# PERFORMANCE PERSPECTIVES

## with David Spaulding

VOLUME 9 – ISSUE 4 DECEMBER 2011

**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**

**CSpaulding@SpauldingGrp.com**

**http://www.SpauldingGrp.com**

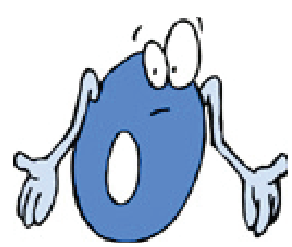
### GOING OUT WITH A BANG!


This being the last newsletter for the year, and having the luxury of spending some time at home (albeit, most of which is still devoted to work) allowed me at least a few moments to devote to this monthly task. And, coincident with it has been the announcement of my top 10 list for GIPS® (Global Investment Performance Standards): things I really like; as well as the items that I'm not overly thrilled with (the 10 "not so good" things). Here are the lists, without the accompanying narratives:

| The 10 Best | | The 10 "Not So Good" |
|---|---|---|
| 3-year Annualized Standard Deviation | 10 | Performance Examinations |
| GIPS Help Desk | 9 | Model fees |
| GIPS Country Council | 8 | The recommendation that compliant firms give their existing clients a copy of the composite(s) their account is in |
| GIPS Executive Committee | 7 | Introducing a rule disallowing intra-month additions of accounts in a Q&A |
| Significant cash flows | 6 | No GIPS Handbook |
| Verifier independence guidance | 5 | Dropping after-tax |
| Dispersion | 4 | The Error Correction Guidance Statement |
| The composite | 3 | The aggregate method for composite returns |
| The globalization of the standards | 2 | The use of asset-weighting to measure performance |
| The standards, in general | 1 | The decision to eliminate the opportunity for firms to allocate cash to carve-outs |

If you're a regular reader of this newsletter or blog, you're no doubt already familiar with the second list, as most of these items have appeared here in one form or another in the past. And, as I stated in the blog posts, I invite your comments.

### DEALING WITH ZERO WEIGHTS



Earlier this month I touched on the fairly common scenario where the manager is "void" one or more sectors in my blog; specifically, how should our attribution model handle this?

Before we get to attribution, it's important to ensure we're dealing with it properly from a benchmark perspective. If our client has directed us to avoid one or more sectors, then the benchmark needs to reflect this (e.g., S&P 500, ex financials), as this is our *strategy*. However, if the decision to avoid a sector is *tactical*, then the benchmark needs to include the sector, with the benchmark's weights and returns.

The Journal of Performance Measurement®:



We should consider the difference in results if we include the interaction effect, a hotly debated topic of its own! Since I prefer to include interaction, we'll start with that case:

**Brinson-Fachler, with the interaction effect**

| | $W_P$ | $W_B$ | $R_P$ | $R_W$ | Allocation | Selection | Interaction |
|---|---|---|---|---|---|---|---|
| Energy | 10.00% | 9.42% | 10.72% | 10.68% | 0.04% | 0.004% | 0.000% |
| Materials | 14.00% | 12.05% | 4.93% | 5.82% | 0.04% | -0.107% | -0.017% |
| Consmr Discr | 10.00% | 12.58% | 1.02% | -0.97% | 0.13% | 0.250% | -0.051% |
| Consmr Staples | 15.00% | 12.23% | 5.55% | 5.65% | 0.05% | -0.012% | -0.003% |
| Health Care | 19.00% | 13.93% | 7.22% | 6.86% | 0.14% | 0.050% | 0.018% |
| Info Tech | 7.00% | 10.45% | 3.10% | 2.64% | 0.05% | 0.048% | -0.016% |
| Telecom Svcs | 15.00% | 18.35% | -2.00% | -1.27% | 0.18% | -0.133% | 0.024% |
| Industrials | 5.00% | 3.34% | 3.28% | 3.08% | -0.02% | 0.007% | 0.003% |
| Financials | 0.00% | 3.72% | | 13.28% | -0.34% | -0.494% | 0.494% |
| Utilities | 5.00% | 3.93% | 4.12% | 3.73% | 0.00% | 0.015% | 0.004% |
| Total | 100.00% | 100.00% | 4.36% | 4.02% | 0.25% | -0.37% | 0.46% |
| | | | ER = | 0.34% | | Total = | 0.34% |

As you can see, the weight for financials is zero, and we have a "null" return, which Excel treats as if it's zero. We show selection and interaction effects which are mirror images of one another; this is because the portfolio weight is zero, and, as just noted, its return is treated as if it's zero. Consequently, the formulas are similar, save for the signs:

$$Selection = w_B\left(r_P - r_B\right) = w_B\left(0 - r_B\right) = \left(w_B\right)\left(-r_B\right)$$

$$Intraction = \left(w_P - w_B\right)\left(r_P - r_B\right) = \left(0 - w_B\right)\left(0 - r_B\right) = \left(-w_B\right)\left(-r_B\right)$$

I would argue that the manager's decision to avoid this sector is solely an allocation effect, and that the selection effect's value should be added to it. In addition, since interaction is between the selection and allocation decisions, and since there is no selection decision, it, too, should be added to allocation, resulting in zero values for these effects:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Financials | 0.00% | 3.72% | | 13.28% | -0.34% | 0.000% | 0.000% |

If you're like my good friends Steve Campisi and Carl Bacon, then you will not even want to show the interaction effect at all, but rather combine it with selection throughout, which yields:

**Brinson-Fachler, without the interaction effect**

| | $W_P$ | $W_B$ | $R_P$ | $R_W$ | Allocation | Selection |
|---|---|---|---|---|---|---|
| Energy | 10.00% | 9.42% | 10.72% | 10.68% | 0.04% | 0.004% |
| Materials | 14.00% | 12.05% | 4.93% | 5.82% | 0.04% | -0.125% |
| Consmr Discr | 10.00% | 12.58% | 1.02% | -0.97% | 0.13% | 0.199% |
| Consmr Staples | 15.00% | 12.23% | 5.55% | 5.65% | 0.05% | -0.015% |
| Health Care | 19.00% | 13.93% | 7.22% | 6.86% | 0.14% | 0.068% |
| Info Tech | 7.00% | 10.45% | 3.10% | 2.64% | 0.05% | 0.032% |
| Telecom Svcs | 15.00% | 18.35% | -2.00% | -1.27% | 0.18% | -0.109% |
| Industrials | 5.00% | 3.34% | 3.28% | 3.08% | -0.02% | 0.010% |
| Financials | 0.00% | 3.72% | | 13.28% | -0.34% | 0.000% |
| Utilities | 5.00% | 3.93% | 4.12% | 3.73% | 0.00% | 0.019% |
| Total | 100.00% | 100.00% | 4.36% | 4.02% | 0.25% | 0.08% |
| | | | ER = | 0.34% | Total = | 0.34% |

*Upcoming Events:*

## First Rate 2012 Performance Conference

**March 26-27, 2012**

Four Seasons Resort and
Club Dallas – Irving, Texas

*Conference Website:*
**http://www.firstrate.com/investmentperformanceconference2012**

The addition of the interaction effect causes selection to be zero, which is the correct representation.

Understanding the difference between *strategic* and *tactical* investment decisions is critical, to the proper use, construction, and representation of benchmarks, and the application of attribution.

### WHO'S THE CLIENT

Last month I blogged about the issue of who the client is, and expanded the topic a bit in the November newsletter. We received some very positive feedback about it, so I am going to continue this topic a bit more.

Three points I raised at the end of the newsletter were especially valuable for some of you; that is, that the criteria for the individual or institution being a "client" for GIPS purposes should be:

- purchases of securities or assets are made specifically for the individual or institution
- the individual or institution *owns* the underlying assets
- the individual or institution has a separate account established, often at a custodian, where the assets are held.

And so, what fails this test? Private equity partnerships, mutual funds, hedge funds, real estate partnerships, and probably a few more pooled vehicles; in fact, just about anything that looks like a pooled vehicle means it's not a client.

Okay, so what about wrap fee accounts? Okay, you've got me on that one. Here, the Standards allow the firm to choose, since another criteria could be *who do you market to?* In most cases, asset managers never market to the end client in a wrap fee relationship; rather, they peddle their services to the wrap fee sponsors. I tend to favor treating each sponsor as the client, as this saves the firm a great deal of headaches and unnecessary labor.

### CLIENTS OR CUSTOMERS…WHAT DO WE HAVE?

I think a lot of folks would think of the words "client" and "customer" as being synonymous, but they actually aren't. As per dictionary.com, a client is "a person, company, etc, that seeks the advice of a professional man or woman," while a customer is "a person who purchases goods or services from another."

Technically, we have both. For example, folks who purchase our books or subscribe to *The Journal of Performance Measurement®* can be viewed as customers. However, most of our relationships are clearly of the "client" variety. We wish to be seen as a "trusted advisor" to our clients. Minor point, perhaps, but this conscious acknowledgment reflects our awareness of the subtle differences, and our appreciation for the relationships we have.

## PERFORMANCEJOBS.COM

Visit PerformanceJobs.com and you'll see that we have several jobs posted. We're very excited with the initial interest this venture has caused and look forward to it becoming the major resource for individuals seeking employment as well as firms looking to hire. If you know of someone who is looking for a career in investment performance, please direct them to our site and encourage them to submit their resume today.

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## SPEAKING OF THE JOURNAL OF PERFORMANCE MEASUREMENT

In last month's newsletter we made a fantastic offer to new subscribers and past subscribers who had let their subscription lapse. Due to the response we have gotten to this offer, we've decided to extend the deadline to participate to January 31, 2012. This gives you a whole extra month to join in. Details follow.

Also, as our editor, Douglas Spaulding, posted on Linkedin, *The Journal of Performance Measurement* is accepting articles on topics including performance measurement, risk, and attribution; we are particularly interested in articles that address alternative investment classes (hedge funds, private equity, real estate), though this is not a requirement. All articles are subject to a double-blind review process before being approved for publication. For more information and to receive our manuscript guidelines, please contact Douglas at DougSpaulding@SpauldingGrp.com.

## ANNOUNCING A NEW SERVICE!

The Spaulding Group has just announced a new service[1]: Software Certification.

While the type of work isn't new for us, as we've reviewed many firms' performance systems for close to 20 years, the formalizing of it is. We provide an independent review of a firm's performance system, addressing the system's:

- Functionality
- Calculations
- Completeness
- Screens/User Interfaces
- Reports
- Usability
- Controls
- Workflow.

Software products or areas that are eligible for certification include:

- Rates of return
- GIPS(R) "Basic"
- GIPS Real Estate
- GIPS Private Equity
- Equity Attribution
- Fixed Income Attribution
- Risk, ex post

with other areas planned.

1 Please see http://www.spauldinggrp.com/whats-new/194-announcing-software-certification-from-the-spaulding-group-a-seal-of-approval-for-performance-attribution-risk-and-gips-systems.html.

The review is intended for software vendors, custodians, and asset managers with internally developed systems. It is both rigorous and comprehensive. John Simpson, CIPM and I designed and developed the process we will use to evaluate systems. For firms to have their system declared "TSG Certified" it must meet the tests we've developed.

The certification

- provides software vendors with a "competitive edge"
- affirms the system's capabilities
- gives the firm's clients and prospects greater confidence, reduces their concerns and risks, and increases the vendor's likelihood of a sale.

To learn more about the service, please contact Christopher Spaulding (CSpaulding@SpauldingGrp.com; 732-873-5700).

*The Journal of Performance Measurement®*
*Tenth Annual International*

**PMAR**

Performance Measurement, Attribution & Risk

**Conference**

*May 23rd - 24th, 2012*

*Save the Date!*

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

| DATE | EVENT | LOCATION |
|---|---|---|
| February 7-8, 2012 | Fundamentals of Performance Measurement Training | Los Angeles, CA (USA) |
| February 9-10, 2012 | Performance Measurement Attribution Training | Los Angeles, CA (USA) |
| March 13-14, 2012 | Fundamentals of Performance Measurement Training | Boston, MA (USA) |
| March 15-16, 2012 | Performance Measurement Attribution Training | Boston, MA (USA) |
| March 19-20, 2012 | CIPM Principles Prep Class | Chicago, IL (USA) |
| March 21-23, 2012 | CIPM Expert Prep Class | Chicago, IL (USA) |

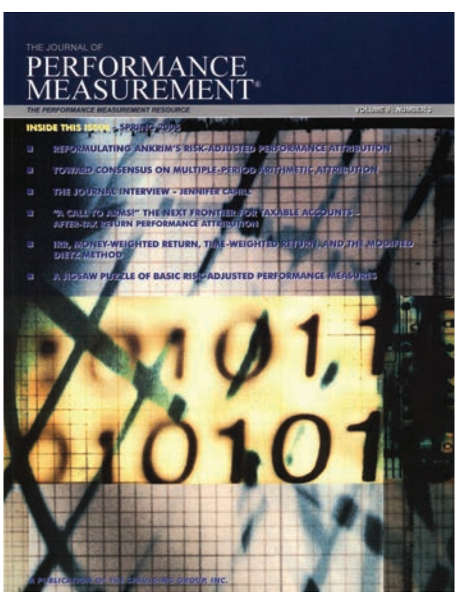
*For additional information on any of our 2012 events, please contact Christopher Spaulding at 732-873-5700*

# Announcing
# *The Journal of Performance Measurement's*
# 16th Anniversary Offer

We are celebrating *The Journal of Performance Measurement's* start of 16 years of publishing with a great offer for new subscribers and those who have let their subscription lapse

*The Journal of Performance Measurement*® (JPM) is ***the*** publication for the best articles on investment performance and risk measurement. JPM is where new ideas are put forward, topics debated, and insights shared. No other publication has served as the resource for so many great articles that are constantly and continuously referenced by performance measurement professionals, worldwide. *The Journal* continues to be ***the*** source for timely articles and innovative thinking. It is recognized as the "bible of investment performance measurement," and no wonder! Its articles are subject to a rigorous double blind peer review process, by recognized performance and risk experts, that ensures that every article meets the demanding and exacting standards of our publication. We top off each year with the awarding of the Dietz Award, which recognizes select authors for their extraordinary contributions to this publication, and the industry at large.

If you are new to *The Journal* or have let your subscription lapse, we invite you to subscribe. And to make the decision easier, we are offering a deep discount from our normal rates. Begin your subscription by January 31, 2012 and we will knock 50% off the normal subscription rates. For U.S. subscribers that means a savings of $163; and for non-U.S., a savings of $175. To make the savings even greater, we will allow you to add a second year, at this same savings rate! **BONUS!** If you elect to add the second year, we will throw in a free gift! Choose from one of the books in The Spaulding Series, and we will include it in your order. Just let us know which you'd like! *Choose one of the following:*




- **The Handbook of Investment Performance (2nd edition)**
  by David Spaulding, CIPM
  *List price $75.00*
- **Classics in Investment Performance**
  edited by David Spaulding, CIPM and Jim Tzitzouris, Ph.D.
  *List price $115.00*
- **Readings in Fixed Income Attribution**
  edited by David Spaulding, CIPM and Stephen Campisi, CFA
  *List price $95.00*
- **Pension Funds: Measuring Investment Performance**
  by Peter Dietz
  *List price $50.00*

**Subscribe today by calling us at: 732-873-5700**

# TRAINING…

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## 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:

February 7-8, 2012 – Los Angeles, CA    March 13-14, 2012 – Boston, MA

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.

CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

## 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:

February 9-10, 2012 – Los Angeles, CA    March 15-16, 2012 – Boston, MA

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.

CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

## IN-HOUSE TRAINING

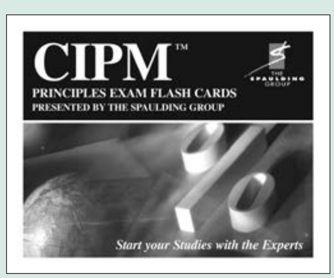
The Spaulding Group has offered in-house training to our clients since 1995. Beginning in 1998, we formalized our training, first with our Introduction to Performance Measurement class and later with our Performance Measurement Attribution class. We now also offer training for the CIPM program. To date, close to 3,000 individuals have participated in our training programs, with numbers increasing monthly.

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).

**UPDATED CIPM Principles and Expert Flash cards are now available on our web store. Please visit www.SpgShop.com today to order your set.**

Our performance experts have created a study aid which can't be beat: ***flash cards!*** These handy cards will help you and your associates prepare for the upcoming CIPM Principles Exam. Unlike a computer-based study aid, you can take them anywhere to help you test your knowledge.

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- Work at your own pace
- Immediate feedback
- Strengthen and reinforce core CIPM principles

These cards are a ***must have*** for anyone preparing to take the CIPM Exams.