VOLUME 9 – ISSUE 5 JANUARY 2012

MORE ON WHY NEGATIVE SHARPE RATIOS *MAY* MAKE SENSE

I took up this topic some time ago, and offered a few ideas as to how one might rationalize why negative Sharpe Ratios make sense. Recall that Bill Sharpe, himself, chimed in, and found a flaw in my approach (pointing out correctly that one cannot have a negative standard deviation).

And so, I was teaching a class for a client in Canada recently, and (as usual) addressed this topic. However, I graphed my rationalization idea, but this time avoided the negative risk, and *think* what I have is a bit better.

Let's begin on the *positive* Sharpe Ratio side of the ledger (see Figure 1). We see that the values align with our table; that is, our portfolio has a higher standard deviation than the benchmark, but ends up with the same return. And, as noted in the graphic, our *expectation* is that we would get a higher return (given the higher risk taken); but instead, our return matches the benchmark's, so we get a lower Sharpe Ratio.

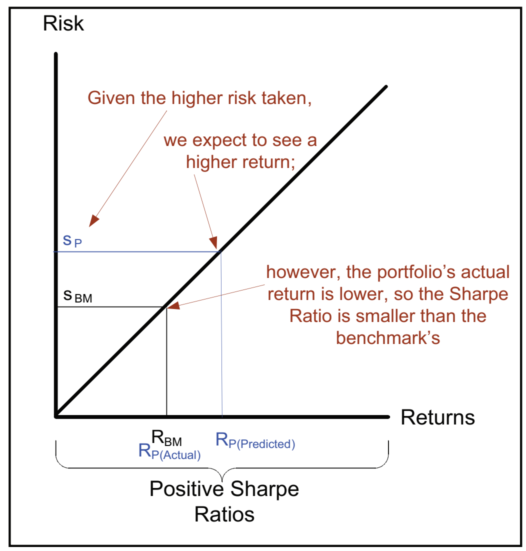

Figure 1

Now, let's turn to Figure 2.

Here, we have the *negative* side. And what we have is a *mirror image* of the positive: the portfolio again has a higher risk than the benchmark. Because of this higher risk, given that the benchmark's return is negative, it is reasonable to expect to see a *more negative* return for the riskier portfolio. However, because it's return is actually higher than anticipated, equaling the benchmark's, our Sharpe Ratio is higher than the benchmark.

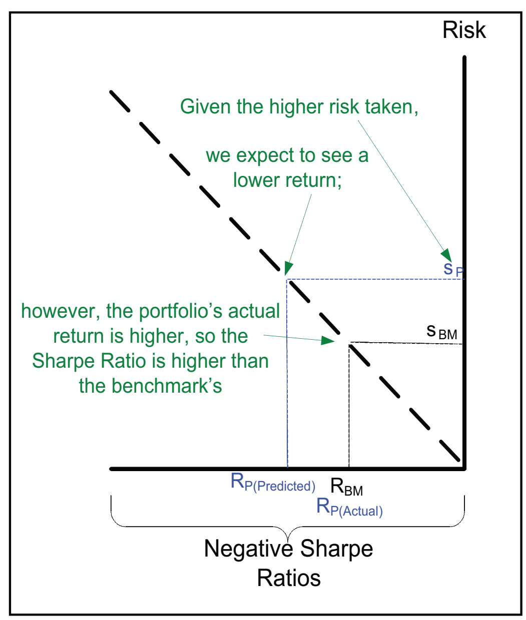

Figure 2

With a higher Sharpe Ratio, we expect when the benchmark's return is

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UPCOMING ARTICLES

positive, for the portfolio to have a higher return; and when the benchmark is negative, we expect to see a larger negative (i.e., worse return). However, if the portfolio doesn't perform as well on the positive side, a lower Sharpe Ratio can result; likewise, if the portfolio does better than we would have expected, why is it surprising to see a higher Sharpe Ratio?

I hope this makes some sense. If you have any thoughts on it, please pass them along.

TRUST: IS IT ALL THAT IT'S CRACKED UP TO BE?

In a recent blog post[1] I commented on the subject of trust. Our industry seems to have suffered a great deal of late in discovering cases where trust was misplaced. Here I am thinking first of Bernie Madoff, and more recently, the company my former governor, Jon Corzine, ran: MF Global.

You're no doubt familiar with Stephen R. Covey, the motivational speaker who brought us the highly successful, Seven Habits of Highly Successful People. His son, Stephen M.R. Covey is the author of The Speed of Trust. I had the chance to hear him speak recently, and found his comments quite insightful.

As I often do, I tried to apply some of his thinking to our business, and concluded that when our firm is engaged by a client, both of us are putting a certain degree of trust into the process. To make it easier for new clients, we offer a "promise," which we believe is very unique.

We, too, commit to a certain degree of trust, when we enter into a relationship with a client, especially our GIPS® (Global Investment Performance Standards) verification clients.[2] Occasionally, early in the relationship we pick up signals that perhaps this isn't an individual or firm we really want to do work with, and so we don't pursue them. I can say with great confidence that we have a lot of trust in all of our clients, and we love that it is this way.

Covey explained that there are two important aspects of trust: character and competence. To gain our full trust, one must have both. To have character without confidence, we know that the person will strive hard to do a good job, but won't fully know enough to be successful, and so will need our support, counsel, and guidance. If the person is highly competent but lacks character, then there is nothing we can do for them.

1 http://investmentperformanceguy.blogspot.com/2012/01/value-and-necessity-of-trust.html

2 Please visit http://www.spauldinggrp.com/services/verification.html for more information.

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In the case of our clients, if we suspect that their character is such that they aren't trust worthy, regardless of their competence, we won't be comfortable continuing a relationship. As for their competence, we must assess where they stand, so that we can provide the appropriate amount of support, as well as due diligence.

We hope that our character speaks for itself; for example, our aggressive opposition to GIPS Performance Examinations, which would only bring us more revenue, we believe is a testament to our honesty.[3] And, we hope that our years of experience and dedication to performance measurement provide the basis for trust when it comes to our competency. Evidently this isn't always the case, but is most of the time.

Trust, is a proverbial "two way street," requiring both parties to feel comfortable trusting the other. Our objective is to be seen as a trusted advisor to our clients; someone they can call upon when they have questions, issues, or challenges. We have succeeded in having clients who are highly trustworthy, making our relationships exceptional, and highly productive.

3 Please do not interpret this to mean that firms that encourage examinations are somehow dishonest or lacking in character; we believe this is a matter of position, and no doubt many firms believe these exercises have value; we don't.

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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)
April 17-18, 2012	Fundamentals of Performance Measurement Training	Toronto, Canada
April 19-20, 2012	Performance Measurement Attribution Training	Toronto, Canada
April 26-27, 2012	Performance Measurement Forum	Atlanta, GA (USA)
May 21-22, 2012	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
May 22, 2012	GIPS® Workshop	Philadelphia, PA (USA)
May 23-24, 2012	Performance Measurement, Attribution & Risk Conference (PMAR)	Philadelphia, PA (USA)
June 11, 2012	GIPS® Workshop	London, England
June 12-13, 2012	Performance Measurement, Attribution & Risk Conference (PMAR Europe)	London, England
June 14, 2012	Fundamentals of Performance Measurement Workshop	London, England
June 21-22, 2012	Performance Measurement Forum	Dublin, Ireland

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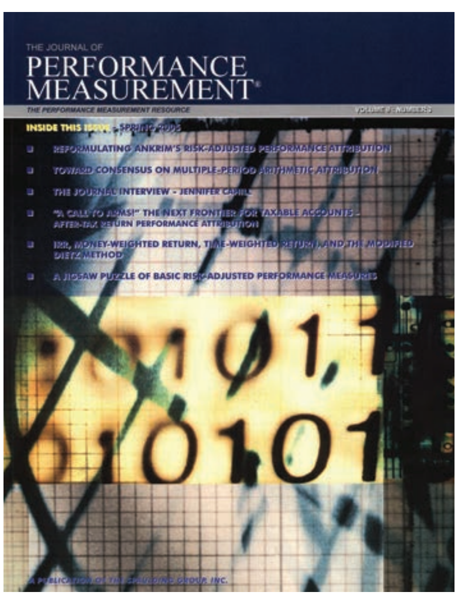

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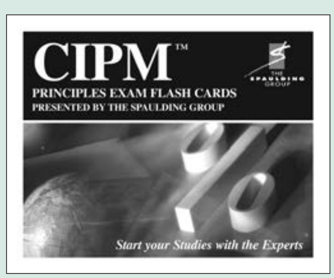

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