Performance Perspectives

with David Spaulding

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A new version of the standards has arrived!

I'm quite excited to be able to discuss what the new performance measurement presentation standards entail. As a member of the Investment Performance Council (IPC), we took a secret oath which prohibited us from talking about the final version of GIPS®[1] until it was approved by the CFA Institute's Board. Well, approval came on February 4, so we can now discuss it.

Here are some of the key changes:

#1 Firms must provide a compliant presentation to all prospective clients.

This provision was already part of the AIMR-PPS®. It essentially says what it means: GIPS-compliant firms are obligated to provide prospects with a copy of the presentation that's appropriate for what they're looking for.

#2 Firms must have written policies and procedures.

This was previously implied, since the standards required verifiers to review them; now, it's crystal clear: you've got to have such documentation. For a list of suggested documents, visit our website.[2]

#3 Firms must abide by guidance statements and interpretations

The original wording included the GIPS Handbook. However, this was dropped since both the guidance statements and interpretive documents contain everything that would be in the handbook.

This is important, since new versions of GIPS will only be introduced every five years or so. But, in the interim, we'll see clarification come out via this documentation, so it's important that you monitor the progress of the IPC.[3]

#4 Compliant firms must provide a list and description of composites to prospects, upon request.

The requirement for a compliant firm to disclose "the availability of a complete list and

[1] For the most part, we'll be referring to "GIPS." By virtue of the fact that the AIMR-PPS, SAAJ, UK-IPS, etc. are *Country Versions of GIPS* (CVGs), anyone complying with one of these are also obligated to follow these changes. If this is unclear, e-mail us and we'll be happy to explain.

[2] Also, if you need assistance preparing these or want them reviewed, we can help. Contact Christopher Spaulding for details (732-873-5700; CSpaulding@SpauldingGrp.com).

[3] A good way to do this is by signing up for the "alert list" by visiting the CFA website. It's free and will result in you getting e-mails of any changes or newsworthy events.

description of all of the firm's composites" has always been present in the standards; however, as silly as it may sound, it wasn't explicitly stated that you had to actually have such a list (just the disclosure).[4] So now you know: you've got to have the list, too!

#5 You must asset-weight composites at least monthly

If you look closely at the 1999 GIPS standards, you'll see that there was no requirement for any specified period for asset weighting the composite. It essentially implies that you've got to calculate the returns at least annually (since annual results are needed), but nothing more. But since January 2001 firms have had to value their portfolios at least monthly. I think the intent was that composites, too, were to be valued at least monthly, but this wasn't stated. Now it has been.

#6 Must value portfolios as of calendar month-end

Most firms do this, any way. There are exceptions (which will no doubt surprise a lot of folks). It's not unusual in some segments of the industry to see firms value their accounts on the last Friday of the month, to allow for the weekend to "close the books." However, for compliance with the standards, the end date must be the month-end, to insure consistency and comparability of results.

#7 Firms must disclose that calculation methods and valuation sources are available upon request

This is a **new disclosure** you'll have to add to your presentation materials. I would expect that some interpretive language will be forthcoming to provide some guidance on what the documentation should include. I'd suggest the following, at a minimum:

- the formula(s)[5] you currently use to calculate portfolio returns
- the formula(s)[6] you use to calculate the composite returns
- any changes that have occurred to these methods[7]
- if you revalue for large flows, you should (a) state this and (b) explain what you mean by "large." (see below)
- what sources you use to value your portfolios (both prices and exchange rates). If you will occasionally override a price (e.g., for a bond), you should explain this and what process you use to arrive at the price.

#8 You must disclose the description of the composite's investment objectives, style, strategy

If you think about it, it's funny that this hasn't been a requirement all along. You were to have a list and description of your composites, but the description of the composite you were handing out wasn't required (at least on that document itself). Now it is! Thus, we have another disclosure.[8]

The standards also contain other changes:

#1 The prior anticipated requirement to accrue for dividends is now a recommendation

Standard 1.A.6 mandated such accruals effective 1 January 2005. However, this was dropped and made a recommendation. This is good, since it (a) only benefits you to accrue, (b) is an added expense, and (c) in many cases, won't make much of a difference. So, rather than force you to accrue, it's your choice.

#2 The requirement for daily valuations of portfolio returns becomes a requirement in 1 Jan 2010, but for "<u>large</u>" cash flows

[4] I realize this is silly, but I've encountered numerous firms that had the disclosure but not the list!

[5] It's not unusual, especially when firms have both separate accounts and mutual funds, for firms to have multiple calculation methods for their portfolios.

[6] It's not clear why you might employ different formulas to calculate composite returns, but if you do, you need to state this.

[7] For example, prior to January 1, 2005, you could have used the Original Dietz Method (which weights cash flows at the mid-point of the period). But, since that date, you have to at least day-weight the flows (e.g., the Modified Dietz formula). So, if you previously used the Original Dietz but changed in January to the Modified Dietz, you should state this.

[8] Many (if not most) of the firms we've dealt with had such a description, any way, so this probably won't be new for many compliant firms.

This was one of the most hotly debated topics of the standards. The original requirement was to revalue for any external[9] cash flow. I, along with many others, felt that this was an onerous requirement that would yield little benefit. However, to require the revaluation for "large" flows makes sense (it's been a recommendation).

The Modified Dietz is a wonderful formula, and works quite well in approximating the *true, time-weighted return* of your portfolios. However, when flows get large, especially during volatile markets, the results can be misleading.

What's large? That's up to you to define. We recommend 10 percent.

#3 The requirement for carve-out segments to be managed with their own cash has been shifted from 1 Jan 2005 to 1 Jan 2010

This will be a welcome change for many who currently employ an *allocation method* to handle their carve-outs. I, along with many, wanted no date at all. Well, we got 2010 (for now). We can try again in five years.

At this point you may be wondering, "so what about mandatory verification?" Well, it's been dropped! Hallelujah! As one who debated this with several folks, I'm quite pleased that this proposed requirement didn't hold.

The requirement to use trade date accounting as of 1 January 2005 remains, but you may be surprised what trade date means. We'll take this up in our next newsletter.

I want to take a moment to congratulate the Investment Performance Council for this major change to the standards. A tremendous amount of work went into it. Special recognition goes to the Country Standards Subcommittee (CSSC), which managed the process; its chairman Glenn Solomon; the IPC's chair, James (Jamie) Hollis; and the CFA Institute's Alecia Licata, who was responsible for much of the work to get this accomplished.

The original plan was for these changes to go into affect 1 January 2005. Well, for a lot of good reasons the date has been shifted to 1 January 2006. So, if you comply with GIPS and/or any of the CVGs, you've got to make some changes between now and next January if you want to be able to continue to claim compliance.[10]

Following up on last month's example

In the January issue of the newsletter, we presented a scenario where two mutual fund investors got the same time-weighted return, even though one made money and the other lost money. We showed their money-weighted returns, which were different and probably more logical. We promised to explain how we did the math. Well, here it is:

Table 1 shows how each investor made their respective purchases during the month. We also show the days in each month as well as the weights. We use this information to calculate our returns.

We're going to calculate the Internal Rate of Return for each investor. But to do that, we need to perform an iterative process, in an attempt to find the correct return. The Modified Dietz can be used as the first approximation to what the actual IRR is, so let's begin with that. And, to do that, we need to come up with the weight (since we're dealing with *weighted flows*). And since we're only valuing the portfolio twice (at the start and end of the year), the weight is for the full year. For example, Investor #1 purchased 100 shares on May 31st. What weight does this represent? If you look at the "Days" column in the table, you see the number of days leading up to and including May (31, 28, 31, 30, 31). We add these together, to get the *day of the cash flow* (the result is 151).

9 By "external," we mean flows that come into (i.e., deposits of cash and/or securities) or leave (i.e., withdrawals) a portfolio. "Internal" flows occur at the sub portfolio level (e.g., a sale of a tech stock, where the proceeds are moved to cash).

10 If you need help with any of this, contact Chris Spaulding (CSpaulding@SpauldingGrp.com).

Table 1 : Investor Details					
Month	**NAV**	**Investor #1**	**Investor #2**	**Days**	**Weights**
Jan.	**10**	1000	1000	31	
Feb	**11**			28	
Mar	**12**			31	
Apr	**8**		800	30	0.671233
May	**14**	1400		31	0.586301
Jun	**9**			30	
Jul	**11**			31	
Aug	**15**	1500		31	0.334247
Sep	**9**		900	30	0.252055
Oct	**10**			31	
Nov	**9**			30	
Dec	**11**			31	
Total Investment		3900	2700	365	
	EMV =	3300	3300		
	Gain/Loss	(600)	600		

Our formula for the weight is:

$$W = \frac{CD - D}{CD} = \frac{365 - 151}{365} = 0.586301$$

You can see that this value is in the "Weights" column, along with the respective weights for the other three cash flows. We can now calculate the Modified Dietz for both investors. Here's the math for Investor #1:

$$ModDietz_{\#1} = \frac{EMV - BMV - \sum C}{BMV + \sum W \times C} =$$

$$\frac{3300 - 1000 - (1400 + 1500)}{1000 + (0.586301 \times 1400 + 0.334247 \times 1500)} = -25.84\%$$

You're invited to calculate it for Investor #2.[11] The answer is 34.02%.

Now that we have these values, we can derive the respective IRRs. We need to take into consideration the timing of cash flows. We raise them to a power that reflects the timing. For simplicity, I used the month that the flow occurred, rather than days. For Investor #1:

$$IRR_{\#1} = 1{,}000 + \left(\frac{1{,}400}{(1+r)^{5/12}}\right) + \left(\frac{1{,}500}{(1+r)^{8/12}}\right) - \left(\frac{3{,}300}{1+r}\right) = 0$$

Now, we have to find the *r* which will satisfy this equation. Table 2 shows the process I went through, beginning with the Modified Dietz return we just calculated.

As you can see, the return that came closest to solving this equation (i.e., to get a value of zero) was -24.86%. That's our solution.

We invite you to try it for Investor #2. You should get the result 35.16%.

Table 2: Iterative Process to find the IRR

Investor #1 IRR	
0.00%	(33.2)
27.00%	947.9
-26.00%	(38.9)
-25.50%	(21.6)
-25.00%	(4.6)
-24.00%	28.6
-24.90%	(1.2)
-24.80%	2.1
-24.85%	0.5
-24.86%	**0.1**
-24.84%	0.8
-24.87%	(0.2)

11 If you can't get the correct answer, e-mail me and I'll provide you with the solution.

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