so the concept itself isn't unheard of.

However, if the meaning we wish to convey with the composite return is the first one, that it represents the average experience of the investors for the given time period, is it wise to include accounts that were present for less than the full period? Let's consider the following three situations:

Scenario #1		
Investor	Return	% Present
1	2.00%	100%
2	2.00%	100%
3	2.00%	100%
4	2.00%	100%
5	2.00%	100%
6	2.00%	100%
7	2.00%	100%
8	2.00%	100%
9	2.00%	100%
10	7.00%	50%
Average Return		2.15%

Scenario #2		
Investor	Return	% Present
1	2.00%	100%
2	2.00%	100%
3	2.00%	100%
4	2.00%	100%
5	2.00%	100%
6	2.00%	100%
7	2.00%	100%
8	2.00%	100%
9	2.00%	100%
10	4.00%	50%
Average Return		2.00%

Scenario #3		
Investor	Return	% Present
1	2.00%	100%
2	2.00%	100%
3	2.00%	100%
4	2.00%	100%
5	2.00%	100%
6	2.00%	100%
7	2.00%	100%
8	2.00%	100%
9	2.00%	100%
10	1.00%	50%
Average Return		1.85%

Tables 2– 4

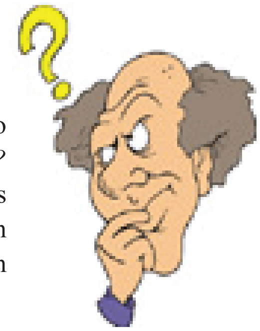
In each case, we have ten accounts, nine of which (Investors 1 through 9) were in the composite for the full month, and one (Investor 10) is there for only half the month. The nine accounts present for the full month all have the exact same experience, demonstrating how consistently the manager performs. However, the partial-period account's return is different, as it was there for only half the month. And while mathematically there is nothing wrong with deriving an average, this 10th account can skew the result. If we wish to know what was the average experience of the accounts present for the period, why would we want to include someone in who wasn't there for the full period? This manager is very consistent in his/her investing (as represented by the nine accounts present the full year), but this isn't obvious when we distort the composite return by allowing an account to be there for only half of the period.

If, on the other hand, we use the second definition, that the composite return represents the return of the composite itself, as if the composite is an account, then there is absolutely nothing wrong with allowing an account to come in during the period. It's just another cash flow, just as if one of the accounts made a mid-period contribution.

The reason the composite returns that were derived using the aggregate method are "accurate" or "correct" (in the examples I have written about) is because they are not measuring the average account experience. They are measuring something very different: the composite's own return, as if it was an account. If, for example, we have three accounts, each having a return of 4.00% for the month, the composite return of 4.48% is correct, because it's not meant to represent the average experience; it's meant to represent the composite's return, as if someone was actually managing the composite (which they weren't!). Likewise, the 4.00% return derived by the BMV and BMV+WCF methods is correct, because in this case the composite return is telling us what the average experience was. And so, we have two very different results, each correct, but only in the context of what we mean by "composite return."

Nowhere in the standards do we find an explicit prohibition to add accounts mid-period. Yet I would caution against doing this, unless (a) you adhere to the second definition and (b) you're using the aggregate method.

WHAT TO DO?



Now, the important question for the GIPS Executive Committee to consider is *what should the definition of the composite return be?* The reality is that today we have two different implied definitions for the same term. Given that the standards have always been consistent, wouldn't we expect this to be consistent as well? Such a definition is critically important.

What should drive the definition: the meaning we back into as a result of the method we employ, or what we think it should be? Shouldn't the formulas be designed to express answers that are consistent with our definition?

I would think that the composite return should be telling a prospective investor "during the period we managed the composite for 'n' investors, and this is how they performed, on average." Not "during the period this is how the composite did," because:

the manager isn't managing the composite;
the manager is managing the underlying accounts.

I stand by my earlier recommendation, but even more so: the GIPS EC should introduce a clear definition of what the composite return means. And, if it means (as I hope it would) "the asset weighted average experience of the firm's investors for the given period," then the aggregate method has to go, because that is not what it measures.

I'm not done with this, yet…

Stay tuned, as I will comment even further on this topic of what the composite return should represent, but from a different angle. First, we need to get this out there. Please let me know your thoughts and reactions.

THE SPAULDING GROUP'S 2011 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
October 11-12, 2011	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
October 13-14, 2011	Performance Measurement Attribution Training	Chicago, IL (USA)
November 10-11, 2011	Performance Measurement Forum	Budapest, Hungary
November 14-18, 2011	Attribution Webinar Week	Online Webinar
December 1-2, 2011	Performance Measurement Forum	Orlando, FL (USA)
December 6-7, 2011	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
December 8-9, 2011	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2011 events, please contact Christopher Spaulding at 732-873-5700

Save the Dates!

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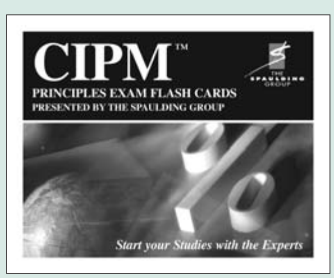

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