Performance Perspectives

with Dave Spaulding

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Our involvement with the industry isn't limited to consulting. We're actively involved as members of the Association for Investment Management & Research (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.

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Is stock level attribution all it's cracked up to be?

In life, there seem to be some universal or de facto "truths," if you will, that few seem willing to challenge; and when people do, they are sometimes ridiculed. For example, that the world is flat; that the earth is at the center of the universe; that no one can run a mile under four minutes; that man isn't supposed to fly. While these beliefs existed for quite a while, they were eventually overturned.

The world of investment performance, too, seems to have such "truths." For example, the notion that daily performance has to be better than monthly. We've seen some challenge this, which hopefully results in people taking a step back and reconsidering their beliefs. In this issue, we take on one of these "truths": that stock level attribution is better than sector level.

In the November newsletter, I discussed how stock level attribution can contribute to a larger interaction effect. This, in of itself, is probably grounds to question why we would want to do attribution at the stock level. Well, let's take a moment and consider the pros and cons to getting to this depth of detail.

One belief about stock level attribution is that it will result in more accurate sector level attribution. But does it? As we showed in the prior issue, if the portfolio isn't invested in a security that the benchmark is invested in, or vice versa, the interaction effect can be enlarged. Thus, this idea of greater accuracy seems to hold little weight.

Some attribution systems are sensitive to these situations and allow you to decide where you want this extra baggage to go – i.e., either to the selection or allocation effect. Okay, so we eliminate the problem. Fine. But why are we looking at attribution at a stock level? There are three possible scenarios to consider:

> Scenario #1 – the portfolio is in a security that the index isn't. In these cases what do the numbers tell us? What do they mean? Has the portfolio manager made a allocation decision or a selection decision? I'd suggest that this was a selection decision.
>
> Scenario #2 – the index holds a security that the manager didn't select. Again, what does the attribution details represent? And again, I'd suggest we have a selection decision – the manager decided not to pick the stock that the index did.
>
> Scenario #3 – the index and portfolio hold the same security, but with different weights. Okay, so both the index and portfolio hold Dell Computer, but the portfolio has more (or less) than the index does. Is this really an allocation decision? Some might say yes, but I think that while one can argue that the manager has allocated the funds resulting in an over (or under) weighting of Dell, it's more likely

that the actual *allocation* decision occurred at the *sector* level, when the manager decided to overweight technology. And since they *selected* Dell, they will, by default, put more of the money there.

Do portfolio managers (or their clients) really want to *look* at the selection, allocation and interaction effects at this level of granularity? I'm sorry, but I don't see why. To me, it's a lot of noise.

Wouldn't it be preferable to see the amount that the securities contributed to the overall return? Or, in the case where we aren't holding a security in the index, perhaps see what the *opportunity loss* (or contribution from not holding the security) is? We're dealing primarily with *selection*-type decisions at this level not *allocation* decisions.

In fact, we find that most managers want to focus on the top and bottom *n* securities (e.g., 5, 10, or 20), and don't want to be bothered looking at the full list. Often, if we're looking at an attribution report at this level we'll see allocation effects measured in fractions of a basis point. Does this truly provide the manager with much insight into what's going on?

Security-level details are definitely of value. I think that when a manager is looking at the sector and sees the effects in their report, they want to be able to *drill down* and see what has contributed to them. Perhaps not just looking at the holding but also to the trade(s) that resulted in them. This has value. At this level, we're not talking about attribution in the same way that we do at the sector level.

An article by Dan diBartolomeo (Spring 2003) was titled "Just Because We Can Doesn't Mean We Should." I suggest that the same statement applies here – just because we *can* do stock level attribution doesn't mean we *should*.

But, I'm not in the trenches each day. Perhaps you have a different view. We heard from several individuals about our last issue, so please, let us know what you're doing with this level of detail and how it's providing extra value for your firm and clients. Perhaps provide some samples to demonstrate how the stock level attribution answered questions and gave you valuable insights into what occurred.

Please e-mail me at DSpaulding@SpauldingGrp.com with your comments or fax the reports to us at 001-732-873-3997.

Pardon the interruption

The subject of stock versus sector level attribution is just one of several areas where we find controversy in the performance measurement industry. At this past May's PMAR™ conference, Carl Bacon and I took on what could be called a "Battle Royale" regarding the subject of geometric versus arithmetic attribution. We did this in a rather playful way, but still managed to get our points across.

At the next PMAR conference, we will see another Battle Royale – this time on the subject of holdings verus transaction-based attribution. Neither Carl nor I will participate in this debate, but we will take on a host of topics in a segment we're calling "Pardon the interruption." You may be familiar with the program on cable television channel ESPN with the same name (which inspired this session). Carl and I will debate a variety of topics, in a rather *crisp* fashion, which again should be fun and informative.

Some clarity on carve-outs

In general, performance measurement professionals have a good understanding of what we mean by *carve outs*, when it comes to the GIPS® or AIMR-PPS® standards. That is, to allow a firm to *carve out* or *slice away* a portion of a portfolio and include it in a composite (i.e., to not include the entire portfolio, but a piece of it). And since the standards require the inclusion of cash, we are faced with the requirement to include a portion of the cash return with the carved out piece.

I was fortunate to have sat in on the first session dealing with *how to deal with carve outs* which AIMR sponsored in early 1993. We recognized that the ideal situation, yielding the most accurate return for the carve out, would be to either have a separate cash account (or "bucket") for the carve outs or to have them setup as separate sub-portfolios or portfolios. But we also recognized that this may not always be feasible, from both a portfolio accounting system and custodial record keeping perspective, so opted to allow for an *allocation* of cash to the carve out, providing that the approach was decided upon (a) in advance (i.e., to avoid *cash allocation optimization),* (b) that the method used was consistently applied, (c) that the method wasn't *arbitrary*, and (d) ideally, that it tied back to the asset allocation strategy. Also, that the carve out should represent the kind of return that one might expect had the investments been in a single asset class portfolio (instead of a balanced portfolio).

In the States, most people who deal with carve outs do so with *balanced* portfolios, where the manager *carves out* the bond and/or equity portion. Allocating cash can be done in a variety of rather straightforward ways, which under most circumstances provide returns which we would feel are reasonable. And many (if not most) firms have adopted an *allocation* approach since becoming compliant with the AIMR-PPS.

When GIPS was introduced, it came with a provision

that effective 1 January 2005 cash allocation would no longer be allowed and that firms would have to adopt a more accurate method (such as separate cash accounts or sub-portfolios). This was done, I believe, because some firms were slicing up their portfolio like one might slice up an apple pie when you realize that you have more guests then you planned – into many small pieces (e.g., the German equity piece or the UK corporate bonds slice from a European portfolio).

Since we expect the carved out piece to represent the kind of performance we'd see in a single asset class portfolio, one becomes a bit suspicious when they see a portfolio sliced into so many pieces.

But is it fair to require managers who don't engage in such aggressive slicing up to have to make changes to their systems or forgo the carve outs in the future? I don't believe so.

While I fully understand the rationale behind the anticipated change to GIPS, I would hope that it would be broadened to allow firms who merely slice at the asset class level, and no deeper, to continue to do so. Verifiers should be encouraged to review the approach and insure that the rules are followed.

The draft for Gold GIPS will soon be going out for public comment (we anticipate this happening in mid-to-late January). I intend to comment on this. If you agree with me, you should, too! And, if you don't agree, feel free to voice your opinion, too (but not too loudly!).

This newsletter is produced by TSG Publications. It is written and edited by Dave Spaulding. The opinions expressed are his and are a result of his own industry experience.
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Some hints for dealing with GIPS®/ AIMR-PPS®

What firms should have policies and procedures for:

1. How you calculate performance (your formula(s)
2. Composite Construction
3. Process for handling new accounts
4. Process for termination/portfolios
5. Change in styles/ strategy
6. Discretion
7. Minimum Account Size
8. How you calculate Gross of Fee returns
9. How you calculate Net of Fee returns
10. Pricing procedures/ sources
11 Treatment of cash flows
12. Temporary removal of portfolios
13. Policy on reporting
14. How you handle as-of adjustments to returns
15. Portability issues -- how were mergers/acquisitions handled
16. Corporate action processing
17. Carve-outs
18. Measure(s) of dispersion
19. Initial Composite Construction the composites).

Reasons why a portfolio may not be in a composite:

1. New account - hasn't been under management long enough to be included.
2. Terminated account
3. Below minimum asset size
4. Large cash flow has occurred
5. Change in investment style
6. Non-discretionary
7. Non-fee paying

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UPCOMING TRAINING DATES

INTRODUCTION TO PERFORMANCE MEASUREMENT

LOCATION	DATES	VENUE
New York, NY	February 10 - 11, 2004	TBA
London, England	February 23 - 24, 2004	TBA
Chicago, IL	April 21 - 22, 2004	TBA
San Francisco, CA	May 4 - 5, 2004	TBA

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New York, NY	February 12 - 13, 2004	TBA
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(www.aimr.org/memservices/continuinged/ceprogram)

2003
Performance Measurement Forum Schedule

May 6 - 7, 2004 - San Francisco, CA
June 9 - 10, 2004 - Edinburgh, Scotland
November 10 - 11, 2004 - Madrid, Spain