

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 CSpaulding@SpauldingGrp.com

THE MYSTERY OF EXCESS RETURNS

On occasion, time-weighted returns don't appear to make sense. And, even more often, excess returns might not appear to make sense.

The reason returns may not is because they eliminate or reduce the effect of cash flows. This can cause occasions where a loss has occurred to have a positive return, which to many simply doesn't make sense.



But for excess returns, the problem is linking; they don't. Time-weighted returns geometrically link in order to capture compounding.¹ Their excess returns don't because excess returns do not compound. This can lead to funny and sometimes unexpected results.

This came up in a recent conversation with one of our verification clients. A manager had a year-to-date return of roughly 35 percent; the associated benchmark had a YTD return of about 26 percent. This translated into a YTD excess return of nine percent. The next day's return (-0.55%) was below the benchmark (-0.04%) by 51 basis points. When this additional day's results were added to the prior YTD return, they expected to see a drop in excess return of about 51 bps; however, it actually dropped by almost 70 bps: how could this be? Makes no sense!!!

The following table shows the numbers:

	R _p	R _B	ER
Period 1	35.00%	26.00%	9.00%
Period 2	-0.55%	-0.04%	-0.51%
Linked	34.26%	25.95%	8.31%

The larger the return, the greater the impact of the additional day's results. Our client wisely provided the manager with an example showing positive results; perhaps something like this:

	R _p	R _B	ER
Period 1	35.00%	26.00%	9.00%
Period 2	0.55%	0.04%	0.51%
Linked	35.74%	26.05%	9.69%

Will the difference between the annual gross-of-fee return and annual net-of-fee return be 40 bps? Let's find out.

1 Please see our October 2015 issue for more on this topic.
<http://www.spauldinggrp.com/wp-content/uploads/2014/05/NLOCT15.pdf>

2 I touched on this in an earlier newsletter (February 2012):
<http://spauldinggrp.com/wp-content/uploads/2014/05/Feb12NL.pdf>

3 It should actually be 0.09985%, but we can round to 0.10 percent; there will be no material difference in our results.

The Journal of Performance Measurement®

UPCOMING ARTICLES

Fixed Income Attribution with Carry Effect

– Tianci Dai, CFA, CIPM
Mark Elliott

The Associative Property of Attribution Linking

– Yindeng Jiang, CFA
Joseph Sáenz, Ph.D.

New Look at Multi-Period Attribution: Solving Rebalancing Issue

– Dmitry Cherkasov, CFA, CIPM

Visualization, R, ggplot2, and Applied Finance in Performance Measurement

– Rodolfo Vanzini

Contribution Fundamentals

– David Spaulding, DPS, CIPM

Here are the monthly returns for a portfolio I constructed. As you can see, the fee was removed at the end of each quarter. The difference at the end of the year is 45 basis points, not 40.

	GOF	Fee	NOF	Return Difference
January	7.09%	0.00%	7.09%	0.00%
February	0.25%	0.00%	0.25%	0.00%
March	3.77%	0.10%	3.67%	0.10%
April	9.12%	0.00%	9.12%	0.00%
May	-4.41%	0.00%	-4.41%	0.00%
June	8.64%	0.10%	8.54%	0.10%
July	-4.95%	0.00%	-4.95%	0.00%
August	-7.63%	0.00%	-7.63%	0.00%
September	0.83%	0.10%	0.73%	0.10%
October	4.25%	0.00%	4.25%	0.00%
November	3.06%	0.00%	3.06%	0.00%
December	-3.95%	0.10%	-4.05%	0.10%
Year	15.34%		14.89%	0.45%

Will the client complain, because they were overcharged? Perhaps. They weren't, of course; it just looks that way. To put their mind at ease, we could show them the results with opposite signs:

	GOF	Fee	NOF	Return Difference
January	-7.09%	0.00%	-7.09%	0.00%
February	-0.25%	0.00%	-0.25%	0.00%
March	-3.77%	0.10%	-3.87%	0.10%
April	-9.12%	0.00%	-9.12%	0.00%
May	4.41%	0.00%	4.41%	0.00%
June	-8.64%	0.10%	-8.74%	0.10%
July	4.95%	0.00%	4.95%	0.00%
August	7.63%	0.00%	7.63%	0.00%
September	-0.83%	0.10%	-0.93%	0.10%
October	-4.25%	0.00%	-4.25%	0.00%
November	-3.06%	0.00%	-3.06%	0.00%
December	3.95%	0.10%	3.85%	0.10%
Year	-16.45%		-16.79%	0.34%

Here it looks like they were undercharged! If we link the monthly fees we will get our 0.40% annual fee; however, because returns compound at varying rates, depending on their size, the differences can be quite different.

I did a blog post on this earlier in the month,⁴ and my friend Carl Bacon commented that with geometric excess returns, the numbers do link. This, of course, is true. The problem is that the geometric returns don't add up, as most folks like to see. As a result, it's also true that by far arithmetic dominates. And so, it's likely that this challenge will arise from time-to-time. The simple answer, again, is that excess returns do not link.

4 See <http://www.spauldinggrp.com/mysteries-excess-returns/>.

THE PERFORMANCE MEASUREMENT FORUM HOLDS ITS 75TH MEETING!

The Performance Measurement Forum got its start in December 1998 with a meeting in New York City. Our first European Chapter meeting was held the following October in Barcelona, Spain. We returned to Barcelona in November for our 74th meeting, and went to Austin, Texas for our 75th, also in November.

Over the past 18 years we've held meetings in a variety of locations. Our 2017 meetings will be in Seattle, Washington; Orlando, Florida; Vienna, Austria; and Rome, Italy.

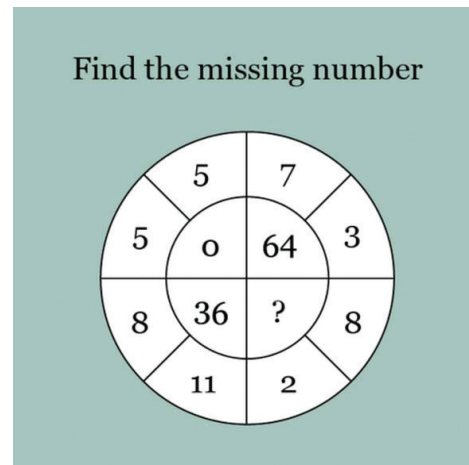
The fact that this group has grown and continues to thrive is testimony to the value it provides the industry. A few years ago we started a separate group for asset owners (Asset Owners' Roundtable), and it held its fifth meeting in Austin. And next year we will introduce a group especially for wealth managers (Wealth Managers Forum).

To learn more, please call us (732-873-5700) or contact Patrick Fowler (PFowler@SpauldingGrp.com).

PUZZLE TIME

November puzzle

Last month's puzzle was tricky. It required you to try different machinations of the given numbers to solve the puzzle.



The solution is as follows: Take the difference between the larger and the smaller of the two numbers (e., $7 - 3 = 4$). Square that number ($4^2 = 16$). Multiply that number by four ($16 \times 4 = 64$).

We see this works for 11 and 8 ($11 - 8 = 3$; $3^2 = 9$; $9 \times 4 = 36$). It's trivial to see that it works for 5 and 5.

And so, for 8 and 2: $8 - 2 = 6$; $6^2 = 36$; $36 \times 4 = 144$.

Only one person got it right: Hans Braker! Hopefully this month's puzzle will yield a few more.

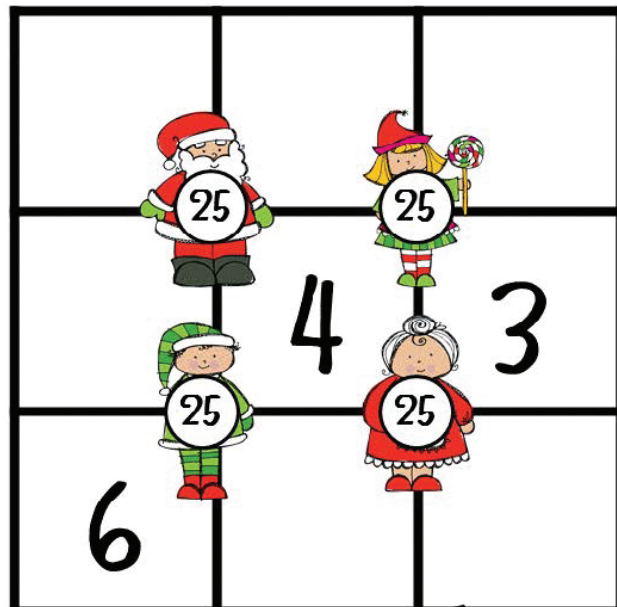
KEEP THOSE CARDS & LETTERS COMING

We appreciate the emails 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.

December puzzle

Christmas Day Math Puzzle

Christmas Day is December 25. That's why Santa's favorite number is 25. Can you put the numbers from 3 – 11 into the square so that each set of 4 numbers surrounding Santa and also the numbers surrounding each of his helpers add to 25? That means that the 4 numbers around each person would add to 25. The numbers 6, 4 and 3 have already been added for you.



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**To register simply give us a call (732-873-5700)
or go to our website, www.spauldinggrp.com/conferences/**

THE SPAULDING GROUP'S 2017 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
February 14-15, 2017	Fundamentals of Performance Measurement	Chicago, IL (USA)
February 16-17, 2017	Performance Measurement Attribution	Chicago, IL (USA)
March 7-8, 2017	Fundamentals of Performance Measurement	San Francisco, CA (USA)
March 9-10, 2017	Performance Measurement Attribution	San Francisco, CA (USA)

For additional information on any of our 2016 events, please contact Christopher Spaulding at 732-873-5700

TRAINING...

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

TO REGISTER:

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www.nasba.org

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 14-15, 2017 – Chicago, IL

March 7-8, 2017 – San Francisco, CA

15 CPE & 12 PD Credits upon course completion

CFA Institute has approved this program, offered by The Spaulding Group, for 12 CE credit hours. If you are a CFA Institute member, CE credit for your participation in this program will be automatically recorded in your CE tracking tool.



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 16-17, 2017 – Chicago, IL

March 9-10, 2017 – San Francisco, CA

15 CPE & 12 PD Credits upon course completion

CFA Institute has approved this program, offered by The Spaulding Group, for 12 CE credit hours. If you are a CFA Institute member, CE credit for your participation in this program will be automatically recorded in your CE tracking tool.



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.

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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