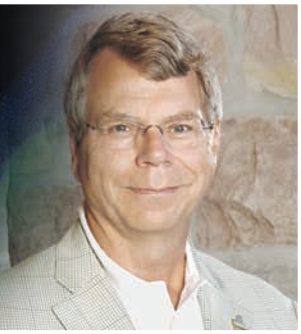
PERFORMANCE PERSPECTIVES
with David Spaulding



VOLUME 4 – ISSUE 12 AUGUST 2007

MINDING THE (MONEY-WEIGHTED) GAPS

In an earlier newsletter (April 2005) I suggested that there were times when *crossing gaps* would be okay. In other words, where gaps are periods when a manager isn't invested in a particular asset.This discussion was limited to time-weighting.

Since that time, (in case you haven't noticed) we've aggressively embraced money-weighting for many levels of performance including returns at the asset level. The question that's been lingering out there has been, is it okay to "cross gaps" when using money-weighting?

Recently we had the chance to see a "real life" example:

Activity		
5/18/2007	Initial purchase	404,628.30
5/21/2007	Sale for profit	410,248.14
6/25/2007	New purchase	409,728.76
6/28/2007	Additional purchase	1,047.32
6/29/2007	Sale for profit	418,445.12
7/26/2007	3rd purchase	1,234,413.10
7/27/2007	Additional purchase	3,086.03
7/31/2007	Additional purchase	850,339.23
8/3/2007	Ending position	1,984,124.89

FIGURE 1

Figure 1 shows what's happened. We begin with a purchase of a security that's sold a few days later for a profit. The following month we make a second purchase which is also sold for a profit a few days later. We make our third purchase the following month, and follow this up with two more purchases. If you do the math you'll see that we have an unrealized loss for this third block of purchases. Overall, the sum of our realized gains (5,619.84 and 7,669.04) and unrealized loss (-103,713.47) comes to a loss of -90,424.59. So, what's our return?

When I calculated the Modified Dietz across the full period (using Modified Dietz as the first step to obtain the IRR), I got a return of -47.63 percent. When I calculated the IRR I got -40.04 percent. These returns clearly didn't make any sense to me. One of the arguments for using money-weighting is that we expect the results to be more intuitive than time-weighting and this return clearly isn't.

If we ignore the first two periods and only focus on the third we get a return of -6.67 percent. Note that this is only for the period 7/26/2007 – 8/3/2007; however, it's for a contiguous period.

The Journal of Performance Measurement®:

One of our clients had tried to use money-weighting across a period with gaps and had similar nonsensical results, suggesting that the practice wasn't a good idea.

This is our conclusion, too.

You might suggest we calculate the returns for the three periods and link them; the problem is this will result in a time-weighted return (basically this is the Modified IRR or Modified BAI method).

We are open to suggestions as well as your reaction to this. Please let us know what you think. Thanks!

SEC COMPLIANCE LETTER

The SEC recently published a letter that summarizes some of their findings. I was particularly struck by comments regarding GIPS compliance and verification (www.sec.gov/about/offices/ocie/complialert.htm):

"A very common deficiency was with respect to advisers' inappropriate claims of compliance with the CFA Institute's performance presentation standards. The majority of the advisers examined during these risk-focused examinations claimed that they had presented their performance in a manner that was consistent with the CFA Institute's performance presentation standards, though only one was in full compliance. This was a common deficiency even though most of the advisers that claimed compliance with the CFA Institute's performance presentation standards had previously had their calculations and methodology 'verified.'"

A "common deficiency" in the inappropriate claim of compliance "even though most of the advisers…had their calculation 'verified.'"

Perhaps the SEC is simply wrong…they *think* the firms are not compliant but they actually are! I wouldn't bet on it.

I found it quite interesting that most had been verified and yet there were still problems. To me, this just adds more reason **not** to mandate verification.[1] In spite of this news, we still strongly encourage firms to become verified. Perhaps this also says that their due diligence in selecting a verifier needs to be thorough, in order to reduce the likelihood that they'll be one of those firms found not to comply.

As someone once offered, "a word to the wise is sufficient."

READERS RESPOND

We got a few comments in response to the apparent inconsistency in discretion / non-discretion when cash flows are involved.

Debi Rossi of Turner Investment Partners wrote:

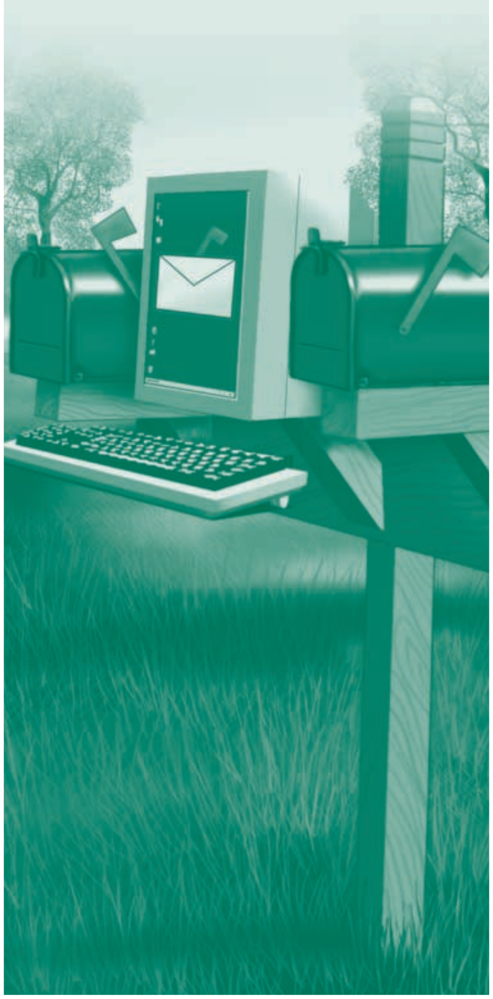
Good article.

Do you agree that such conditions should be eligible for nondiscretionary status? Yes, if the investment strategy would be compromised due to numerous and significant cash

1 I will debate Carl Bacon on this topic at the upcoming GIPS Annual Conference in Chicago (September 27-28).

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.



flows that occur regularly or irregularly then I would argue that that account's status may be considered non-discretionary. I think it would depend on the investment strategy. I believe there may be instances where cash flow activity may warrant being considered a "client imposed restriction". For example, if the firm's investment strategy is fully-invested in small cap stocks, with say 1-2% cash, and a new account has stated that there will be regular cash flows in and out of 20% or more, and cash levels should remain at 15%. I believe will hinder the investment strategy and it may be enough to consider it non-discretionary. Personally, I would consider creating a new composite for this account, allowing for a larger cash position.

• *If yes, have you implemented this rule at your firm? No.*

And Neil Riddles, COO at Hansberger Global wrote:

Dave,

I appreciate your Performance Perspectives newsletter. You bring to the fore difficult problems that I do not hear discussed in any other forum.

When I read your thoughts about making portfolios non-discretionary due to cash flows my reaction was the same as yours, that it is not allowed. I was surprised by the Guidance Statement you quoted because I do not remember that language either.

However, after further consideration I think that a broad prohibition against making portfolios non-discretionary due to cash flows may not be the best course.

I can imagine a scenario where a portfolio in an illiquid asset class could have its investment strategy materially effected by cash flows. If the client discloses these demands ahead of time then I believe the portfolio should be non-discretionary. Of course, the suitability of that product for that client is questionable but that would be a CFA question not GIPS.

A different scenario would be a client which has indicated that their portfolio will have regular capital flows such that, for the majority of the time, it would be excluded from the composite anyway due to the firm's cash flow policy. It would seem strange to include the portfolio in the composite only to exclude it all of the time.

Regards,
Neil

I'll be teaching a class for the CFA Institute the day before the upcoming annual GIPS conference in Chicago and this will be the first opportunity since I discovered the inconsistency to address this. I try to avoid confusion (there's enough already) so we may just ignore this completely. If you'd like to offer an opinion, please let us know.

THE SPAULDING GROUP'S 2007 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
September 17-18	Introduction to Performance Measurement Training	Los Angeles, CA (USA)
October 8-9	Introduction to Performance Measurement Training	Boston, MA (USA)
October 10-11	Performance Measurement Attribution Training	Boston, MA (USA)
October 22	Trends In Attribution Symposium	Philadelphia, PA (USA)
October 23-24	Introduction to Performance Measurement Training	New York, NY (USA)
October 25-26	Performance Measurement Attribution Training	New York, NY (USA)
November 8-9	Performance Measurement Forum	Athens, Greece
November 29-30	Performance Measurement Forum	Orlando, FL (USA)
December 3-4	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 5-6	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For Additional information on any of our 2007 events,
please contact Christopher Spaulding at 732-873-5700

TRAINING...

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

TO REGISTER:

Phone: 1-732-873-5700

Fax: 1-732-873-3997

E-mail: info@SpauldingGrp.com

The Spaulding Group, Inc. is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417.
www.nasba.org

INTRODUCTION TO 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:

September 17-18, 2007 – Los Angeles, CA

October 8-9, 2007 – Boston, MA

October 23-24, 2007 – New York, NY

December 3-4, 2007 – New Brunswick, NJ

CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

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:

October 10-11, 2007 – Boston, MA

October 25-26, 2007 – New York, NY

December 5-6, 2007 – New Brunswick, NJ

CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

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.

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 1,500 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.