

PERFORMANCE PERSPECTIVES

with David Spaulding



VOLUME 11 – ISSUE 11

JULY 2014

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

WHY RATES OF RETURN AREN'T BEING GIVEN TO PROSPECTIVE INVESTORS

For quite some time we've known that many firms do not provide their prospects with return, as a way to demonstrate their past success. I'm not speaking solely of managers who cater to the retail market: on occasion, even those who market to institutions simply do not provide returns. Why not? Before we get to that, let's have a bit of background on this topic.

By the way, I am not speaking of firms claiming compliance with the Global Investment Performance Standards (GIPS®).

This topic was addressed in a recent article by Jason Zweig ("Financial Advisers: Show Us Your Numbers").¹ Jason advocates for such firms to adopt the GIPS standards, which require compliant firms to make every reasonable effort to provide prospects with presentations.

I would think that if investors asked for them, advisors would provide them, but many investors are unaware of the importance they hold. For many, manager selection is a "relationship thing," so to speak. That is, if the manager has been referred by a friend or colleague, and seems to be competent and knows what questions to ask and is able to explain his/her investment approach, that's enough.

While educating investors would be a good thing to do, it's probably easier to educate the advisors. Hopefully, Jason's article helped.

IN MEMORIAM

Sandra Hahn-Colbert

1963 – 2014

While I posted in my blog² about Sandra's death, I wanted to do so here, too, for those who don't read my blog or perhaps who didn't notice.

In reality, by now I'm sure that anyone who knew Sandra knows of her untimely passing. I still can visualize her and think that this doesn't seem possible. The last time I saw her was at our annual PMAR conference in Philadelphia. She had spoken at several of our conferences: we considered her to be a great choice, given her background, expertise, insightfulness, and willingness to openly share her thoughts and opinions.

ADVERTISE
YOUR
BUSINESS



<http://www.SpauldingGrp.com>

1 It appears in Jason's blog (<http://blogs.wsj.com/moneybeat/2014/07/11/financial-advisers-show-us-your-numbers/http://blogs.wsj.com/moneybeat/2014/07/11/financial-advisers-show-us-your-numbers/>) and was in the July 13-14, 2014 issue of *The Wall Street Journal*.

2 <http://spauldinggrp.com/sandra-hahn-colbert/>

The Journal of Performance Measurement®

UPCOMING ARTICLES

Mind the GAP: Questioning the Investment Manager's Stated Benchmark

– *Panagiota Balfousia, CFA*

The Journal Interview

– *Jenny Lor, CIPM, CFE, FRM*

Residual Interaction Compounding: A New Term in Multi-Period Arithmetic Attribution

– *Joseph D'Alessandro*

Puzzles in Risk and Performance: Part 2

– *Marcus Hedbring*

Contribution of Initial Holdings and Transactions to Performance

– *Laurent Cantaluppi*

Exact Multi-Period Performance Attribution Model

– *Carsten V. Berg*

She did the same sort of communicating at our Performance Measurement Forum, a group she was a member of for many years. The Forum is how many of us got to know Sandra well.

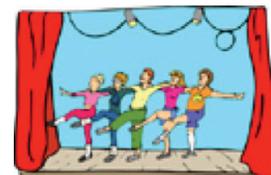
She was one of my favorite verification clients. We had something to do with her “landing” the job at OSAM, and I enjoyed my annual visits to her office. We invariably had lunch together at least once during each trip, which allowed us to talk about all kinds of things.

Sandra was the person who introduced me to Audible.com: the website that sells audio books, which can be easily downloaded to an iPod.

Our industry has lost a wonderful member. Her friends and colleagues have lost a dear, kind, highly likeable friend. And her children have lost a caring and dedicated mother.

DOES ORDER DEPENDENCE MATTER?

Several folks have introduced methods to link arithmetic attribution effects across time, including Jose Menchero and David Cariño. When Andrew Frongello³ introduced his, it was “order dependent.” If, for example, you were linking January, February, and March results, you couldn’t change the order to March, January, February: you’d get different answers. This isn’t true with Jose’s and David’s methods. A discussion ensued, and shortly thereafter, Andrew conceded that “order dependence” was a good characteristic for such models.



Is it a necessary characteristic? Geometric linking abides by the commutative law (e.g., $A \times B = B \times A$), and is therefore not order dependent. But some linking models are.

This came to the surface when I was reviewing a client’s operation, and found that the linking method they employed for contribution was not order dependent. It turned out that this method was the same that is in Bruce Feibel’s book: a method he mentioned is frequently employed. He apparently doesn’t know the originator of this method, but I’ll briefly describe it here.

The process is as follows: compound the contribution effects for each period by the subsequent period’s compounded rate of return. When we get to the last period, since there are no subsequent periods, no change is made. These two formulas are employed:

$$\text{AdjustedContribution}_{(\text{ForMonths}I\text{To}N-1)} = \text{CurrentMonthContribution} \times (\text{CumulativeReturnForRemainingPeriods} + 1)$$

$$\text{AdjustedContribution}_{(\text{ForMonth}N)} = \text{CurrentMonthContribution}$$

Consider the data in Table 1. We have three months and wish to link our contribution effects. If we simply add them, our result is 5.79%, 10 bps off from our linked geometric return (5.89%).

³ Notice the pattern? Menchero, Cariño, Frongello. Makes you wonder if having the “O” at the end of your name is a requirement!

Table 2 shows the results of the linking. I've introduced a term to this process: Post Current Month Cumulative Return (PCMCR). Although its meaning is probably obvious, I will explain it, nonetheless. For January, the factor we use is the portfolio's cumulative return for February and March $((1+2.14\% \times 1+1.06\%)-1 = 3.22\%)$. We take this return, add one, and multiply it by January's contribution effects, to arrive at its adjusted contribution effects.

February's PCMCR is pretty simple, since there's only one month remaining: it's the return for March (1.06%). Again, add one to this value and multiply it by February's contribution effects to arrive at its adjusted contribution.

Finally, March's adjusted effects are identical to its contribution effects, since there are no trailing months. When we total our adjusted contribution effects to arrive at the first quarter's effects, our result matches our three-month cumulative return: 5.89 percent.

	January			February			March		
	Beginning Weights	Returns	Contrib Effects	Beginning Weights	Returns	Contrib Effects	Beginning Weights	Returns	Contrib Effects
Cons Disc	9.98%	6.98%	0.70%	9.98%	4.49%	0.45%	9.99%	5.48%	0.55%
Cons Staples	9.97%	1.53%	0.15%	9.98%	0.58%	0.06%	9.98%	1.46%	0.15%
Energy	9.98%	3.12%	0.31%	9.98%	2.02%	0.20%	9.98%	5.78%	0.58%
Financials	9.96%	3.98%	0.40%	9.96%	4.48%	0.45%	9.95%	-0.05%	0.00%
Health Care	9.98%	4.46%	0.45%	9.97%	3.60%	0.36%	9.98%	-3.67%	-0.37%
Industrials	9.97%	1.11%	0.11%	9.95%	0.46%	0.05%	9.95%	-0.25%	-0.02%
Info Tech	9.97%	1.78%	0.18%	9.97%	-0.60%	-0.06%	9.97%	-0.61%	-0.06%
Materials	9.99%	3.49%	0.35%	9.97%	1.18%	0.12%	9.97%	-0.20%	-0.02%
Telecom Svcs	9.99%	1.44%	0.14%	9.99%	1.80%	0.18%	9.99%	-0.50%	-0.05%
Utilities	9.97%	-1.94%	-0.19%	9.99%	3.40%	0.34%	9.98%	3.21%	0.32%
Cash	0.24%	0.00%	0.00%	0.26%	0.00%	0.00%	0.25%	0.00%	0.00%
TOTALS	100%	2.59%	2.59%	100%	2.14%	2.14%	100%	1.06%	1.06%

Table 1

	January			February			March		1Q
	Contrib Effects	PCMCR	Adj'd Contrib	Contrib Effects	PCMCR	Adj'd Contrib	Contrib Effects	Adj'd Contrib	Contrib Effects
Cons Disc	0.70%	3.22%	0.72%	0.45%	1.06%	0.45%	0.55%	0.55%	1.72%
Cons Staples	0.15%	3.22%	0.16%	0.06%	1.06%	0.06%	0.15%	0.15%	0.36%
Energy	0.31%	3.22%	0.32%	0.20%	1.06%	0.20%	0.58%	0.58%	1.10%
Financials	0.40%	3.22%	0.41%	0.45%	1.06%	0.45%	0.00%	0.00%	0.86%
Health Care	0.45%	3.22%	0.46%	0.36%	1.06%	0.36%	-0.37%	-0.37%	0.46%
Industrials	0.11%	3.22%	0.11%	0.05%	1.06%	0.05%	-0.02%	-0.02%	0.14%
Info Tech	0.18%	3.22%	0.18%	-0.06%	1.06%	-0.06%	-0.06%	-0.06%	0.06%
Materials	0.35%	3.22%	0.36%	0.12%	1.06%	0.12%	-0.02%	-0.02%	0.46%
Telecom Svcs	0.14%	3.22%	0.15%	0.18%	1.06%	0.18%	-0.05%	-0.05%	0.28%
Utilities	-0.19%	3.22%	-0.20%	0.34%	1.06%	0.34%	0.32%	0.32%	0.46%
Cash	0.00%	3.22%	0.00%	0.00%	1.06%	0.00%	0.00%	0.00%	0.00%
TOTALS	2.59%			2.14%			1.06%		5.89%

Note: PCMCR = Post Current Month Cumulative Return

Table 2

To demonstrate the problem with order dependence, I will use the example from Bruce's book: refer to Table 3.

The Journal of Performance Measurement[®] has begun a series on performance measurement professionals, and we need your help to identify the folks we should include. We focus on one or two people in each issue, with the list driven by input from other PMPs.

And so, please contact our editor, [Doug Spaulding](#) (732-873-5700) with your suggestions.

Day 1				Day 2				Day 1-2
Security	Weight	Return	Contribution	Security	Weight	Return	Contribution	Return
A	50.00%	20.00%	10.00%	A	0.00%	0.00%	0.00%	20.00%
B	20.00%	10.00%	2.00%	B	50.00%	10.00%	5.00%	21.00%
C	20.00%	10.00%	2.00%	C	25.00%	10.00%	2.50%	21.00%
D	10.00%	10.00%	1.00%	D	25.00%	10.00%	2.50%	21.00%
Total	100.00%	15.00%	15.00%	Total	100.00%	10.00%	10.00%	26.50%
								Day 1-2
Day 1 Contribution to Day 1-2 Return				Day 2 Contribution to Day 1-2 Return				Contribution
A	11.00%			A	0.00%			11.00%
B	2.20%			B	5.00%			7.20%
C	2.20%			C	2.50%			4.70%
D	1.10%			D	2.50%			3.60%
	16.50%				10.00%			26.50%

Table 3

It involves just two periods' of data. I switched the order of the days, and the results are in Table 4.

Day 1				Day 2				Day 1-2
Security	Weight	Return	Contribution	Security	Weight	Return	Contribution	Return
A	0.00%	0.00%	0.00%	A	50.00%	20.00%	10.00%	20.00%
B	50.00%	10.00%	5.00%	B	20.00%	10.00%	2.00%	21.00%
C	25.00%	10.00%	2.50%	C	20.00%	10.00%	2.00%	21.00%
D	25.00%	10.00%	2.50%	D	10.00%	10.00%	1.00%	21.00%
Total	100.00%	10.00%	10.00%	Total	100.00%	15.00%	15.00%	26.50%
								Day 1-2
Day 1 Contribution to Day 1-2 Return				Day 2 Contribution to Day 1-2 Return				Contribution
A	0.00%			A	10.00%			10.00%
B	5.75%			B	2.00%			7.75%
C	2.88%			C	2.00%			4.88%
D	2.88%			D	1.00%			3.88%
	11.50%				15.00%			26.50%

Table 4

You can see that we get different contribution results for our three securities (refer to Table 5).

The question that we need to answer: does it matter?

At this point, I'm honestly unsure, and need to reflect a bit on it.⁴

	Contribution Effects	
	Order #1	Order #2
A	11.00%	10.00%
B	7.20%	7.75%
C	4.70%	4.88%
D	3.60%	3.88%
Total	26.50%	26.50%

Table 5

⁴ Because of the dearth of articles on the subject of contribution, I've written one for *The Journal of Performance Measurement*[®], which I'm hoping will appear in our forthcoming Winter issue (provided our advisory board finds it acceptable).

PUZZLE TIME

June Puzzle

Last month's puzzle came from the book *How Not to Be Wrong* by Jordan Ellenberg.

Anthony Howland	UK
Andrew Peakman	UK
Hans Braker	Netherlands
Russ Glisker	USA

During World War II, the Statistical Research Group (SRG), a classified program in the United States, was asked to help in an effort to safeguard American planes. The military provided the SRG with data they felt would be useful. It turned out that when planes returned from engagements over Europe, they were covered in bullet holes, but the damage wasn't uniform in its distribution across the planes: there were more holes in the fuselage and not much in the engines:

Plane section	Holes / square foot
Engine	1.11
Fuselage	1.73
Fuel system	1.55
Rest of the plane	1.80

If they added more armor throughout the plane, the weight would be problematic. And so, the thought was to redistribute the armor, concentrating on places with the greatest need.

Question: you're a member of the SRG and have to make a decision. Where would you place the armor? Of the four places in the table, where would you reduce and where would you increase the armor?

I will quote from Anthony Howland's response:

This month's puzzle is more of a lateral thinking one as there is no detailed information. I guess the key here is the amount of damage done by a bullet to a specific area. A bullet in the engine is likely to disable the plane completely, one in the fuel tank would also be critical whereas the fuselage is "cosmetic". Now I am rereading the puzzle and notice it is about planes "returning" ... and if a plane was disabled (hit in the engine) it would likely not return! So I would put the armour (correct spelling!) on the engine and not worry about the fuselage.

Despite his habit of occasionally adding the superfluous "u" to words (e.g., armour, flavour, neighbour),⁵ his answer is "spot on."

May Puzzle

I apologize for leaving Anthony Howland's name off the list of those who got it correct. Since he's a regular (and always correct) participant, I have to credit the error to my advanced age.

⁵ I also didn't correct his placement of the ending quotes following "cosmetic" (the US version would have the period *within* the quote.

KEEP THOSE CARDS & LETTERS COMING

We appreciate the emails we receive regarding our newsletter. Mostly, 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.

July Puzzle

For this month, something a bit different: a word puzzle.

*The beginning of eternity
The end of time and space
The beginning of every end,
And the end of every place.*

What is it?

Have fun!



BEHIND THE SCENES AT TSG

Chris Spaulding

What do you do? I head up strategy and business development for The Spaulding Group. This includes leading all marketing and sales activities, client relations, and playing a major role in the overall direction of the company.

How long you've been with the firm? Since November 2002.

What you like about working for us: I love the entrepreneurial nature of The Spaulding Group. We are not a massive corporation, and this allows us to try new things, make decisions quickly, and provide tremendous value to our clients.



Personal info

Family: Married – 3 children – Brady 5 years old – Caden 2.5 – Sonia 8 months.

Education: I attended the University of Delaware, but am a huge believer in self-education. I've truly gotten my education on the job, and I spend a tremendous amount of time studying marketing, selling, persuasion, copywriting, and other similar topics related to business growth. I've received a Certificate in Expert Selling from The University of San Francisco and currently teach classes for the Rutgers Center for Management Development's Mini-MBA™ Program in Entrepreneurship.

Hobbies / past times: Spending time with my family, reading.

Miscellaneous: I am also involved in a number of other businesses that keep me challenged, sharp and engaged.



TRAINING...

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

TO REGISTER:

Phone: 1-732-873-5700

Fax: 1-732-873-3997

E-mail: info@SpauldingGrp.com



The Spaulding Group, Inc. is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. www.nasba.org

FUNDAMENTALS OF 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 Fundamentals of Performance Measurement on these dates:

September 23-24, 2014 – Los Angeles, CA

November 11-12, 2014 – Dallas, TX

October 14-15, 2014 – Chicago, IL

December 9-10, 2014 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

CFA Institute has approved this program, offered by The Spaulding Group, for 12 CE credit hours. If you are a CFA Institute member, CE credit for your participation in this program will be automatically recorded in your CE tracking tool.



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:

September 25-26, 2014 – Los Angeles, CA

November 13-14, 2014 – Dallas, TX

October 16-17, 2014 – Chicago, IL

December 11-12, 2014 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

CFA Institute has approved this program, offered by The Spaulding Group, for 12 CE credit hours. If you are a CFA Institute member, CE credit for your participation in this program will be automatically recorded in your CE tracking tool.



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, close to 3,000 individuals have participated in our training programs, with numbers increasing monthly.

CIPM PREP TRAINING: August 18-19, 2014 – Principles Level–Chicago, IL
August 20-22, 2014 – Expert Level–Chicago, IL

UPDATED CIPM Principles and Expert Flash cards are now available on our web store. Please visit www.SpgShop.com today to order your set.

Our performance experts have created a study aid which can't be beat: *flash cards!* These handy cards will help you and your associates prepare for the upcoming CIPM Principles Exam. Unlike a computer-based study aid, you can take them anywhere to help you test your knowledge.

Benefits of Flash Cards:

- Work at your own pace
- Immediate feedback
- Strengthen and reinforce core CIPM principles

These cards are a *must have* for anyone preparing to take the CIPM Exams.

