PERFORMANCE PERSPECTIVES

with David Spaulding

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BEHOLD, I HAVE PREPARED MY CASE. I KNOW THAT I AM IN THE RIGHT.

The title above comes from the book of Job (chapter 13, verse 18). As I did last year, I began the year with a goal of reading 5-7 pages a day from the Bible, with the expectation of having it completed by year end. I am now reading my favorite book, Job, and came across this verse earlier this week, and immediately realized it had applicability to performance measurement...at least to the money- vs. time-weighting debate.

I know that you may be saying "no, not again!!!," but a topic which I believe continues to be an important one. We have definitely seen movement to adopting money-weighting by many firms, especially in the brokerage community, but opportunities exist for further employment of this approach.

When I teach our Fundamentals of Performance Measurement course and contrast the two approaches, most of the students "get it" right away that money-weighting deserves a prime role in performance reporting.

As I explained at PMAR Europe earlier this month, the argument for money-weighting can be seen from three perspectives:

1. **Documentation:** there are many, many articles and books which through the years have shown how money-weighting is quite appropriate. Peter Dietz, the "father," if you will, of time-weighting, never abandoned money-weighting: he saw how it had applicability:

"The basic approach used to measure the actual return on assets is variously called the compound rate of return, internal rate, discounted rate, or dollar weighted rate of return. This approach measures investment return by finding the level annual rate of return which, if earned on all net contributions from the time they were received by the fund for investment, would reproduce the value of the fund at a given date. In practice this technique is often used to measure results over a long period of time- five or ten years. This type of technique has appeal since the resulting rate of return is useful to determine whether actuarial assumptions are being met, and what the actual return is on invested funds." <emphasis added>

Time-weighting was to be used to judge the manager.

The Bank Administration Institute, too, in their 1968 standards, saw room for money-weighting,

"Both the time-weighted rate of return and the internal rate of return should be computed. The time-weighted rate of return measures the results of investment decisions made by a fund manager. It is not affected by decisions about the timing and amounts of cash flows – decisions which the fund manager typically does not make. The internal rate of return measures a fund's total investment performance, regardless of the source of decision-making, and is helpful in determining the adequacy of the fund to meet its obligations." <emphasis added>

The Journal of Performance Measurement®:

UPCOMING ARTICLES

as did the ICAA, in their 1971 standards:

"Rates of return are of two general types: dollar weighted (or internal) and time weighted. The dollar weighted rate of return has specific value in measuring a given portfolio's results and this is the most appropriate figure for comparison with actuarial assumptions for corporate pension funds....It can be argued that a dollar weighted rate of return is appropriate for use when measuring only the common stock portion of a portfolio because the investment manager has control over the timing and amounts of cash flows into and out of equities within the portfolio." <emphasis added>

Both the AIMR-PPS® and GIPS® (Global Investment Performance Standards) point out how the justification for time-weighting is simply based on the control of cash flows, thus requiring money-weighting for venture capital/private equity because the manager controls the flows for these markets.

Clifford Hymans and John Mulligan in their book *The Measurement of Portfolio Performance* (1980) wrote:

"...we have consistently emphasized the necessity to be absolutely clear in one's own mind as to exactly what question one wants answered. This statement seems to be so obvious that it seems hardly necessary to make it. Unfortunately, trustees too often confuse the question they should be asking with the answers they are getting... We have already demonstrated the fallacy of attempting to compare the performance of various investment managers by using the true rate of return (IRR). It is equally futile to attempt to measure the true rate of return of a fund using a time weighted formula." <emphasis added>

William G. Bain in his 1996 book, Investment Performance Measurement wrote:

"Whilst the MWR is the true return of the asset, it includes the impact of the timing of cash flows and therefore cannot be used to compare the relative performance of two managers. As the cash flows at the total fund level are normally outside the control of the manager of the assets, and will vary from one fund to another, it is important to have a more consistent measure when trying to compare the performance across funds...different methodologies were adopted by performance measurers while all adhered to the basic necessity to calculate a TWR as well as a MWR."

J.B. Marshall in his April 1980 article, "Pension Fund Performance – A New Approach" for *The Investment Analyst* offered:

"Trustees seek a measure of performance in both its definitions, as a rate of return and by comparison with some standard…The MWR correctly defines the return actually enjoyed…The TWR…usually produces a return which has not actually been enjoyed by the fund. It is quite possible…to suggest to Trustees that they have made a positive return when they have in fact lost money." <emphasis added>

1 I frequently make this point: what question do you want answered? For example, if you want to know "how the manager did in managing the portfolio?," use time-weighting. If you want to know "how did we (the portfolio owner) do?," money-weighting!

2 Several authors refer to the money-weighted return as the "true" rate of return. Of course they're right!

And finally, Dugald Eadie in his article, "A Practical Approach to the Measurement and Analysis of Investment performance" for *The Investment Analyst* wrote:

"it is necessary to use the established DCF (discounted cash flow) [IRR] methods...and this should be done if the return is to be compared with the actuarial assumption or with alternative investment opportunities...The conclusion to be drawn is that the time-weighted rate of return should only be used to compare funds where the new money flows are genuinely beyond the control of the managers." *<emphasis added>*

I could continue to provide other references that champion money-weighting, but will stop here.

2. **Calculations:** all one needs to do is look at a few examples of positive returns when clients lose money and other nonsensical scenarios to show how money-weighting is a justified return to include along with time-weighting. And examples abound as to how money-weighting is superior and justified at the subportfolio level. I have provided several in this newsletter as well as elsewhere.

3. **Logic:** If Peter Dietz, the BAI, ICAA, AIMR, GIPS all clearly state that we use time-weighting because the manager doesn't control the cash flows, to jump and say, "well, you can't use the counter argument that if the manager controls the flows to justify MWRR" is a failure in logic. It's being incongruent. Like it or not, the justification for time-weighting is based on the desire to eliminate the impact of cash flows that aren't controlled by the manager. And the inverse holds: when the manager does control the cash flows, time-weighting is inappropriate. And, if we want to reflect how the client's decisions impacted the return, use money-weighting. To argue to the contrary simply obviates the first premise, and therefore says that there is no link whatsoever to cash flow controls as the basis for time-weighting, meaning that Peter Dietz, the BAI, ICAA, AIMR, GIPS, and others are wrong!

What more is needed to convince the industry?

LIQUIDITY RISK

Risk, to me, remains one of the most challenging areas of our business. Heck, we can't even agree on what risk is, let alone how to calculate it! But "liquidity risk" has gained attention of late, especially following the subprime mortgage and housing crises and their impact on various investments. Liquidity clearly dried up, impacting many portfolios. But how does one measure liquidity risk? Fortunately, some have given this topic some thought, including Bernd Fischer of Investment Data Services (IDS). Bernd delivered a presentation at our recent Performance Measurement Forum meeting in London, which was extremely insightful.

In his presentation he cited David Cintioli of StatPro who defined market liquidity risk as "the risk of losing a certain amount of money when liquidating one or more positions in a portfolio." Furthermore, Cintioli identified the liquidity risk paradox: "information on bid/asks, book and volumes is only available for liquid instruments…the information is not available for the most opaque and illiquid instruments. In other words, the financial information required to calibrate the 'traditional' models of measurement of liquidity risk is not available for the instruments where a measure of this risk is mostly needed."

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.

A further challenge is that something that's highly liquid today (as, for example, collateralized instruments that comprised subprime mortgages five years ago) may not be when a crisis occurs. This, to me, has been the biggest challenge in attempting to measure this risk.

The approach that Bernd and his firm take is to look at securities from various perspectives, including type (bonds vs. real estate vs. equities), ratings, and daily trading volume. User defined rankings are established for each criteria which result in an indication as to the level of liquidity the asset / portfolio has. If, for example, daily trading volume begins to shrink, this could impact a portfolio's position. In addition, by knowing how long it would take to unwind a position, given its size and the daily trading volume, one can gauge the risk they have in holding or increasing it. This "time to liquidity" is an important aspect of their model. Their rankings (green: liquid; yellow: fairly liquid; red: not liquid; grey: not classifiable) provide management and their clients great insights as to the portfolio's liquidity status.

Tools like IDS's, which provide flexible ways to sensitize the model's rules to the firm's views, can be great aids in assessing liquidity. Such a tool should be monitored on a regular basis (ideally daily) in order to identify changes that may require attention.

I am sure there are others who have come up with similar models and I look forward to learning of them, too. This is an important area and it's great to see that much progress has already been made.

Special New Brunswick Training
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Fundamentals of Performance Measurement Training

August 10-11, 2010

Performance Measurement Attribution Training

August 12-13, 2010

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

DATE	EVENT	LOCATION
August 10-11, 2010	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
August 12-13, 2010	Performance Measurement Attribution Training	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 20-21, 2010	CIPM™ Principles Exam Preparation Class	New Brunswick, NJ (USA)
September 22-24, 2010	CIPM™ Expert Exam Preparation Class	New Brunswick, NJ (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)
October 23-24, 2010	CIPM™ Principles Exam Preparation Class	London, England (UK)
October 25-27, 2010	CIPM™ Expert Exam Preparation Class	London, England (UK)
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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August 10-11, 2010 – New Brunswick, NJ
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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Two full days devoted to this increasingly important topic. The Spaulding Group, Inc. invites you to attend Performance Measurement Attribution on these dates:

August 12-13, 2010 – New Brunswick, NJ
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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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.

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).

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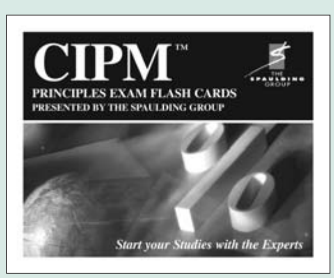

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