PERFORMANCE PERSPECTIVES with David Spaulding

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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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GIPS PORTABILITY

The Global Investment Performance Standards (GIPS®) provide rules regarding the transfer of historical performance from one firm to another. There are actually two sides to this:

- the movement of managers from one firm to another
- the merger or acquisition of firms.

If a group of managers leaves a firm to either join another or start their own firm, there are three fundamental requirements, taken directly from the Standards:

> 5.A.8 a. Performance of a past firm or affiliation MUST be LINKED to or used to represent the historical performance of a new or acquiring FIRM if, on a COMPOSITE-specific basis:
>
> i. Substantially all of the investment decision makers are employed by the new or acquiring FIRM (e.g., research department staff, portfolio managers, and other relevant staff);
>
> ii. The decision-making process remains substantially intact and independent within the new or acquiring FIRM; and
>
> iii. The new or acquiring FIRM has records that document and support the performance.

Figure #1

Most managers find the third requirement to be the most challenging to fulfill. But, at least we have relatively clear rules. Granted, what "substantially all" means, or "remains substantially intact" can be open to interpretation, but the guidance, nonetheless, is itemized for us.

The same cannot be said for the second form, where, continuing with ¶ I.5.A.8 we find:

> b. If a FIRM acquires another firm or affiliation, the FIRM has one year to bring any non-compliant assets into compliance.

Figure #2

What does this mean? Over the years I've been involved with a number of conversations on this, and there are generally two camps:

- Camp #1: firms must bring the prior firm or affiliation "into compliance," which means the basic requirements that a minimum of five years of history be brought into compliance.
- Camp #2: the compliant firm must only deal with the records on a going forward basis.

I have always found myself in Camp #1, for several reasons:

The Journal of Performance Measurement®:

UPCOMING ARTICLES

A General Framework for the Business Requirements of an Investment Performance Measurement System
– Timothy P. Ryan

The Journal Interview:
– Frances Barney

High Frequency Equity Performance Attribution
– Ricky Cooper and Tingting Li

Differences in Fund Trackers' Performance Rankings: A Mean Variance Perspective
– Michael Stutzer

Asset Allocation vs. Security Selection
– Renato Staub and Brian Singer

- "into compliance" is a fairly straightforward term
- if one were only worried about going forward, would this not encourage a non-compliant firm who wishes to comply to simply acquire a smaller, already compliant firm, and save themselves a lot of work?
- Camp #1 is more in line with the "spirit of the Standards."

Sadly, clarity is lacking in this regard, though there is some evidence to support Camp #1's position.

There is a Q&A from 10 years ago that supports this (see Figure #3).

Portability

If Firm A acquires Firm B and all of the portability requirements are met, is Firm A required to present Firm B's historical performance, or can Firm A choose to not present Firm B's historical performance?

The GIPS standards are based on the fundamental principles of fair representation and full disclosure. If all of the portability requirements are satisfied and Firm B is included in the definition of Firm A, it would be misleading for Firm A to discard Firm B's historical performance. Accordingly, Firm A cannot disregard Firm B's historical performance. If Firm A were permitted to exclude Firm B's historical performance, it would be cherry-picking which is against the spirit of fair representation of the GIPS standards.

Date Added: September 2002

Figure #3

Does this not lend credence to the need to fully bring the non-compliant firm "into compliance"?

Possible scenarios to consider

When one firm merges with or acquires another, we typically see four different scenarios unfold (see Figure #4). For our discussion we will assume that Firm A is compliant with GIPS and that Firm B is not. The dotted portion of the lines represent the non-compliant period.

In Scenario #1, we find that both firms have a strategy that will continue after the merger. This often happens when firms that focus on different parts of the market merge; e.g., a U.S. equity manager acquires a global equity manager, or an equity manager merges with a fixed income manager).

Firm B must bring at least five years of history into compliance.

In Scenario #2, both firms have similar strategies, but going forward, Firm A's will survive. Firm B's clients move over to Firm A's composite, and so we will see a "bump" in both its number of accounts as well as its assets. Firm B is required to bring five years of its history into compli-ance, even though going forward it won't be used.

Why, you might ask? Well, let's consider the following: let's say that Firm B hasn't merged with or been acquired by or acquired Firm A, but remains an independent firm. They choose to comply with GIPS, and during their review of their five years of history find strategies which they once employed but no longer do; perhaps they had an emerging markets strategy that failed. Must they create a composite for it, with presentations, even though its last account left within the past five years? You know the

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answer to this question, right? Of course they must! And so, why wouldn't the same rule apply here? It must!

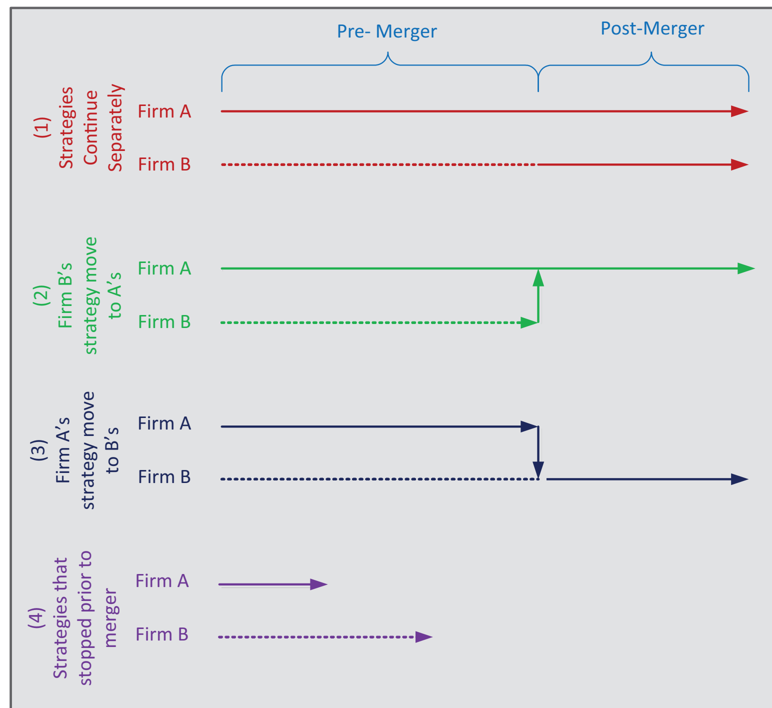

Figure #4

The third scenario shows the situation where both firms have similar strategies, as with the second scenario. In this case, Firm B's survives. Firm A's history is already compliant. Its accounts move to Firm B's composite, and at least five years of history must be brought into compliance.

The fourth scenario shows strategies that existed in both firms prior to the merger, and within the past five years. Firm A already has composite presentations, which they must continue to make available for at least five years since the composite terminated. Firm B must create composites and have presentations for these composites.

A lot of work!

Yes, it is! But compliance IS a lot of work. Why would we not expect the non-compliant firm to be obligated to prepare such materials?

I must confess that this is my interpretation of what the rules are. I believe there is sufficient evidence in the Standards and the portability guidance statement to support this belief. Others feel differently.

As I write this, I am conducting a verification for a client who recently acquired a non-compliant firm. They are in the process of bringing that firm into compliance.

The one-year deadline starts at the point of the merger/acquisition. If the non-compliant firm will continue to operate independently, then you do not have to go through this exercise; if, however, the intent is to combine the firms under the compliant firm, you must.

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.

Can this work be done over time?

Yes! You do not have to delay the movement of Firm B's accounts or composites until you're all done; you can bring parts of the firm into compliance and combine the new composites with Firm A. This work must be completed within the one year following the merger/acquisition.

What about Assets Under Management?

As parts of Firm B are brought across, the AUM can adjust. I believe that the presentations should reflect the assets of the new, larger firm.

Your comments, thoughts, and reactions are welcome.

WHY DON'T THE NET VERSUS GROSS RETURN DIFFERENCES NOT EQUAL THE FEE?

In our February newsletter, we discussed deriving net-of-fee returns and showed that when we link the monthly (or quarterly) returns, we discover that, on an annual basis, the difference does not equal the fee.

But why, when we compound the negative values, do we not achieve the same result?

In general, numbers compound at different rates, depending on whether they're positive or negative, and their relative size (higher numbers compound faster). Figure 5 shows a few examples. And so, if our fee is deducted from really large monthly returns, the difference at the end of the year will far exceed our annual fee; and if added to negative, it will fall below. I wrote about this in a March 3, 2010 blog piece.[1]

Given that as positive numbers increase, we see the difference increasingly exceed our annual fee, and as negative numbers decrease (get smaller and smaller), the difference is decreases, it seems to make sense that at a zero return, we'd find that the difference matches our annual fee; however, this isn't the case, as we can see in Figure 6. The question I posed was, "why not?" That is, why aren't we seeing the compounding of just our monthly fees equal our annual return.

Let's spend a brief moment on the numbers that were used. First, what is the monthly fee? Well, the annual fee in this case is 1.50 percent. And so, to determine the monthly fee, I raised the annual fee (plus one) to the 1/12th power, and then subtracted one. This yields 0.12414877 percent. If we compound this number 12 times we get our 1.50% (see Figure 7), and so we know that this is the right fee to use on a monthly basis.

But why, when we compound the negative values we don't achieve the same result? As noted above, negative values compound differently than positive. As Figure 5 shows, the positive and negative values yield different results, with the negative being less than the positive (on an absolute value basis).

1 http://investmentperformanceguy.blogspot.com/2010/03/how-come-math-doesnt-work-out.html

The Journal of Performance Measurement® is beginning a series on performance measurement professionals, and we need your help to identify the folks we should include. We plan to focus on one or two people in each issue, but want the list to be driven by input from other PMPs.

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

This is confusing, no doubt. We want our annual return differences (gross minus net) to equal our annual fee, and don't understand why (in positive years) it's higher or (in negative) lower. Again, it's a feature of compounding. The monthly (or quarterly) net-of-fee return is the right return, and arguably is the return you should be compounding to yield your annual result. I foresee spending more time on this in the future, as I think it's an interesting topic.

We had a few folks respond to the question that was posed in February, and our winner is Derek Hagen from Columbia Management. Congratulations!

Jan	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Feb	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Mar	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Apr	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
May	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Jun	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Jul	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Aug	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Sep	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Oct	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Nov	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Dec	1.00%	-1.00%	2.00%	-2.00%	5.00%	-5.00%	10.00%	-10.00%
Year	12.68%	-11.36%	26.82%	-21.53%	79.59%	-45.96%	213.84%	-71.76%

Figure 5

Scenario #5	
Annual Fee = 1.5%	
GOF	NOF
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-0.12%
0.00%	-1.48%
1.48%	

Figure 6

Jan	0.12414877%
Feb	0.12414877%
Mar	0.12414877%
Apr	0.12414877%
May	0.12414877%
Jun	0.12414877%
Jul	0.12414877%
Aug	0.12414877%
Sep	0.12414877%
Oct	0.12414877%
Nov	0.12414877%
Dec	0.12414877%
Year	1.500000%

Figure 7

EASTER EGG HUNT WINNERS

The PMAR X US Easter Egg winner:

Alison Davis
W.H. Reaves & Company

The PMAR Europe Easter Egg winner:

Ben Blane
UBS Wealth Management

THE SPAULDING GROUP'S 2012 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
May 21-22, 2012	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
May 22, 2012	GIPS® Workshop	Philadelphia, PA (USA)
May 23-24, 2012	Performance Measurement, Attribution & Risk Conference (PMAR)	Philadelphia, PA (USA)
June 11, 2012	GIPS® Workshop	London, England
June 12-13, 2012	Performance Measurement, Attribution & Risk Conference (PMAR Europe)	London, England
June 21-22, 2012	Performance Measurement Forum	Dublin, Ireland
July 10-11, 2012	Fundamentals of Performance Measurement Training	San Francisco, CA (USA)
July 12-13, 2012	Performance Measurement Attribution Training	San Francisco, CA (USA)
August 20-21, 2012	CIPM Principles Exam Prep Course	New Brunswick, NJ (USA)
August 22-24, 2012	CIPM Expert Exam Prep Course	New Brunswick, NJ (USA)
September 18-19, 2012	Fundamentals of Performance Measurement Training	Boston, MA (USA)
October 23-24, 2012	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
October 25-26, 2012	Performance Measurement Attribution Training	Chicago, IL (USA)
November 8-9, 2012	Performance Measurement Forum	Istanbul, Turkey

For additional information on any of our 2012 events, please contact Christopher Spaulding at 732-873-5700

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July 12-13, 2012 – San Francisco, CA
October 25-26, 2012 – Chicago, IL

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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 of transporting their staff to our training location and limits their time away from the office. With the discounted 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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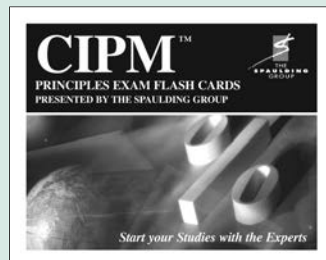

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