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Since 1990, The Spaulding Group, Inc., an employee-owned business, has had an increasing presence in the money management industry.

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We are actively involved as members of the CFA Institute and other industry groups. The Spaulding Group has also led the charge for the industry in the handling of error correction, attribution guidelines/ standards, and Investment Performance Measurement Analyst Certification (since handed over to the CFA Institute and now called the CIPM program).

Several of our senior staff regularly speak at and/or chairs industry conferences. Our founder and CEO, David Spaulding, is a frequent author and source of information to various industry publications. Our firm continues to make huge contributions to our industry, in terms of valuable content, innovative ideas, and volunteer activities.

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More on the SEC's new marketing rules

If you are registered with the U.S. Securities & Exchange Commission, you're no doubt aware of the new marketing rules that go into effect in just a few months.

At our recent North American Performance Measurement, Attribution & Risk (PMAR) conference, there was quite a bit of discussion around this topic. While I think the rules are generally quite good, there is some language that is causing some concern and confusion. I have it on "good authority" that we cannot expect the SEC to issue FAQs (Frequently Asked Questions) anytime soon, meaning firms need to either interpret the rules themselves or seek the assistance of their compliance team and/or outside counsel.

I want to comment briefly on three questions that were raised at the conference, and share my thoughts with you.[1]

Portability of Performance

An item that is raising a lot of concerns is the question as to what happens to the track record of a manager a firm acquired, should their investment decision makers depart.

One interpretation is that you will no longer be able to show it.

For example, Firm A acquires Firm B, that is a global equity small cap manager. Firm B has a 15-year track record. The acquisition meets the GIPS® rules (i.e., substantially all the decision makers come along, they have records to support performance, and they continue to manage at Firm A as they did at Firm B).

Firm A immediately showcases Firm B's track record. The team from Firm B remains at Firm A for five years. Then, the portfolio manager and her performance analyst depart.

Some believe that after this occurs, Firm A can no longer report the performance of Firm B prior to its acquisition. That is, they can't show the 15 year history prior to the acquisition, just the 5 years since. but can only show the performance since the acquisition.

I believe that under most circumstances, Firm A <u>can</u> show the record. What do I mean "most circumstances"? Well, if the team from Firm B remains at Firm A for at least one year. If they "jumped ship" shortly after the acquisition (e.g., in the first six months), then I believe they wouldn't be able to.

That is my view. Many take a more conservative view. We will have to wait

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for something substantial from the SEC, but this is what I believe, based on conversations I have had.

Do I have to go to 10 years?

The new SEC rules essentially endorse the idea of composites. Prior to these rules, it wasn't difficult for a manager to showcase their past performance using representative portfolios, model performance, back-tested performance, a subset of accounts in the strategy, and other forms of hypothetical performance.

But, the new rules make this quite difficult, so full composites are going to be the way to go.

Let's say Firm X wants to comply with the GIPS standards, and they have a Global Bond strategy that they've managed for 12 years. Historically, the firm has used a "rep portfolio" to market this product, but now must create a composite. Because of the large number of portfolios and challenges with historical records, they have opted to only go back five years.[2]

The new marketing rules require firms to show 1-, 5-, and 10-year annualized returns.

Must the firm go back to 10 years, even though for GIPS purposes they only need five?

I believe they will be required to go back. This will, for many firms, be difficult to achieve. Hopefully, I am wrong.

Attribution: net and gross? What about risk?

Firms must show net returns with equal prominence to gross.

Does this extend to performance attribution?

Well, is attribution "performance"? Is it "returns?

I'd say "no." It *explains* where the returns came from, but isn't returns.

I therefore believe that the firm need only show attribution using gross-of-fee returns.

The reality is that showing for net-of-fee returns would be challenging, as it would require the firm to spread the fee across sectors, securities, etc. In addition, what possible insights would we gain from such an analysis?

This question can be extended to risk measures. E.g., if the firm shows, for example, tracking error and standard deviation using gross-of-fee returns, must they show the statistic for net-of-fee, too? One can only hope not.

Consider the case where fees are taken out quarterly. This means that with every quarter, the gross- and net-of-fee returns will be identical; the third month they'll be different. This difference will introduce false volatility, that can be misleading.

What about risk-adjusted returns; must they be shown net and gross?

This is different. I would make the case that for a true risk-adjusted return (e.g., Modigliani-Modigliani), the answer would be YES! For Jensen's alpha, which is a risk-adjusted excess return, I'd also say YES!

What about Sharpe ratio, Treynor ratio, Sortino ratio, and Information ratio? Aren't they risk-adjusted returns? Actually, they aren't; they're ratios. Must they be shown using net-of-fee returns, too? I would say probably. I can see where there would be value in seeing these statistics based on net returns.

What say you?

You're invited to share your thoughts on this. The next year or so should be quite interesting as firms adopt the new rules and the SEC eventually chimes in with a bit more details on topics like these.

Endnotes

1. I should probably point out that I am not an attorney, though my girlfriend is, so perhaps that helps? I am a guy that's been in the industry nearly 40 years, has worked with the performance presentation standards for 30 years, and has spent a great deal of time in performance measurement, so I'd like to think my views have some value, but you get to decide.

2. Recall that the GIPS standards require a minimum of five years or since inception (if the firm or strategy exists for less than five years), building to ten years.

THE SPAULDING GROUP'S 2022
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
May 25, 2022	Asset Owner Roundtable Meeting	Nashville, TN
May 26-27, 2022	North American Meeting of the Performance Measurement Forum	Nashville, TN
June 16-17, 2022	EMEA Meeting of the Performance Measurement Forum	Amsterdam, The Netherlands
November 10-11, 2022	EMEA Meeting of the Performance Measurement Forum	London, England
November 15-16, 2022	Fundamentals of Performance Measurement Training Class	San Diego, CA
November 16, 2022	Asset Owner Roundtable Meeting	San Diego, CA
November 16, 2022	Broker/Dealer Symposium – First Meeting	San Diego, CA
November 17-18, 2022	North American Meeting of the Performance Measurement Forum	San Diego, CA

For additional information on any of our 2022 events, please contact Patrick Fowler at 732-873-5700.

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