

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 CSpaulding@SpauldingGrp.com

WHEN ASSET WEIGHTING WORKS (AND WHEN IT DOESN'T) (PART II - MONEY WEIGHTING)

In the last issue we touched on the subject of asset-weighting vs. aggregating returns from a time-weighted perspective. Let's now turn our attention to doing this from a money-weighted perspective. We will use the same scenario as we described before: We have a client that begins the period with a single account, valued at £250,000. Midway through the month, a second account is opened for £250,000. At this time, our first account was valued at £242,000. As you can see, the first account recovered from its downturn to increase to £260,000. The table shows the returns for each of these accounts. Since there are no cash flows, our money-weighted returns match the time-weighted returns at the individual account level.

Account	BMV	Mid-month Value	EMV	ROR
A	250,000	242,000	260,000	4.00%
B	0	250,000	255,000	2.00%
Total	250,000	492,000	515,000	

Figure 1

If we calculate the return on the aggregate (total) values, we get 3.60 percent.¹ What's our return if we asset-weight? Figure 2 shows the approach I took. Here, I used a weight based on the amount of time the flow was present; for the first account, the money was present the entire period; for the second, the money was present only one-third of the time. The 333,333.33 value is the sum product of the starting values and weights.

Account	Starting Value	ROR	Weight	Weighted ROR
A	250,000	4.00%	100%	3.00%
B	250,000	2.00%	33.33%	0.50%
			333,333.33	3.50%

Figure 2

In this case, our results are quite similar (3.60% vs. 3.50%). So, which is correct?

¹ I haven't included this math but can do so if our readers feel it's necessary.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

**A General Approach for
Linking Arithmetic
Attribution Results Over Time**
– *Mikael Broberg*

**Fixed Income Attribution:
A Unified Framework Part 1**
– *Bernard Murira and
Hector Sierra*

Is Sharpe Ratio Still Effective?
– *Yasuaki Watanabe*

Risk Attribution
– *Philippe Grégoire and
Herve van Oppens*

**Do Stock Indexes Have
Abnormal Performance?**
– *Bruce Costa and Keith Jakob*

To answer this I think we need to know *what's the question?* This should *always* be an important step when speaking about returns (see below). So, in this case, what question *are* we trying to answer? Moneyweighting deals with the *client's* experience...the return from the client's view, taking into consideration the cash flows. For the individual accounts, the 4.00% and 2.00% measure how the client did. There were no cash flows at the account level, so these returns match, as noted previously, our time-weighted results.

If we *asset-weight* these numbers, we say what our *average* experience was for each of these accounts. If we *aggregate* the numbers, we say what our *overall* experience was, and I believe that *this* is the preferred approach if we want to know how we did at the total level. Therefore, I would argue the case FOR money-weighting to aggregate, not asset-weight. Recall that last month, when it came to time-weighting, I suggested the opposite approach...probably not surprising that a former politician can come down somewhat equally on both sides of an issue! Your thoughts?

WHAT IS THE QUESTION?

I had a long conversation with a client earlier this month on whether they should be reporting time-weighted or money-weighted returns. This client happens to be a very large brokerage firm and I was suggesting money-weighted when the client makes the decisions. He asked a question: what if we want to show how an individual mutual fund did ... that is, how the fund manager performed? Answer: time-weighting. But what if we want to say how the client's investment decisions did? Answer: money-weighting. And what if we want to show how the client's advisor's recommendations (such as "shift 50% of your growth fund assets into your value fund") paid off? Answer: time-weighting. In general, for most retail investors, I would argue that they want to see returns that (a) add value and (b) make sense.

And, in most cases we're talking money-weighted. In addition, these investors like to see the change in their assets...how they're doing from a dollar, euro, pound, yen, peso, etc. perspective (how much money did I make last year?). This alone should give credence to wanting to see money-weighted returns.

ABUSIVE GAP CROSSINGS & ANNUALIZING WHEN THERE IS A GAP

In the April and May 2005 issues of this newsletter we touched on the notion of "crossing gaps." That is, when there's a halt to performance, whether it's appropriate to *cross the gap*?

I suggested that in many cases it is, especially when the decision to be *void* some asset was part of our strategy (e.g., to temporarily shift from stocks into bonds). Without crossing the gap we don't reflect the results of this decision.

We recently encountered a scenario when (a) it appeared that these gaps were created for other than strategic reasons and (b) the gaps could be quite long. In these cases I would guard against crossing the gap, as I believe the results would be misleading. I would call these cases *abusive gap crossings*. As always, your thoughts are invited.

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.

As an aside, a question arose when discussing this topic: how do we annualize our returns when there's a gap? That is, do we use the entire period in our calculation or just the period that was invested? Say, for example, we're measuring performance for a 24-month period and there was a 2-month period when there was a gap; do we use 24 or 22 months in our annualization formula? I would suggest 24 months since that's the length of the period.

MORE WORK COMING!

We recently formed two additional working groups to develop standards.

Recall that in a previous issue we mentioned the establishment of a group to work on day-count annualization rules. We also felt there was a need for rules on hedge fund performance and so have created a working group, consisting of the following individuals:

John Jacobi, Grantham Mayo Van Otterloo
Christine Iannacone, Goldman Sachs
Valerie Lamanna, Goldman Sachs
Nadia Van Dalen, Morningstar
Paul d'Ouille, Northern Trust
Martin Schlieman, Ernst & Young

Plus, during a discussion with software vendors we saw an opportunity to develop a template for software search RFPs. This group will be headed by John Simpson and consists of:

Joe McDonagh, Eagle Investment Systems
Mark Goodey, Foreign & Colonial
Debi Deyo Rossi, Turner Investment Partners
John Imbriale, Fiduciary Trust
Sandra Hahn Colbert, Neuberger Berman
Roman Darewych, SS&C Technologies
Elske van de Burgt, ORTEC

We're pleased that we have had success in the past with such efforts (e.g., the development of annualization standards, guidelines for error correction (which served as the basis for the GIPS® guidance) and the "blue ribbon committee" that began work on a certification program for performance professionals, which we turned over to the CFA Institute to support them in their CIPM program). We will keep you abreast of our efforts.

FROM OUR READERS

Last month's asset-weighting vs. aggregation topic drew a few comments, including:

In the November 2006 Performance Perspectives, you asked for reader's thoughts on your comments addressing a choice between asset-weighted and aggregation approaches to combining the returns of portfolios in an example you specified. That induced me to the following response.

Both the asset-weighted approach (giving 3.33%), and an IRR approach (giving 4.01%),

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.

ignore the available information that specifies the mid-month value of account A. The asset-weighted approach is an approximation of the aggregation approach that was specifically created to deal with cases when the mid-period information is lacking. (I believe there are other approximations that are superior.) Thus, it is hard to believe that it is ever appropriate to replace the aggregation approach with an approximation for it when the information is actually available.

The aggregation approach gives the experience of a person who bought a share of the initial holdings, which were all in A, and then redistributed those holdings by money-weighting it among both A and B when B became available for the second sub-period. The reason that the experience is lower than for either A or B alone is that it takes the big hit for A's initial experience and then gets a watered down version of A's second period rise. This seems to me to represent the overall experience that is sought.

I believe you describe this situation well in your paragraph mentioning the -3.20% return for A in the first sub-period and the 4.67% return for the combination of the A and B in the second subperiod.

The IRR approach, which you did not mention, provides the compounding of the sub-period return that if it were experienced in each sub-period by all cash flows would have resulted in the actual final value. This is a kind of average that ignores available information about what actually occurred in the sub-periods.

You then go on to call the asset-weighted approach an average, but there are unlimited ways of creating an average, which here simply means nothing more than that it relies on both A's and B's outcomes. You also say that the asset-weighted approach "shows the overall return for this client." However, you do not explain what "overall return" means and I cannot think of a meaning other than that it is the result of the asset-weighted approximation.

Your final comment in support of the asset-weighted approach is that it treats A and B independently. However, I do not know what you mean by this since all approaches, including the asset-weighted approach, combine the results of A and B to get the final return. Can you just be referring to the fact that it ignores the intermediate information about A?

Therefore, I believe that the aggregation approach is always better than the asset-weighted approach when the information for calculating the aggregation approach is available. Further, it answers a different question than IRR, and it is always the first requirement to decide what the question is.

I responded by suggesting:

Thanks for your comments. In the next issue we plan to address the money-weighted side.

I think it boils down to what you're trying to tell the client? Or, what's the context of the presentation?

If we're trying to tell the client the average return of the time-weighted returns of the individual holdings (in this case, various portfolios managed independently, by different



As 2006 draws to a close, we would like to extend our best wishes to you for a safe, happy, and joyous holiday season, as well as a healthy and rewarding 2007. May God bless you and your family.

Happy Holidays



managers), then I believe that the asset-weighted approach is better, because we would want to treat the two managers separate, in order to not have one manager's actions impact another's. However, if we're trying to tell the client how they did overall, then first, I'd be showing IRR and second, I'd use the aggregation method. Again, we'll discuss this next month.

And, he responded with:

In my view, the only experience asset-weighted could describe is the following: Assume a person knew ahead of time the amount of all in-flows that would occur and put aside at the beginning an amount of cash to cover all these in-flows. Assume that person would fund all in-flows from this cash when those in-flows occurred, and would otherwise keep un-invested all cash not yet committed and all cash from out-flows, not employing any cash from out-flows to fund any in-flows. Then the asset-weighted return would give the return experienced by this person.

However, since

- 1. I do not believe that people know about in-flows far in advance,*
- 2. I do not believe that the out-flows would not be used to fund in-flows, (trade-balancing) and*
- 3. I do not believe that cash is kept un-invested when the period is long,*

I, thus, believe that it is far-fetched to think that asset-weighting will ever be appropriate for periods much longer than a day, and often it will not be appropriate for short periods if it does not explicitly take into account trade-balancing.

And, regarding our issue of reporting our performance relative to an index in relative percentage terms a reader offered the following:

I agree it's an interesting question, and I also agree with your answer – except that you didn't mention one consideration that seems decisive.

Presumably, if one were going to report returns that way, one would need to be consistent about it...so, if the benchmark return was 1% and the portfolio return was -2%, we would need to say that we underperformed the benchmark by 200%. Or, even worse, if the benchmark return was 0% and the portfolio return was -1%, we would need to say that we underperformed the benchmark by an infinite amount. It is a safe bet that nobody would ever want to say that!

CIPM (FORMERLY KNOWN AS CGIPS) RESULTS

The results from the last round of testing have been announced: 62% of those taking the principles exam passed while 60% of those who took the expert exam passed.

And we're pleased to announce that John Simpson and I passed the experts exam. I have to admit that I was quite nervous and am excited by the results. Note: that the CIPM program will be a subject at our upcoming PMAR V conference in May.

THE SPAULDING GROUP'S 2007 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
January 23-24	Introduction to Performance Measurement Training	Reykjavik, Iceland
January 25-26	Performance Measurement Attribution Training	Reykjavik, Iceland
February 12-13	Introduction to Performance Measurement Training	New York, NY (USA)
February 14-15	Performance Measurement Attribution Training	New York, NY (USA)
February 12-15, 20	CIPM Principles Exam Preparation – Special 5-Day Night Class	New York, NY (USA)
February 26-27	CIPM Principles Exam Preparation	Los Angeles, CA (USA)
February 28-March 2	CIPM Expert Exam Preparation	Los Angeles, CA (USA)
March 5-6	CIPM Principles Exam Preparation	New Brunswick, NJ (USA)
March 7-9	CIPM Expert Exam Preparation	New Brunswick, NJ (USA)
March 12-13	Introduction to Performance Measurement Training	Boston, MA (USA)
April 16-17	Introduction to Performance Measurement Training	San Francisco, CA (USA)
April 18-19	Performance Measurement Attribution Training	San Francisco, CA (USA)
April 26-27	Performance Measurement Forum	New Orleans, LA (USA)
May 8-9	Introduction to Performance Measurement Training	Chicago, IL (USA)
May 10-11	Performance Measurement Attribution Training	Chicago, IL (USA)
June 4-5	Advanced Performance Measurement Training	New Brunswick, NJ (USA)
June 14-15	Performance Measurement Forum	Helsinki, Finland
July 16-20	Investment Performance Measurement Boot Camp	New Brunswick, NJ (USA)
August 20-21	CIPM Principles Exam Preparation	Boston, MA (USA)
August 22-24	CIPM Expert Exam Preparation	Boston, MA (USA)
August 27-28	CIPM Principles Exam Preparation	Los Angeles, CA (USA)
August 29-31	CIPM Expert Exam Preparation	Los Angeles, CA (USA)
September 17-18	Introduction to Performance Measurement Training	Los Angeles, CA (USA)
September 25-26	Introduction to Performance Measurement Training	Chicago, IL (USA)
September 27-28	Performance Measurement Attribution Training	Chicago, IL (USA)
October 8-9	Introduction to Performance Measurement Training	Boston, MA (USA)
October 10-11	Performance Measurement Attribution Training	Boston, MA (USA)
October 15-16	Advanced Performance Measurement Training	San Francisco, CA (USA)
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)

*For Additional information on any of our 2006 events,
please contact Christopher Spaulding at 732-873-5700*

Save The Date!

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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:

January 23-24, 2007 – Reykjavik, Iceland
 February 12-13, 2007 – New York, NY
 March 12-13, 2007 – Boston, MA
 April 16-17, 2007 – San Francisco, CA
 May 8-9, 2007 – Chicago, IL
 September 17-18, 2007 – Los Angeles, CA
 September 25-26, 2007 – Chicago, IL
 October 8-9, 2007 – Boston, MA
 December 3-4, 2007 – 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.



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:

January 25-26, 2007 – Reykjavik, Iceland
 February 14-15, 2007 – New York, NY
 April 18-19, 2007 – San Francisco, CA
 May 10-11, 2007 – Chicago, IL
 September 27-28, 2007 – Chicago, IL
 October 10-11, 2007 – Boston, MA
 December 5-6, 2007 – 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 10 PD credit hours as granted by CFA Institute.



ADVANCE PERFORMANCE MEASUREMENT

June 4-5, 2007 – Reykjavik, New Brunswick, NJ
 October 15-16, 2007 – San Francisco, CA

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 CGIPS/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.