PERFORMANCE PERSPECTIVES with David Spaulding

VOLUME 8 – ISSUE 4 DECEMBER 2010

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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SIMPLY NOT GETTING IT…ERROR CORRECTION GUIDANCE

"I worry incessantly that I might be too clear" [1]
– Alan Greenspan

I must confess an occasional bout of denseness which makes my ability to comprehend certain things a challenge; and while I often attribute these episodes to my advancing age, perhaps there are other things at work. I find the GIPS® (Global Investment Performance Standards) to be a document that often causes me such difficulties, the most recent in regards to the Q&A[2] that appeared last year, which was to provide some much needed lucidity.

I recently engaged in a discussion (debate?) with a colleague regarding the issue of disclosures for material errors. I interpreted the Q&A as essentially eliminating the need for them, provided the GIPS-compliant firm had kept track of who had received their presentations, so they could make sure all parties received the corrected copy; my counterpart said this wasn't the case. Interestingly, we both felt that the Q&A was the foundation for our position.[3]

It was only after this discussion that I read the "revised" guidance,[4] that (more?) clearly marks this case. Here we find:

> With respect to a material error:
> - The error must be corrected and disclosed in a corrected compliant presentation.
> - Disclosure of the change in the corrected compliant presentation must be included for a minimum of 12 months following the correction of the compliant presentation. Firms are not required to disclose the material error in a compliant presentation that is provided to prospective clients that did not receive the erroneous presentation. However, for a minimum of 12 months following the correction of the compliant presentation, if the firm is not able to determine if a particular prospective client has received the materially erroneous compliant presentation, then the prospective client must receive the corrected compliant presentation containing disclosure of the material error. This may result in the preparation of two versions of the corrected compliant presentation to be used for a minimum of 12 months following the correction of the compliant presentation.

It is only through this source that I can say "I was wrong!" Compliant firms must, when they uncover a material error, ensure that anyone who received the previous version (i.e., with the error) must disclose that the error in the corrected copy and get this to them. And while I might (and do) disagree with this requirement, that's a moot point and not worth any further discussion.

1 Source: Hitchins, Henry. "The Syntax of Style." *Wall Street Journal*. December 15, 2010.

2 See http://www.gipsstandards.org/programs/faqs/gipsresults.asp?Id=254.

3 Interestingly, another colleague supported the opposing view, again citing this document, that to me completely lacks support. Oh, well.

4 See http://www.gipsstandards.org/standards/guidance/develop/pdf/gs_error_correction_clean.pdf.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Refining Core-Satellite Investing
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An Advanced Methodology for Fund Rating
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Life Settlements: Valuation and Performance Reporting for an Emerging Asset Class
– Darwin M. Bayston, Douglas R. Lempereur, and Anthony Pecore

The Characterstics of Factor Portfolios
– Jose Menchero

Tailoring Manager Allocation to Market Conditions Using Alpha Optimization: Part 1
– Eric A Stubbs and Enrique Jaen

NET OF FEE RETURNS…FREQUENCY OF APPLYING THE FEE

The GIPS standards recommend[5] that compliant firms *accrue* their fees. On the surface, this seems to make a lot of sense; however, upon further reflection I have concluded that it doesn't; for two reasons!

First, why?!?!?! Shouldn't fees be applied when they occur? The argument for accruing income is that the income is earned at some point before it is received, so the market value should reflect it, but this isn't the case (to me) with fees. Do we accrue to *smooth out* the effect? If so, isn't this distorting reality?

Second, it doesn't make a difference! Now this, to me, is the more interesting point. I was in a discussion recently with some colleagues on this very topic and suggested that monthly accruals would hurt a manager who charged fees quarterly, because it would result in more frequent compounding, when the compounding wasn't warranted. To demonstrate this I came up with several scenarios, a few of which I will provide here.[6,7]

		Monthly Accrual		Quarterly Actual	
	GOF Rtn	Monthly Fee	NOF Rtn	Quarterly Fee	NOF Rtn
Jan	0.50%	0.083%	0.42%		0.50%
Feb	1.00%	0.083%	0.92%		1.00%
Mar	1.50%	0.083%	1.42%	0.250%	1.25%
Apr	0.75%	0.083%	0.67%		0.75%
May	1.25%	0.083%	1.17%		1.25%
Jun	1.75%	0.083%	1.67%	0.250%	1.50%
Jul	-0.50%	0.083%	-0.58%		-0.50%
Aug	-1.00%	0.083%	-1.08%		-1.00%
Sep	1.00%	0.083%	0.92%	0.250%	0.75%
Oct	0.50%	0.083%	0.42%		0.50%
Nov	1.60%	0.083%	1.52%		1.60%
Dec	1.55%	0.083%	1.47%	0.250%	1.30%
	10.32%		9.23%		9.23%
		Annual Deduction			
		NOF Rtn	9.32%		

Example #1

Our first example shows that the monthly accrual results in the exact same net-of-fee return (9.23%) as the quarterly!

Our second involves an overall negative return, and the difference is only one basis point!

5 See ¶ 1.B.4, *Global Investment Performance Standards*. 2010.

6 I blogged about this recently and provided only one example, due to the expectation that blogs don't go on-and-on as I can do in this newsletter. See http://investmentperformanceguy.blogspot.com/2010/12/calculating-net-of-fee-returns.html.

7 In all cases an annual fee of 1% is used; I don't think a difference in fee will make much of a difference, but will encourage the curious reader to pursue this for him/herself.

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		Monthly Accrual		Quarterly Actual	
	GOF Rtn	Monthly Fee	NOF Rtn	Quarterly Fee	NOF Rtn
Jan	-1.00%	0.083%	-1.08%		-1.00%
Feb	-2.00%	0.083%	-2.08%		-2.00%
Mar	-3.00%	0.083%	-3.08%	0.250%	-3.25%
Apr	-1.50%	0.083%	-1.58%		-1.50%
May	-2.50%	0.083%	-2.58%		-2.50%
Jun	-3.50%	0.083%	-3.58%	0.250%	-3.75%
Jul	1.00%	0.083%	0.92%		1.00%
Aug	2.00%	0.083%	1.92%		2.00%
Sep	-2.00%	0.083%	-2.08%	0.250%	-2.25%
Oct	-1.00%	0.083%	-1.08%		-1.00%
Nov	-3.20%	0.083%	-3.28%		-3.20%
Dec	-3.10%	0.083%	-3.18%	0.250%	-3.35%
	-18.23%		-19.06%		-19.07%
		Annual Deduction			
		NOF Rtn	-19.23%		

Example #2

And our third example suggests that as the returns increase in size, we will see some divergence between the two approaches, but not enough (in my opinion) to warrant monthly accruals. Someone, thought that monthly accruals made sense; but do they? While this brief presentation hardly provides extensive empirical evidence, it should at least cause some reflection and perhaps rethinking about this idea.

One other thing we clearly see: using the "annual deduction" approach can be problematic as it reflects no accruing whatsoever and is arguably inappropriate as it overstates the return. And while it is permitted, given these results I would suggest that it be abandoned.

Oh, and when it comes to reporting returns to your clients, I see no reason to accrue: take the charge at the time it hits.

		Monthly Accrual		Quarterly Actual	
	GOF Rtn	Monthly Fee	NOF Rtn	Quarterly Fee	NOF Rtn
Jan	2.50%	0.083%	2.42%		2.50%
Feb	5.00%	0.083%	4.92%		5.00%
Mar	7.50%	0.083%	7.42%	0.250%	7.25%
Apr	3.75%	0.083%	3.67%		3.75%
May	6.25%	0.083%	6.17%		6.25%
Jun	8.75%	0.083%	8.67%	0.250%	8.50%
Jul	-2.50%	0.083%	-2.58%		-2.50%
Aug	-5.00%	0.083%	-5.08%		-5.00%
Sep	5.00%	0.083%	4.92%	0.250%	4.75%
Oct	2.50%	0.083%	2.42%		2.50%
Nov	8.00%	0.083%	7.92%		8.00%
Dec	7.75%	0.083%	7.67%	0.250%	7.50%
	60.90%		59.36%		59.40%
		Annual Deduction			
		NOF Rtn	59.90%		

Example #3

Upcoming classes:

CIPM™ Principles Exam Preparation Class

- March 21-22, 2011
  Chicago, IL
- August 22-23, 2011
  New Brunswick, NJ

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- March 23-25, 2011
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HURDLE RATES AND WHY YOU SHOULDN'T COMPOUND THEM[8]

Let's say that you have a client who has a goal of you beating a particular index by 100 bps. And let's say you report to them monthly. Should your benchmark (*i.e.*, the index with the hurdle) be compounded as you move through the year? Apparently lots of firms do this and then wonder why their yearly benchmark is something other than the index plus the hurdle. Well, the answer is because by combining the hurdle with the index, you're compounding it; and its compound rate will vary, depending on the return on the index itself. For example:

	Index	Fee	Index + fee
Jan	1%	0.083%	1.083%
Feb	1.50%	0.083%	1.583%
Mar	2.50%	0.083%	2.583%
Apr	1.40%	0.083%	1.483%
May	1.30%	0.083%	1.383%
Jun	1.70%	0.083%	1.783%
Jul	2.10%	0.083%	2.183%
Aug	3.10%	0.083%	3.183%
Sep	2.10%	0.083%	2.183%
Oct	2.20%	0.083%	2.283%
Nov	1.30%	0.083%	1.383%
Dec	2.10%	0.083%	2.183%
	24.70%	1.00%	25.93%
		Delta	
		1.23%	

While the fee compounds independently to the hurdle rate of 1.00%, when combined with the index its rate of compounding is altered, resulting in a hurdle of 1.23%: 23 basis points higher than what was agreed to!

Not surprisingly, this difference ("delta") varies, depending on the size of the return. As we can see in the next table, the differences become smaller and smaller, as our return grows smaller and smaller. One can see this as an advantage when the markets are really bad, but does it make any sense? If the client and you agree that your annual hurdle is 1.00%, then why should it end up being something different? In reality, the only time it will be 1.00% is when the index has a return of zero, which is highly unlikely.

Index	W/hurdle	Delta
39.03%	40.39%	1.36%
24.70%	25.93%	1.23%
11.73%	12.84%	1.11%
-10.60%	-9.70%	0.91%
-20.17%	-19.36%	0.82%
-28.80%	-28.07%	0.74%
-40.17%	-39.54%	0.63%
-49.86%	-49.33%	0.53%

So, what's the answer? Don't combine the hurdle when you compound; compound the index separately, and simply add the hurdle to it.

FROM OUR READERS...

Andre Mirabelli sent us a comment regarding last month's issue:

David,

As usual, your November, 2010 Newsletter provided much food for thought.

As I read the original statement of the situation regarding the returns on employee stock purchases, I see it as a case of free money and, thus, the return is infinite. The problem can be described as one where there is no initial funding but there are four deposits of $1000 on the last day of each quarter, each "immediately" followed by liquidation withdrawals of $1150, which is how I read the way the original situation is described.

Thus, the way I read the description of the situation, no money is invested during each

8 I touched on this briefly in my blog earlier this month; see http://investmentperformanceguy.blogspot.com/2010/12/compounding-is-great-but-is-it-always.html

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.

quarter. There is only money invested for a moment at the end of each quarter. Of course, this ignores the "investment" of just being an employee of the company, which is what allows for these immediate gains.

Under this reading, the return factor F = infinity is the only solution to the corresponding IRR equation $1000*(F^3 + F^2 + F^1 + F^0) = 1150*(F^3 + F^2 + F^1 + F^0)$.

Another way to look at this is that getting all your invested money back and more a little time later is not as good as immediately getting all the money you invested back and more.

The annualized return for getting \$1150 back on \$1000 after only one month is over 400%. And this deal is better than that since the \$1150 is received "immediately" after the \$1000 is invested. For the transaction at the end of each quarter one has: $\$1000*(1 + R)^{(t/yr)} = \$1150$.

The smaller the period of the investment, t, is the larger the annualized return, R, needs to be. In the limit ("immediately") when $t = 0$, R must be infinity for each transaction.

Four sequential investments, each with an infinite return, and absolutely no money invested in the interims, implies infinite return in my book.

As to the intuitive understanding of the Sharp Ratio, I believe a lot has to do with our uncertainty as to whether, when the market is going down, we would rather have a lot of variation in hopes of getting a positive bounce and not going down with it or a little variation to allay our fear that we will get a negative bounce and go down even more than the market.

On an ex ante basis, we know that what is generally accepted as desirable is positive returns with little variation.

Negative returns are not as clear. If the further down you expect to be the more uncertainty you would like, then you prefer less negative Sharpe Ratios. But if the further down you expect to be the less uncertainty you would like, then you prefer more negative Sharpe Ratios.

I believe that being risk-adverse means taking one's lumps and not throwing good money after bad. Thus, most people would, upon consideration, rather go quietly into the night, which implies taking the absolute value of the Sharpe Ratio as a measure of goodness.

Regards,
Andre

Some great insights; thanks, Andre!

Merry Christmas & Happy New Year

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

DATE	EVENT	LOCATION
February 8-9, 2011	Fundamentals of Performance Measurement Training	Los Angeles, CA (USA)
February 10-11, 2011	Performance Measurement Attribution Training	Los Angeles, CA (USA)
March 8-9, 2011	Fundamentals of Performance Measurement Training	Boston, MA (USA)
March 10-11, 2011	Performance Measurement Attribution Training	Boston, MA (USA)
March 21-22, 2011	CIPM™ Principles Exam Preparation Class	Chicago, IL (USA)
March 23-25, 2011	CIPM™ Expert Exam Preparation Class	Chicago, IL (USA)
April 12-13, 2011	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
April 14-15, 2011	Performance Measurement Attribution Training	Chicago, IL (USA)
May 16-17, 2011	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
July 12-13, 2011	Fundamentals of Performance Measurement Training	Toronto, Ontario
July 14-15, 2011	Performance Measurement Attribution Training	Toronto, Ontario
August 22-23, 2011	CIPM™ Principles Exam Preparation Class	New Brunswick, NJ (USA)
August 24-26, 2011	CIPM™ Expert Exam Preparation Class	New Brunswick, NJ (USA)
September 20-21, 2011	Fundamentals of Performance Measurement Training	San Francisco, CA (USA)
September 22-23, 2011	Performance Measurement Attribution Training	San Francisco, CA (USA)
October 11-12, 2011	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
October 13-14, 2011	Performance Measurement Attribution Training	Chicago, IL (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)

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September 20-21, 2011 – San Francisco, CA
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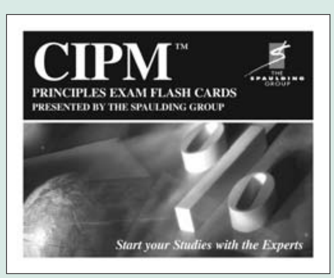

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