PERFORMANCE PERSPECTIVES

with David Spaulding

VOLUME 10 – ISSUE 7 MARCH 2013

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

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SIGNIFICANT CASH FLOWS

Firms that claim compliance with GIPS® (Global Investment Performance Standards) may take advantage of the option to temporarily remove portfolios that experience "significant" cash flows. Let's briefly contrast this term with "large," as they are often confused:

- **Significant Cash Flows:** the option to remove portfolios temporarily from a composite as a result of external flows which might cause the portfolio to temporarily not be representative of the strategy (because of either it taking time to invest the cash that was added, or the need to sell securities to produce the cash required by the client, and the potential for that cash to remain in the portfolio for days or weeks, awaiting its removal).

- **Large Cash Flows:** the requirement to revalue portfolios for large flows, in order to improve the accuracy of returns. When calculating returns using a monthly method (Modified Dietz or Modified BAI), we have, by definition, an *approximation* to the true, exact rate of return (which is obtained by calculating daily returns or revaluing whenever cash flows occur). The accuracy of these monthly methods is diminished when large flows occur; thus, this requirement.

And so, "significant" refers to flows that might cause an account to not be representative, while "large" deals with the desire to improve the accuracy of returns.

Again, the use of significant cash flows is an option, and can be done at the composite level. We generally discourage clients from using it when there are only a few accounts in the composite, because of the risk that they all experience significant flows, which would mean they'd all have to leave, creating a gap or break in performance; no one likes gaps in their performance.

The idea for this came from the AIMR-PPS®, which was, of course, a forerunner of GIPS and arguably led to the GIPS standards. The idea was one that a few of us championed, and which was initially met with resistance. The use of a "temporary new account" was preferred.

With temporary new accounts, when a significant inflow occurs, you would put the funds aside (i.e., in its own "account"), invest the money, and then move the investments over to the actual account. And for outflows, you'd move the cash you create from the sales into this account, and possibly the securities you intend to sell. While the idea is a great one, implementing it can be quite difficult. These aren't *real* accounts, and they might create challenges when you're trying to reconcile and/or report to your clients.

When I became a member of the AIMR-PPS Implementation Committee, I, along with a few others, encouraged the adoption of this option, and we succeeded. GIPS inherited it.

The Journal of Performance Measurement®

UPCOMING ARTICLES

High Frequency Equity risk Attribution and Forecasting
– Ricky Cooper and Ting Ting Li

Performance Evaluation and Prediction
– Larry Harris

Combining Attribution Effects Over Time
– David Cariño

A Case for Arithmetic Attribution
– Mark David

The Journal Interview
– Phil Page

An idea that seemed to have some merit

John Simpson, CIPM was working with a client who wanted to use the following rule for their significant cash flows: if all of the accounts in a composite experience significant flows, then none will be removed, in order to avoid having a gap.

We discussed this and initially had differing views as to its appropriateness. In my way of thinking, the rule does not cause any "gaming" of the returns (i.e., that would improve the overall performance); it's only to avoid a gap. Is that such a bad thing?

In the course of our research, John discovered a new "Q&A" in the recently revised GIPS Handbook:

3. *Can we temporarily suspend our significant cash flow policy when we only have one portfolio in the composite and then reinstate it once we have two portfolios in the composite?*

No. A significant cash flow policy, once adopted, must be applied consistently. If a firm has a single portfolio in a composite and that portfolio is temporarily removed from the composite due to the firm's significant cash flow policy, then the track record of the composite is broken and the continuous performance history ends. Once the portfolio is added back into the composite and the composite performance is restarted, the performance history must be presented for periods both before and after the break and cannot be linked across the break. A significant cash flow policy can be composite specific and does not need to be applied firm-wide. Firms that choose to adopt a significant cash flow policy for certain composites must define the significant cash flow level on a composite-specific basis. A significant cash flow policy may be amended as long as it is done prospectively and the amendment is documented in the firm's policies and procedures.

As an alternative to a significant cash flow policy, a firm may consider the use of a temporary new account. This allows a firm to create a new portfolio into which a client's contributions are directed. Within this new portfolio, the firm will purchase securities. Once the new funds are invested, the securities are transferred in-kind to the existing portfolio contained within a composite. For a withdrawal, the securities are transferred in-kind to the temporary new account and then sold from the temporary new account. Like the significant cash flow policy, the temporary new account policy may be composite-specific. Firms that choose to use temporary new accounts for certain composites must define policies for using temporary new accounts on a composite-specific basis and must apply those policies consistently.

This Q&A, while not matching our client's policy exactly, is close enough that we can conclude that what they wish to do is not permissible.

But let's study the question as it's posed here. First, I would have told the client to establish a higher threshold than just two accounts, because I'd think it not unlikely that two accounts could have significant flows in the same month, and so a gap would be created. Putting this aside, let's explore further.

The firm wants to "temporarily suspend" their policy. Is this what the responder is troubled by; that it's "temporary"?

There is no prohibition for the firm to simply declare a change in their policy once the number of accounts falls below or rises above a minimum. And so, when, in this case, the composite dropped to only one account, they could have made a change effective that date, suspending their policy. At some future date, if the number rises above, they could then go in and establish the policy once again. There is nothing in the Standards to prohibit this.

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.

What troubles me a bit with this response is the absence of any wording within either the Standards or the Guidance Statement that it is based on (i.e., where's the "chapter and verse" that we can attribute this to?). This is strictly an interpretation, one that different people will have different views on.

Recall that the Standards have tried to avoid being overly prescriptive. Is this a case of doing just that? Would it not be up to the client, perhaps with input from their verifier, to decide if such a policy is permitted?

I think I understand the logic behind the response: if a firm believes that for a particular composite, significant cash flows can result in returns that are not truly representative, the accounts should be removed. And so, if one month they remove the accounts but then the next they don't, there's an inconsistency in the application of their rules. We should strive for consistency. But, if the firm feels that they are willing to accept the distortion in order to avoid a gap, is that so bad?

Had the response explained WHY, I think we would all be a bit better off. By providing additional verbiage, the reader will better understand the rationale, and could apply it to other cases.

What if the word "temporarily" was removed, would that result in a different response? As I've already noted above, there is nothing to stop a firm from discontinuing a policy. Would it therefore have also been beneficial had the answer included this as an option?

The touting of the "temporary new account" suggests that the author(s) is(are) a fan of this option. Again, while it's a great idea, implementing it can be quite difficult. Sadly, I've gotten into heated discussions with some who argue against the SCF option, in favor of the temporary new account. Perhaps not unexpectedly, these individuals typically don't work for asset managers and don't have to be responsible for making it work.

We all know that there are different interpretations of what is written in the U.S. Constitution. If the mix of the court changes, different rulings can be pronounced. The same exists with GIPS: depending on who is doing the writing or interpreting, different answers can result. When this is the case, perhaps it's best to allow the firm to decide.

EFFECTIVE DATES OF Q&As

I am unaware of any formal provision that Q&As have "effective dates." But shouldn't there be?

Let's take the Q&A just discussed; it's dated "March 2013." Shouldn't this be the effective date for it? If not, let's consider the case where this has been the rule that a firm has applied for the past 15 years. Now, all of a sudden, a Q&A is published that provides previously unknown information. Must they then go back and redo their history? I think not.

PERFORMANCE & RISK MEASUREMENT

The Performance and Risk Measurement Hall of Fame recognizes investment industry professionals who have made significant contributions to our industry, through their writings, creativity, speaking, and in other ways. This year marks the first year that inductions will be made. Going forward, new inductees will be added annually.

Nominations were solicited from the industry, and more than 25 names were submitted. Members of *The Journal of Performance Measurement's* Advisory Board were asked to select five individuals from the list. In order to qualify for induction, individuals had to receive votes from a majority of the members. The following individuals were chosen for induction.

GARY P. BRINSON

PETER O. DIETZ

WILLIAM F. SHARPE

A recent Q&A informed us that firms cannot add or remove accounts within a month (e.g., on April 13); that this must occur at month-end. While I had no objection to this rule change,[1] I know there are firms who have been doing this historically. Must they go back and change their history, at a great inconvenience and cost? I would say "no."

To me, the date of the Q&A should be the effective date. The Standards have been around since 1999 (and, for those who claimed compliance with an earlier standard (e.g., the AIMR-PPS), even longer). To now, all of a sudden, read a Q&A that conflicts with something you've been doing should be considered a prospective declaration. Except, perhaps, if the result could be deemed material, though I'm not sure how that would be handled.

To my recollection, there is nothing formal about this; shouldn't there be?

OUR MONTHLY PUZZLE

Here's the answer to January's puzzle AND a puzzle for this month!

Recall that Frank Holmberg, of Nykredit (Copenhagen) provided the puzzle:

1
11
21
1211
111221
312211
13112221

What's the next number?

Well, the answer is (drum roll, please): 1113213211

Why? Let's go through the series of numbers:

1 [our starting point]
11 [it means that the number "1" appears one time in the number above]
21 [it means that the number "1" appears twice in the prior number (i.e., two ones)]
1211 [the number two appears once above, and the number one also appears once (one two; one one)]
111221 [the number one appears once, the number two appears once, then the number one appears twice (one one; one two; two ones)]
312211 [three ones; two twos; one one]
13112221 [one three; one one; two twos; two ones]

And so, we would conclude that the next number would be one one; one three; two ones; three twos; one one): 1113213211.

Anthony Howland once again got it right! He was joined by Eric Ardito (USA) and Phil Butler (UK). The Brits are clearly leading!

1 It is, in my view, a rule change, which should have been put out for public comment.

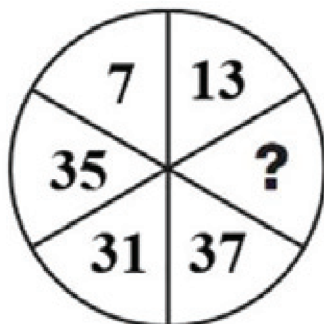
KEEP THOSE CARDS & LETTERS COMING

We appreciate the e-mails 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.

MARCH PUZZLE

I found this month's puzzle on the Internet:

What's the missing number?



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EUROPE
11 - 12 June 2013 – London

THE CIPM DESIGNATION: BEYOND PERFORMANCE AND RISK MEASUREMENT

By Todd Jankowski, CFA

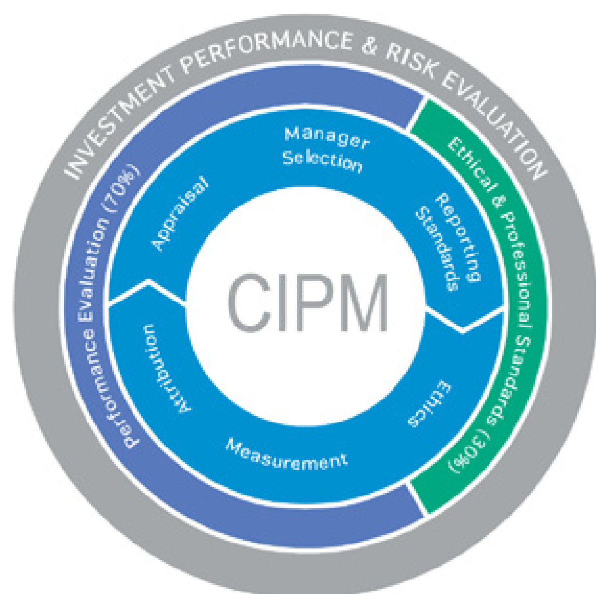
The 2008 financial crisis led to a shift in the need for investment performance and risk professionals to add value in appraising investment decisions and help optimize results for investors. The CIPM Program has always provided candidates with the practical skills needed to rigorously and ethically evaluate investment decision making and communicate performance results, but recently, we have made updates to the curriculum that better align the program with industry demands.

An Enhanced Program

After consulting industry practitioners and experts around the globe, we have developed a CIPM Program that provides an actionable, practice-based approach to performance and risk evaluation and that helps to drive smarter, more informed investment decision making, improve manager search and selection, and produce comprehensive and transparent reports that will ultimately benefit investors. Specifically, the feedback we received revealed the need to increase coverage and increase the emphasis on the practical relevance of content for performance and risk evaluation. The analogy is that the previous CIPM program was teaching someone "how to build a car" ("construct reports") instead of teaching someone "how to drive" ("understand and explain the decisions behind those reports").

Manager Search And Selection

The 2013 CIPM curriculum contains 17 new or revised readings (in total for both levels of the program). The updates represent a repositioning of the CIPM Program to emphasize the heightened importance of manager search and selection to the investment performance profession. Previously, the CIPM curriculum was split about evenly between content related to ethical and professional standards and content specific to performance evaluation. Based on our research, the weightings will increase performance evaluation content to 70 percent and content for ethical and professional standards will decrease to approximately 30 percent. Although the "ethics" component actually will stay the same, the offset will come in a reduction of content related to specific topics in performance standards, such as the GIPS standards.



The enhanced CIPM Program has expanded the scope of performance and risk measurement to include evaluation and presentation. Performance evaluation consists of the following areas of focus: measurement, attribution, and appraisal.

- Measurement: What was the manager's performance?
- Attribution: Why did the manager produce the observed results?
- Appraisal: Is the manager's performance attributable to skill or luck?
- Manager search and selection: Should we hire, retain, or replace the manager?

Measurement is the foundation of performance evaluation, and it can be as simple as calculating the rate of return of a single long-only stock or as complex as evaluating a long–short multicurrency portfolio. Attribution builds on the measurement function by comparing return with a valid benchmark while better understanding what decisions were undertaken and showing why the manager outperformed or underperformed. The appraisal process looks at whether the manager was lucky or skillful in outperforming or something else was going on—possibly even fraud. Once equipped with the skills to appraise a single manager's performance, the next step is to be able to engage in a manager search and selection. This new area will be of particular interest to investment consultants, wealth advisers, and financial planners, because they often select managers for their clients.

The enhanced CIPM Program is being well received by practitioners. "The new emphasis on practical applications of the analysis will be helpful for the senior managers that make broad asset allocation as well as manager evaluation decisions," says Frances Barney, CFA, head of performance and risk analytics consulting for the Americas at BNY Mellon Asset Servicing. "The previous program provided a strong foundation, but the new focus should be more useful for the senior investment staff as well as the people that support them."

"The CIPM program has evolved from a focus on calculating performance to a robust and well-rounded program for everyone involved in investing—helping them improve their ability to

understand, evaluate, and communicate investment results," says Stephen Campisi, CFA, director of institutional investments at U.S. Trust. "The CIPM Program is not just for performance analysts. It's also a great way for practitioners to learn how to evaluate and communicate the value of their investment process in ways that are relevant and understandable to their clients."

CFA Program And CIPM Program

The CIPM Program can complement the CFA Program; in fact, more than a third of those holding the CIPM designation also hold the CFA charter. CFA charterholders make investment decisions under conditions of uncertainty, whereas new CIPM designation holders effectively evaluate and communicate how those investment decisions were made. The new CIPM Program offers increased value to CFA charterholders because it provides them with the competencies needed to evaluate their own decisions.

The new curriculum should help those with the CIPM designation to stand out in their abilities to drive smarter, more informed investment strategies and to communicate performance information to their firm and clients. Moreover, the benefits go beyond individual practitioners to the firm level. "The CIPM program is a critical source of competitive advantage for your firm," says Campisi. "In a crowded marketplace of investment providers, the skills this program provides can help you differentiate your firm by demonstrating the highest standards of practice and the greatest effectiveness in communicating your investment results. Keeping current with the latest analytics will help you showcase your skills to your clients and prospects more effectively while helping your firm manage its own investment processes with increased control and greater insights into risk management and its relationship to the art of investing."

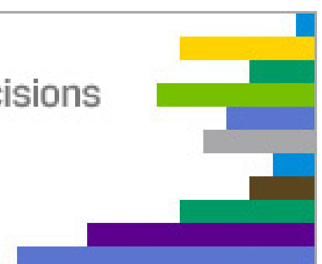
Todd Jankowski, CFA, is head of the CIPM Program at CFA Institute.

old Curriculum Weights

new Curriculum Weights

- Performance Measurement
- Performance Attribution
- Performance Appraisal
- Manager Selection
- Ethical Standards
- Global Investment Performance Standards (GIPS)
- Investing Performance Reporting

Gain the skills to drive smarter, more effective investment decisions to maximize investors' value.
EXPLORE THE NEW CIPM PROGRAM.



THE SPAULDING GROUP'S 2013 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
April 16-17, 2013	Fundamentals of Performance Measurement Training	Toronto, ON, Canada
April 18-19, 2013	Performance Measurement Attribution Training	Toronto, ON, Canada
May 14-15, 2013	Fundamentals of Performance Measurement Training	Philadelphia, PA
May 15, 2013	Fundamentals of GIPS Workshop	Philadelphia, PA
May 16-17, 2013	PMAR XI	Philadelphia, PA
May 25, 2013	Performance Measurement For Non-Performance Professionals	San Francisco, CA (USA)
June 10, 2013	Fundamentals of GIPS Workshop	London, England
June 11-12, 2013	PMAR Europe IV	London, England
June 13-14, 2013	Fundamentals of Performance Measurement Training	London, England
July 16-17, 2013	Fundamentals of Performance Measurement Training	San Francisco, CA (USA)
July 18-19, 2013	Performance Measurement Attribution Training	San Francisco, CA (USA)
July 23-24, 2013	Fundamentals of Performance Measurement Training	Sydney, Australia
July 25-26, 2013	Performance Measurement Attribution Training	Sydney, Australia
August 19-20, 2013	CIPM Principles Exam Preparation	Chicago, IL (USA)
August 21-23, 2013	CIPM Expert Exam Preparation	Chicago, IL (USA)
September 18, 2013	Portfolio Risk	Boston, MA (USA)
September 24-25, 2013	Fundamentals of Performance Measurement Training	Vancouver, BC, Canada
September 26-27, 2013	Performance Measurement Attribution Training	Vancouver, BC, Canada
October 22-23, 2013	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
October 24-25, 2013	Performance Measurement Attribution Training	Chicago, IL (USA)
November 19-20, 2013	Fundamentals of Performance Measurement Training	Boston, MA (USA)
November 21-22, 2013	Performance Measurement Attribution Training	Boston, MA (USA)
December 10-11, 2013	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
December 12-13, 2013	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2013 events, please contact Christopher Spaulding at 732-873-5700

TRAINING…

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

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:

April 16-17, 2013 – Toronto, ON, Canada
May 14-15, 2013 – Philadelphia, PA
June 13-14, 2013 – London, England
July 16-17, 2013 – San Francisco, CA
July 23-24, 2013 – Sydney, Australia
Sept. 24-25, 2013 – Vancouver, BC, Canada
October 22-23, 2013 – Chicago, IL
November 19-20, 2013 – Boston, MA
December 10-11, 2013 – 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:

April 18-19, 2013 – Toronto, ON, Canada
July 18-19, 2013 – San Francisco, CA
July 25-26, 2013 – Sydney, Australia
Sept. 26-27, 2013 – Vancouver, BC, Canada
October 24-25, 2013 – Chicago, IL
November 21-22, 2013 – Boston, MA
December 12-13, 2013 – 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.

PORTFOLIO RISK MEASUREMENT

This class is intended for investment professionals who would like to gain a better understanding of investment risk as it pertains to portfolio risk reporting, as well as it's use in predicting results.

Sept. 18, 2013 – Boston, MA

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.

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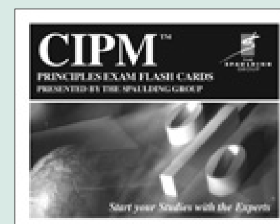

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