PERFORMANCE PERSPECTIVES

with David Spaulding

VOLUME 7 – ISSUE 5 JANUARY 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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For additional information about The Spaulding Group and our services, please visit our web site or contact Chris Spaulding at

CSpaulding@SpauldingGrp.com

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GIPS 2010 UPDATE

Neil Riddles, a member of the Global Investment Performance Standards (GIPS®) Executive Committee, briefed many of our clients about the status of the standards through a webinar on January 21st. The EC's plan has been to release the final decision on the changes this month. And while this may still happen, a public meeting of the EC is scheduled for January 29th, when its members will vote on the final changes.

We have previously outlined some of what we know or expect to change, and anxiously await the final word. We will be tuned in on the 29th to discover what's going on. And, as soon as we know we'll make you aware of the details in this newsletter as well as my blog (InvestmentPerformanceGuy.Blogspot.com).

I want to take this opportunity to thank the members of the GIPS Executive Committee and the folks at the CFA Institute who have worked countless hours on this revision. It's very easy to be critical about the content and/or pace of this process, but the amount of work here, the various positions that need to be considered, and the care that must be exercised in publishing such a document, are monumental. All content, down to the use of specific words has to be considered. This is a dauntless task and we owe this group a debt of gratitude, for their working to benefit the industry as a whole. We won't all agree on the final product, but that's to be accepted. There are country, region, and industry segment differences which cause individuals to take different positions on the various items. As former NJ Governor Whitman remarked in response to a student who asked "what's the hardest thing about being governor," "knowing that you can't please everyone." The same naturally applies here, too.

RISK MONITORING / MANAGEMENT

We often speak about the "three Ms of risk": management, monitoring, and measurement. Clearly, measurement gets the most attention, as we debate what risk is and how it should be calculated. But risk management and monitoring are extremely important and are too often overlooked.

John C. Hull is very well regarded in the world of derivatives. His book, *Options, Futures, and Other Derivatives*, goes through frequent revisions and is much sought after by those engaged in this segment of the market. In his seventh edition, his final chapter addresses mishaps that have occurred in the world of derivative trading and offers some guidelines for risk management. The good news is that these guidelines don't just apply to derivatives, and therefore should be heeded by all. I'll briefly summarize them here, and encourage you to obtain a copy of Hull's book, not only to read more about these items but also to learn more about derivatives.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Decomposing the Money – Weighted Rate of Return – an Update
– Stefan J. Illmer

Models of Risk and Financial Crises
– Paul D. Kaplan

Multi-Currency Performance Attribution
– Jose Menchero and Ben Davis

Strategic Asset Allocation and Risk Attribution
– Philippe Gregoire and Philippe Vandooren

The (more than) 100 Ways to Measure Portfolio Performance: Part 2: Special Measures and Comparison
– Philippe Cogneau and Georges Hübner

- **Define risk limits:** clear and unambiguous rules need to be defined. Procedures should be established to ensure they're being obeyed. There should be broad limits and then limits at each level, as well (e.g., there might be corporate wide limits, limits by portfolio, and then perhaps limit by manager, when multiple managers are involved with an account). These limits should be monitored regularly: ideally, daily (definitely daily in the world of derivatives).

- **Take the risk limits seriously:** Rules need to be defined as far as what the consequences are of violating these limits. Hull asks what should be done if a manager violates the risk limits and yet generates a positive return. There should be no exceptions, whether profits or losses are realized. To allow a manager to skirt these limits when they generate positive returns will send mixed signals and will encourage further risk taking. Hull cites the Orange County example, where the treasurer generated profits through derivatives trading before taking the county into bankruptcy.

- **Do not assume you can outguess the market:** Outstanding track records aren't usually repeatable, so risks always have to be monitored.

- **Do not underestimate the return of diversification:** When someone does particularly well in a particular segment, one might be tempted to increase the investments there, thus shifting the balance of the portfolio. This can be risky (pardon the pun), as trends shift as well as outperformance. Rebalancing is an important exercise. (I know from personal experience, when my growth fund had a 100%+ return in 1999; I failed to rebalance and 2000 saw it drop by roughly 50 percent).

- **Carry out scenario analysis and stress tests:** it's interesting that few firms seem to engage in these exercises. While their benefit is, perhaps, open to some debate, there is still no doubt some value to occasionally *stress test* one's investments, to at least get an idea as to what the potential losses might be.

- **Monitor traders carefully:** while this doesn't apply a great deal to "buy side" firms, it is still something worth considering, yes? Too many firms have been taken down by traders who engaged in actions that weren't officially sanctioned, nor properly monitored.

- **Separate the front, middle, and back office:** the front office is the traders and portfolio managers; the middle is the risk managers who monitor the risks; and the back office is where the record keeping is done. Keeping these functions separate provides a better way to properly monitor what's going on.

- **Do not blindly trust models:** I love Warren Buffet's line: "beware of geeks bearing models." Here, the author is speaking of models that value assets, which is one of the problems AIG had.

- **Be conservative in recognizing inception profits:** this may be more appropriate for derivatives, where models are used to value many assets. "Recognizing inception profits immediately is very dangerous. It encourages traders to use aggressive models, take their bonuses, and leave before the model and the value of the deal come under close scrutiny. It is much better to recognize inception profits slowly, so that traders have the motivation to investigate the impact of several different models and several different sets of assumptions before committing themselves to a deal."

- **Do not sell clients inappropriate products:** 'nough said, yes?

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- **Do not ignore liquidity risk:** "it is dangerous to assume that less actively traded instruments can always be traded at close to their theoretical price." Some of our readers, no doubt, feel that liquidity risk deserves greater attention, especially during the recent market challenges.
- **Beware when everyone is following the same trading strategy:** "portfolio insurance" of the mid '80s is probably an example of this.
- **Market transparency is important:** the author cites the credit crunch of '07 in addressing this topic. "With hindsight, we can say that investors should have demanded more information about the underlying assets and should have more carefully assessed the risks they were taking."
- **Make sure you fully understand the trades you are doing:** you may have heard that a few portfolio managers confessed that they didn't fully understand some of the instruments they invested in: pretty sad.

Perhaps all of these ideas don't apply to your firm; and, perhaps there are other items that you would add to the list. The essential ideas, I believe are:

1. <u>Establish a risk management/monitoring facility</u>. This can be a single person, a group, or a department. It would seem fitting, I believe, that this would be within the performance measurement group and/or compliance.
2. <u>This group should be independent</u> of the money management process (e.g., as suggested by Hull, in the "middle," not "front" office).
3. <u>Rules should be established</u>. As noted previously, the Goldman Sachs "Green Zone" idea, of using tracking error, is perhaps a reasonable approach to employ.
4. <u>Monitor the risk measures on a regular basis</u>. When rules are violated, take immediate action, regardless of whether the resulting returns are positive or negative.

Reporting various risk statistics to clients isn't risk management. Nor is simply reporting these statistics internally to the portfolio managers. Management and monitoring is an active process, that requires policies and procedures to ensure that the rules are adhered to.

OOPS!

We had an error in the last newsletter, as pointed out by one of our readers:

Just reading your newsletter and pleased to learn that I was born in the 19th century.

1901 to 2000 was the 20th century not the 19th - how soon we forget. We didn't jump straight from the 19th to the 21st century, we would have missed out on a lot.

Yes, a goof! Sorry. *Mea culpa.*

Upcoming classes:

CIPM™ Principles Exam Preparation Class

- March 15-16, 2010
  New Brunswick, NJ
- September 13-14, 2010
  Los Angeles, CA

CIPM™ Expert Exam Preparation Class

- March 17-19, 2010
  New Brunswick, NJ
- September 15-17, 2010
  Los Angeles, CA

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ERROR CORRECTION…ONE MORE TIME?[1]

When I started my business 20 years ago, I sought to take advantage of as many sources as possible to learn how to run and grow a business. One of these resources was a consultant-to-consultants (forget his name...sorry) who was big on leverage: for example, if you write an article, turn it into a presentation; you do a presentation, turn it into an article; you write enough articles, turn them into a book. I leverage a great deal today, including work that I do for clients or questions I answer, which end up being reflected here and/or in my blog.

As I am putting the finishing touches on this month's newsletter I am conducting a GIPS verification for a client and offered them comments on error correction which I am duplicating here, as I believe they are relevant to all:[2]

As-of January 2010 you are required to have an Error Correction Policy. Arguably, what you have today is fine, but going forward it should be in line with this policy. The policy has four levels of errors:

- *<u>Take No Action:</u> appropriate when an error is deemed immaterial and does not require a change to any data or disclosures in the presentation*
- *<u>Correct the presentation with no disclosure of the change:</u> error correction changes items in presentation, but changes are not material according to the firm's policy and do not require disclosure or distribution of corrected presentation. This applies, in your case, when the corrected return is above what was previously reported or is below by less than five basis points and doesn't result in a switch from out- to underperformance.*
- *<u>Correct the compliant presentation with disclosure of the change and no distribution of corrected presentation:</u> the error correction results in changes to items in the presentation, and requires disclosure based on firm's policy but does not require distribution to parties that received erroneous presentation. You arguably don't have any situations that fall here, which is fine; see below.*
- *<u>Correct the presentation with disclosure of the change and make every reasonable effort to provide a corrected presentation to all prospective clients and others that received the erroneous presentation:</u> the error is deemed "material," thus it requires correction and disclosure, plus redistribution to parties. This falls within your current policy for occasions when the correction results in a return that is greater than a five basis point drop from what had been reported and/or causes the return to move from out- to underperformance. Will discuss the other aspect (disclosure) next.*

The GIPS 2010 disclosure draft proposed a new requirement to disclose when "material errors occur," which would necessitate the disclosure of the correction in presentations for at least 12 months. This suggestion was met with an overwhelming "push back" from the investment community, resulting from it being pulled from the final standards document. However, (a) the proposed requirement didn't speak to the third level of error, non-material but warranting a disclosure and (b) didn't result in a rewording of the guidance statement, which went into effect this month. Consequently, firms are obligated to follow the guidance. Technically, that is.

1 Funny how my admission of a mistake leads into this section...wasn't intended.

2 Note that I included, as an example, some of the client's conditions, which may prove helpful for guidance and help put this into perspective, as well.

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.

The GIPS Executive Committee issued a "Q&A" as an attempt to clarify what is intended, though arguably it hasn't gone far enough. Basically, the Q&A only addresses the fourth level and says that you would only have to disclose the change if you weren't sure that you had notified everyone that you gave a previously erroneous copy to a corrected copy (assuming that they are (a) still considering you (and therefore still a "prospect") or (b) they became a client and therefore should be aware of the correction as it may have influenced their decision.

And so, what does this mean? First, you are not required to have all four levels: you pick the ones that apply to you. Second, there is no requirement to disclose errors (even for non-material errors) provided you maintain records of who you give presentations to, so that you can alert them if errors are discovered that require correction (in your case, the "material" type).

I am very pleased that the GIPS EC decided not to include the requirement in the corpus of the standards. I had hoped that they would issue a revised guidance statement, but was basically told "get real," as their plate is VERY full right now, as they wrap up the 2010 edition. Perhaps this will be addressed in the coming months. I believe, though, that I captured their intent above, and would suggest that firms move forward in this manner. If you have questions, please pass them along.

THE SPAULDING GROUP'S 2010 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
February 16-17, 2010	Fundamentals of Performance Measurement Training	Los Angeles, CA (USA)
February 18-19, 2010	Performance Measurement Attribution Training	Los Angeles, CA (USA)
March 15-16, 2010	CIPM™ Principles Exam Preparation Class	New Brunswick, NJ (USA)
March 17-19, 2010	CIPM™ Expert Exam Preparation Class	New Brunswick, NJ (USA)
March 22-23, 2010	Fundamentals of Performance Measurement Training	Boston, MA (USA)
March 24-25, 2010	Performance Measurement Attribution Training	Boston, MA (USA)
April 20-21, 2010	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
April 22-23, 2010	Performance Measurement Attribution Training	Chicago, IL (USA)
May 17-18, 2010	Fundamentals of Performance Measurement Training	New York, NY (USA)
July 12-16, 2009	Performance Measurement Boot Camp	New Brunswick, NJ (USA)
September 13-14, 2010	CIPM™ Principles Exam Preparation Class	Los Angeles, CA (USA)
September 15-17, 2010	CIPM™ Expert Exam Preparation Class	Los Angeles, CA (USA)
September 27-28, 2010	Fundamentals of Performance Measurement Training	Boston, MA (USA)
September 29-30, 2010	Performance Measurement Attribution Training	Boston, MA (USA)
October 19-20, 2010	Fundamentals of Performance Measurement Training	San Francisco, CA (USA)
October 21-22, 2010	Performance Measurement Attribution Training	San Francisco, CA (USA)
November 16-17, 2010	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
November 18-19, 2010	Performance Measurement Attribution Training	Chicago, IL (USA)
December 7-8, 2010	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
December 9-10, 2010	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2010 events, please contact Christopher Spaulding at 732-873-5700

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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 Introduction to Performance Measurement on these dates:

February 16-17, 2010 – Los Angeles, CA
March 22-23, 2010 – Boston, MA
April 20-21, 2010 – Chicago, IL
May 17-18, 2010 – New York, NY
September 27-28, 2010 – Boston, MA
October 19-20, 2010 – San Francisco, CA
November 16-17, 2010 – Chicago, IL
December 7-8, 2010 – New Brunswick, NJ

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February 18-19, 2010 – Los Angeles, CA
March 24-25, 2010 – Boston, MA
April 22-23, 2010 – Chicago, IL
September 29-30, 2010 – Boston, MA
October 21-22, 2010 – San Francisco, CA
November 18-19, 2010 – Chicago, IL
December 9-10, 2010 – 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 2,000 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.

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