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.

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For additional information about The Spaulding Group and our services, please visit our web site or contact Chris Spaulding at

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AMSTERDAM EC MEETING

Although I didn't attend this month's GIPS® Executive Committee (EC) meeting in Amsterdam, I've heard some preliminary reports of what was discussed and want to pass some of these details along to you.

One of the subjects that's "near and dear" to my heart has to do with the planned elimination of the ability to allocate cash for carve-outs. The planned date for this change is January 2010 and apparently will not be reconsidered. I am disappointed that we will not have the opportunity to lobby once again for its continued allowance, as the change will impact numerous managers. Granted, the change was originally planned for 2005 and the five year extension should have provided firms with ample time to make the adjustment. Nevertheless, the change will no doubt impact many. Firms can continue to use carve-outs, but will have to manage the cash separately. This can be done by having separate "cash buckets" for each carved-out entity or to have these entities established as separate subportfolios with their own cash. For example, if the firm has a balanced account (bonds and stocks) and wishes to carve out the stock portion to include it in an equity composite, then the cash has to be totally separate from cash that would be used for the bond portion. While many have already made the transition to such an approach, many more will find this change difficult. Consequently, many will simply cease using carve-outs, which I believe is unfortunate.

I also believe that the planned change to the calculation rule, that will require firms to revalue their portfolio for large flows, will remain as it is written: January 1, 2010. Many of us could see how this rather broad change will have mixed effects: while highly liquid markets (e.g., U.S. large cap equities) will have accurate prices readily available to accommodate the change, others (e.g., emerging market equities and debt, and even U.S. municipal bonds) which are less liquid may have some problems.

The key dates for the next edition of GIPS are:

- Public comment draft: ready early 2009
- Public comment period: early 2009
- Final version: should be ready by the end of 2009
- Effective date: 1 January 2011.

We will host a series of luncheons in early 2009 to present the key aspects of the draft. As we learn more, we'll report on it.

GETTING THE DATA CLEAN

We recently spoke with a firm that wanted to develop their own performance measurement system. The reason? While they had run their data through a variety of packaged systems, in each case they found the results to be somewhat outlandish, and consequently they concluded that these packages had some fundamental problems with their logic. While we would very much welcome the opportunity to manage and direct another systems

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Multi-currency Attribution – Part 2 – Factoring in Interest Rate Differentials
– Carl Bacon, CIPM, StatPro Group

Performance Attribution Against Transient Buckets
– Timothy P. Ryan, Hartford Investment Management Company

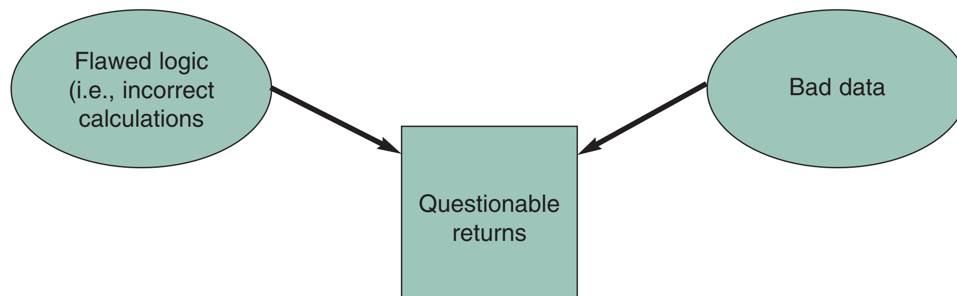
Derivative Products in Performance Attribution
– Mathieu Cubilié, StatPro Group

Evaluating Target Date Lifecycle Funds
– Ronald J. Surz, PPCA, Inc., and Craig L. Israelsen, Ph.D., Brigham Young University

The Role of Conceptual Context in Finding the Rate of Return
– Yuri Shestopaloff, Ph.D., SegmentSoft Inc., and Konstantin Shestopaloff, SegmentSoft Inc.

The Journal Interview
– Douglas Lempereur CFA, CIPM, FRA, Franklin Templeton

development project, we felt it wise and ethical to pause and suggest that we reflect a bit more on the potential contributors to the apparently incorrect returns. Please understand that we didn't feel compelled at this time to discuss the possibility that the returns were actually correct but simply confusing because of the way time-weighting behaves at times (for example, those occasions when one loses money but has a positive return). If the returns are, in fact, erroneous, we believe there are two potential contributors: flawed logic (i.e., problems with the calculations that are being employed) or bad data.



How might we decide? When told what vendors they had considered, I leaned towards the latter, given my previous experience with at least one of the vendors who I knew to have good solid logic in their software. But how might the data be bad?

There are two key contributors to our returns: market values and cash flows. We can generally assure that our market values are fairly accurate if we reconcile our month-end positions. However, if we revalue on a more frequent basis, then some additional work is in order. I'm not a particular fan of storing more than month-end data but am aware that many do; as long as we have valid month-end, we can "back into" any day's position. One challenge, however, is to make sure our month-end data is accurate. While reconciling is clearly the first step, we also need to be mindful of "as-of" adjustments that may occur which could alter the makeup of our end-of-month positions; unless we dynamically adjust the month-end values when such events occur, the accuracy of these month-end values may become suspect.

When we speak of cash flows we're referring to a subset of our transactions which translate into cash flows. Unfortunately, knowing which ones are cash flows and at what level(s) they're flows can often be a challenge. Asset managers typically have multiple sources of transactions, with each having their own rules. Some sort of mapping logic is needed to ensure that the codes are being properly handled. If we're calculating returns at both the portfolio as well as subportfolio (e.g., security, sector) levels, we will need to distinguish between these levels as some codes are cash flows at one level but not the other.

Code	Transaction	Portfolio Level	Subportfolio Level
B	Buy	No	Yes
S	Sell	No	Yes
IF	Cash Inflow	Yes	No
OF	Cash Outflow	Yes	No
DI	Deliver In	Yes	Yes
DO	Deliver Out	Yes	Yes

Sample transaction code mapping table

Save the Date!

Save the date for the inaugural **Investment Performance Analysis and Risk Management Congress,** where performance analysts and risk managers will meet to exchange ideas and get updated on new strategies and solutions.

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INVESTMENT PERFORMANCE ANALYSIS & RISK MANAGEMENT CONGRESS 15 - 16 July 2008

The accompanying table provides a brief snapshot of what such a table might look like. It's often the case that most transactions aren't cash flows at either level; however, there are many that need to be taken into consideration. In addition, we need to know how to treat the values that appear (in some cases, the values are always positive, so one must adjust them if they're leaving the portfolio (or subportfolio); in other cases, we will need to calculate the value based on the quantity and price. Since there are no transaction code standards, care must be exercised to get this right. It's not unusual to have to review thousands of codes. In addition, we must be on the lookout for new codes which may appear.

While this is far from a complete accounting of all the possible causes of "bad data," incorrect mapping is often a contributing party.

While we haven't moved beyond a brief discussion yet with this firm, we recommended that before they proceed down the very costly path of developing a system, that we reflect a bit more on what's occurring; some additional analysis might be in order to discover what the culprit(s) might really be behind the inaccurate returns.

UNSUPERVISED ASSETS *(and the income that comes from them)*

Many firms have to contend with the presence of unsupervised (nonmanaged) assets. These are assets the client has in their account that you're not permitted to sell but which you're required to report on.

While it's often easy enough to flag the assets as "unsupervised" for performance purposes (so that they're not part of your market values for return purposes), what about the income that's generated from them? Shouldn't that be excluded, too? But how does your system handle it?

I would argue that if you have an asset that you can't trade, which is therefore flagged as unsupervised and which is excluded from your return, the income should be treated as a cash flow, so that it, too, is excluded. If you're not sure how your system handles these transactions, perhaps a review is in order.

And speaking of the assets, these assets should (arguably) not be part of your "firm assets," as they're unsupervised. While their typically *de minimis*, technically they should be excluded.

WHAT DO YOU SHOW IF THERE'S NOTHING TO SHOW?

Let's say you're claiming GIPS compliance and have a new product you want to market; what do you provide a prospect if there aren't any clients in the composite yet? Paragraph 0.A.11 of the standards requires compliant firms to "make every reasonable effort to provide a compliant presentation to all prospective clients." While it doesn't say "the appropriate" presentation, I think the intent is clear. Since you don't have any returns yet, you won't have a presentation that you can provide. You can, however, show disclosures. But returns are what prospects often want to see.

If you have model returns, these can be shown as "supplemental information" (and must be labeled as such).

Verifiers' Corner

So, what does "link" mean…

Without going into my Bill Clinton routine (about what the word "is" means), I do want to comment briefly on another word: "link." If you read the *GIPS Guidance Statement on the Use of Supplemental Information* you'll see that you cannot "link" model, hypothetical, backtested, or simulated results to actual performance. In this context, what does the word "link" mean?

Having worked on this document (both the original as well as the revision), I recall that we meant it to mean an association or relationship, not specifically as in t*o geometrically link* returns. Therefore, we've always recommended that firms not display both real and non-real (e.g., model) results on the same page, as the numbers might be "linked" in the reader's mind in such a way that he/she believes that *all* the numbers are real. Apparently the use of the word has caused a fair amount of confusion. Since we (as performance measurers) typically use the word "link" to mean "geometrically link," readers tend to limit their scope to just this meaning. A bit ambiguous, yes?

Given the apparent absence of any further details on what the expression means, we are left to our own interpretation. And so, I will offer my (somewhat conservative) view: I recommend that you *not* show both real and non-real (again, model, hypothetical, etc.) on the same page. While I've heard that on occasion regulators will join me in this view, at other times they're more lenient. So, in the end, until something more definitive comes about, you're free to come to your own conclusion.

If you provide returns from other products which are deemed to be "similar to" the intended investment style, you have to be careful to spell out the details so that you don't mislead the prospect into believing that these returns represent the new style. The differences should be made clear.

FROM OUR READERS

Andre Mirabelli wrote:

David,

As usual, I always find your Performance Perspectives worth pondering.

This time I was struck by the comment, in the recent March 2008 issue, that "Modified Dietz's error increases as cash flows grow larger."

As a counter example, consider a portfolio that does great. It triples its value in each of two consecutive and equal duration time periods (W = 1/2), so the performance is 200% and 200% for a combined 800%. We withdraw money between the periods and still the portfolio ends up with more than we started.

In the first new case we have a cash flow of -55%, withdrawing 55% of the value existing at the end of the first period. In the second new case we have a cash flow of -70%, withdrawing 70% of the value existing at the end of the first period. In the third new case we have a cash flow of -85%, withdrawing 85% of the value existing at the end of the first period. Calculating the error created by the Modified Dietz approach, as you did, shows that it is the middle size cash flow that has the largest error. Thus, it is not always the case that the "Modified Dietz's error increases as cash flows grow larger." This conclusion holds whether absolute values of the error are taken or not and whether more negative cash flows are considered larger or smaller.

Note that in the last two cases I consider, the Modified Dietz approach assigns very negative returns to these hugely positive results. Thus, it is an extremely bad approximation.

As you state, "Modified Dietz is only an approximation" and "we are only willing to accept a certain degree of error" and that "problems…can occur with Modified Dietz when there are large flows, especially in volatile markets." These new examples show that the situation is even worse then your note indicates in that the error is not even an increasing function of the cash flows. In situations like the ones here considered, such blatant anomalies can be created whenever the product of the Modified Dietz weighting factor and the first period return factor is greater than one (W[1+R1] >1).*

This is only one indication of why I have found it necessary to develop for my own work a more viable approach to performance measurement then Modified Dietz and its many similarly problematic variations. In a related matter, I eagerly look forward to comparing the conclusions of your IRR Standards Working Group to those I have developed on that topic.

Best regards,

Andre

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.

PERFORMANCEJOBS.COM WEBSITE

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.

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The Journal of Performance Measurement®
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Performance Measurement, Attribution & Risk
Conference
May 21st - 22nd, 2008

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

DATE	EVENT	LOCATION
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 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)
September 22-23	Introduction to Performance Measurement Training	Boston, MA (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 13-14	Performance Measurement Forum (Europe)	Amsterdam, The Netherlands
December 4-5	Performance Measurement Forum (North America)	Orlando, FL (USA)
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 2008 events, please contact Christopher Spaulding at 732-873-5700

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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:

May 6-7, 2008 – Los Angeles, CA

September 22-23, 2008 – Boston, MA

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

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Two full days devoted to this increasingly important topic. The Spaulding Group, Inc. invites you to attend Performance Measurement Attribution on these dates:

May 8-9, 2008 – Los Angeles, CA

October 9-10, 2008 – New York, NY

October 9-10, 2008 – San Francisco, CA

December 11-12, 2008 – New Brunswick, NJ

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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 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.