PERFORMANCE PERSPECTIVES with David Spaulding

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BEST PRACTICE…DEFINED…OR PERHAPS, NOT

We often hear the term "best practice" tossed around, with firms wishing to calculate their returns or report to their clients in adherence to "best practice." But what is best practice? I recently blog posted[1] on this topic, although I had an earlier post[2] which I'll refer to as well.

In the history section of the Global Investment Performance Standards (GIPS®) we find:

> "In 2008, the GIPS Executive Committee began its review of the GIPS standards in an effort to further refine the provisions as well as eliminate provisions that are no longer necessary and add new requirements and recommendations that promote best practice."[3]

Under the "objectives" section of the preamble we find:

> "The establishment of a voluntary global investment performance standard leads to an accepted set of best practices for calculating and presenting investment performance that is readily comparable among investment firms, regardless of geographic location."[4]

In this section we also learn that one of the "goals of the GIPS Executive Committee [is to] establish investment industry best practices for calculating and presenting investment performance that promote investor interests and instill investor confidence."[5]

In addition we learn that "[f]irms should also adhere to the recommendations to achieve best practice in the calculation and presentation of performance."[6] In other words, recommendations are deemed "best practice." The term appears several more times but nowhere do we find a definition for it.[7]

A Google search of "best practice" provides a variety of definitions, including:

- "A best practice is a technique, method, process, activity, incentive, or reward which conventional wisdom regards as more effective at delivering a particular outcome than any other technique, method, process, etc. when applied to a particular condition or circumstance. The idea is that with proper processes, checks, and testing, a desired outcome can be delivered with fewer problems and unforeseen complications. Best practices can also be defined as the most efficient (least amount of effort) and effective (best results) way of accomplishing a task, based on repeatable procedures that have proven themselves over time for large numbers of people."[8]

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1 http://investmentperformanceguy.blogspot.com/2011/01/best-practice-when-it-comes-to-rates-of.html

2 http://investmentperformanceguy.blogspot.com/2010/02/so-what-is-best-practice.html

3 See page IV, *Global Investment Performance Standards*. 2010.

4, 5 Ibid. Page 1.

6 Ibid. Page 2.

7 In my comment letter to the GIPS 2010 Exposure Draft I recommended that a definition be included in the glossary. See http://www.gipsstandards.org/news/releases/2009/pdf/david_spaulding_comment14.pdf

8 http://en.wikipedia.org/wiki/Best_practice

The Journal of Performance Measurement®:

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– Eric A Stubbs and Enrique Jaen

- "A best practice is a technique or methodology that, through experience and research, has proven to reliably lead to a desired result."[9]
- "'Best practice' is a phrase used to identify a documented way of achieving a specific result under specific circumstances in an effective way. It is a concept based on lessons learned by one group that are passed on to other groups."[10]
- "A superior method or innovative practice that contributes to the improved performance of an organization under given context, usually recognized as 'best' by other peer organizations."[11]
- "The methods and achievements of the recognized leader(s) in a particular field."[12]

I found the following of interest: "There is no universally accepted definition of a 'best practice.' However, as the definitions below indicate, a 'best practice' is a practice that upon rigorous evaluation, demonstrates success, has had an impact, and can be replicated."[13]

Suffice it to say, there are loads of definitions. But which one, if any, can we apply to GIPS or for that matter, anything we do in performance and risk measurement / reporting, which one might want to say is "best practice"?

Let's consider some of these (and other) definitions:

- <u>The practice that produces superior performance</u> – probably not what the EC (Executive Committee) had in mind.
- <u>A superior method or innovative practice that contributes to the improved performance of an organization under given context, usually recognized</u> – again, not really what is probably intended within GIPS.
- <u>The methods and achievements of the recognized leader(s) in a particular field</u> – while I think this is much closer, is there evidence that this is the case? For example, the new recommendation to "provide each existing client, on an annual basis, a compliant presentation of the composite in which the client's portfolio is included"[14] is, to my knowledge, not being done today by very many firms at all. While this might be a desirable definition, many would argue that it doesn't apply (who are the recognized industry leaders who do these things?).
- <u>The most desirable or most effective level of activity, which becomes a standard to which other practices are compared</u> – while this seems good, desirable by whom? And the standard is the standard.

If we boldly label all recommendations as "best practice" then there should be some understanding as to what the term means, shouldn't there? If you say "well, we all know what is meant," then fine, please put in writing what is meant.

9 http://searchsoftwarequality.techtarget.com/definition/best-practice

10 http://www.wisegeek.com/what-are-best-practices.htm

11 http://thiyagarajan.wordpress.com/glossary/

12 http://www.et.teiath.gr/tempus/glossary.asp

13 http://info.k4health.org/practices.shtml

14 ¶ 0.B.4. *Global Investment Performance Standards*. 2010.

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We are often asked what is "best practice." When I offer an opinion it's usually based on what I think would be "best practice." The problem here, of course, is that my view can be different than others.

Is it really best practice, for example, to update GIPS presentations quarterly[15] or to disclose if a composite contains proprietary assets.[16]

When someone declares something to be "best practice," what is this based on? Should we care?

I recently posted a question regarding what the term means on the Performance Measurement Forum's Linkedin group site, and received a few responses. For example:

- Douglas Lempereur offered "I would say 'best practice' means, in its most basic sense, 'doing the right thing' for clients, for regulators, and for the industry, which in the long run will benefit the firm by enhancing its reputation as a financial services provider (thereby attracting more clients) and as a place to work (thereby attracting talented investment professionals). Included in 'doing the right thing' is having proper policies and procedures in place, appropriate checks and balances, and good risk management, all of which will mean better service to clients, better risk control to avoid disasters, and therefore better results over the long term."
- John Simpson wrote "I think before defining 'best practices,' we must first consider what are the definitions of 'practice' and 'common practice.' Practice: one's repeated or customary action, one's way of doing something . Common practice: the usual way of doing something; a way of doing something that is shared by several or many people or entities. (In the above I have taken some liberties with Merriam Webster definitions.) Thus, I would say that 'best practices' are: ways of doing something which are the best interests of the beneficiaries of our services (our clients), promote the integrity of capital markets, foster trust in the industry and support the ideas behind the professionalism we attest to. These include obtaining and maintaining our expertise and placing our clients interest first. I would also note that best practices need not be common practices, but our goal should be to promote best practices so that they become as common as possible."

Both great ideas, right? Perhaps we can, through some collaboration, arrive at something we can gain some consensus on, so that when we hear "best practice" being offered, we will agree.

FROM OUR READERS…

We have received a number of responses to our newsletter.

Jed Schneider offered a comment on our November issue:

"I hope all is well. I wanted to comment on the article regarding returns on Employee Stock Purchases (ESP). I agree with the results John received based on making a 15% gain on the purchase of the stock. However, I would have looked at this another way based on my interpretation and experience with an ESP. At my old company, we had an ESP that allowed the employee to purchase stock at a 15% discount. That being said, the return on

15 ¶ 5.B.9. *Global Investment Performance Standards*. 2010.

16 ¶ 4.B.8. Ibid.

Upcoming Events:

January 26, 2011

Ortec Finance institutional Seminar (Pfäffikon SZ)

March 28-29, 2011

2011 First Rate Performance Conference

Arlington, Texas Sheraton Hotel

Conference website can be found here

http://www.firstrate.com/about-first-rate/events

February 3, 2011

PEARL Seminar

(Zürich)

February 11, 2011

9:00 am

Best of Breed vs. One Stop Shopping: Pros, Cons and Challenges in Middle Office Analytics.

A webcast and dialog with David Spaulding, CIPM hosted by DST Global Solutions.

February 17, 2011

11:00 am

Hedge Fund Risk webcast

with Dr. John Longo, CFA, Edge Financial Group.

the immediate sale would be 17.65% (your article assumes a 15% gain, which would result from a 13.04% discount). Assume you started with $85 in cash and one share of stock equaled $100. You can buy 1 share at $85, sell it for $100 and get a 17.65% return. (Of course in the case of starting with $100, you may not be able to purchase fractional shares, but for the purpose of my argument, you can.)"

Andre Mirabelli offered the following in response to our last issue:

*"I agree with your comment on Hurdle rates: They should be added to and not compounded with the ytd return. But instead of adding an additional constant one twelfth of the Hurdle (H) each month giving a total arithmetically supplemented arithmetic hurdle on the nth month = (n*H/12), one can add an additional monthlyized Hurdle each month giving a total geometrically supplemented arithmetic hurdle on the nth month = (1+H)^(n/12)-1. In both cases, the goal will end up being at the end of the year that the fund beat the benchmark exactly by the additive amount H.*

"The differences will usually be small; in this case, instead of your addition of an additional 83.3bp/M, I range from adding an additional 82.9 to 83.6bp/M. But adding this geometrically increasing term, instead of adding the arithmetically increasing term you suggest, better takes into account the fact that an increased basis (caused by having achieved the hurdle up to a point in time) is an advantage in achieving a greater arithmetic difference in the future. In the more difficult case to beat, when the monthly benchmark returns vary a lot, this quasi-geometric approach will give a more uniform geometric factor over the actual benchmark as the monthly goal that needs to be achieved."

Tim Ryan, also in response to last month's issue, offered the following:

"I wanted to reply to your 'net of fee returns…frequency of applying the fee' commentary in the December 2010 Performance Perspectives. As usual, it was good provocative writing.

"There are 3 aspects to further consider on this topic (primarily in regards to prospective rather than existing clients).

"First, is a model representative fee can be applied to compute composite net of fee return streams so applying actual fees is not the only option. Additionally, applying actual fees of underlying portfolios may not always be the most representative to a particular prospect if actual portfolios have much higher asset bases rendering the existing clients paying lower effective fees, on a sliding scale of assets fee schedules, than the prospect. Also, the actual timing of fee paying may be inconsistent across portfolios (based upon billing cycles or start dates, client negotiations, among a myriad of potential reasons) and may be more subject to client control than investment manager control.

"Second, the frequency of fee application to arrive at net returns (between monthly and quarterly) can make a difference. Situationally, the difference can be below a basis point or above a number of basis points, depending upon the timing of applying the fee and the particular magnitude (size and direction) of the gross-of-fee returns in the stream (including more opportunity for larger swings in return magnitude across longer timeframes such as 60-months or greater). Given GIPS' return calculation periodicity, and its components, being primarily monthly (or less) having the fee accrual be monthly for net of fee returns seems most consistent.

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.

"Lastly, returns are not the only consideration; impact to portfolio values from fees are important and/or necessary. The U.S. Securities and Exchange Commission clarifies that point in its September 23, 1988 No-Action Letter reply to the Investment Company Institute's letter dated May 3, 1988. In it the Commission notes "…a representative example (e.g., a cable, graph, or narrative), which shows the effect an investment advisory fee, compounded over a period of years, could have on the total value of a client's portfolio." The frequency at which a portfolio's value is lowered (monthly or quarterly) through fee deduction does impact the portfolio's terminal and intermediate values by which the portfolio can grow/shrink through compounding into the subsequent period's/periods' return(s). The full no-action letter and other regulatory citations should be reviewed for further information and specific applications."

And finally, from Alice Main:

"I enjoyed your article in the newsletter. You said, '…when it comes to reporting returns to your clients, I see no reason to accrue: take the charge at the time it hits.' The problem is that the fee does not always "hit." We accrue fees daily at the portfolio level, because not all clients pay their fees from the account we manage."

We greatly appreciate our readers' comments and insights.

THE SPAULDING GROUP'S 2011 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
February 8-9, 2011	Fundamentals of Performance Measurement Training	Los Angeles, CA (USA)
February 10-11, 2011	Performance Measurement Attribution Training	Los Angeles, CA (USA)
March 8-9, 2011	Fundamentals of Performance Measurement Training	Boston, MA (USA)
March 10-11, 2011	Performance Measurement Attribution Training	Boston, MA (USA)
March 21-22, 2011	CIPM™ Principles Exam Preparation Class	Chicago, IL (USA)
March 23-25, 2011	CIPM™ Expert Exam Preparation Class	Chicago, IL (USA)
April 11-12, 2011	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
April 13-14, 2011	Performance Measurement Attribution Training	Chicago, IL (USA)
May 16-17, 2011	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
July 12-13, 2011	Fundamentals of Performance Measurement Training	Toronto, Ontario
July 14-15, 2011	Performance Measurement Attribution Training	Toronto, Ontario
August 22-23, 2011	CIPM™ Principles Exam Preparation Class	New Brunswick, NJ (USA)
August 24-26, 2011	CIPM™ Expert Exam Preparation Class	New Brunswick, NJ (USA)
September 20-21, 2011	Fundamentals of Performance Measurement Training	San Francisco, CA (USA)
September 22-23, 2011	Performance Measurement Attribution Training	San Francisco, CA (USA)
October 11-12, 2011	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
October 13-14, 2011	Performance Measurement Attribution Training	Chicago, IL (USA)
December 6-7, 2011	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
December 8-9, 2011	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2011 events, please contact Christopher Spaulding at 732-873-5700

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February 8-9, 2011 – Los Angeles, CA
March 8-9, 2011 – Boston, MA
April 11-12, 2011 – Chicago, IL
May 16-17, 2011 – New Brunswick, NJ
July 12-13, 2011 – Toronto, Ontario
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March 10-11, 2011 – Boston, MA
April 13-14, 2011 – Chicago, IL
July 14-15, 2011 – Toronto, Ontario
September 22-23, 2011 – San Francisco, CA
October 13-14, 2011 – Chicago, IL
December 8-9, 2011 – New Brunswick, NJ

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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.

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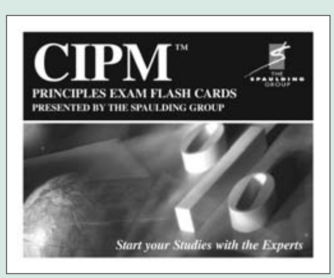

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