

# 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](mailto:CSpaulding@SpauldingGrp.com)

This issue will be a bit shorter than normal owing to (a) our busy schedule, (b) it being the summer (poor excuse, I know), and (c) that we're getting ready for our first "Performance Boot Camp."

## I OBJECT!<sup>1</sup>

I just discovered a conflict between what's in the GIPS handbook and what's in a class we teach for the CFA Institute, dealing with discretion. One of our exercises lists several scenarios and we ask the students to indicate whether the account would be discretionary or nondiscretionary. One of these reads as follow: "Client account often has large cash inflows and outflows." The answer sheet shows that this situation should be "Discretionary." Recall that we do allow firms to *temporarily remove* an account from a composite in the event of significant cash flows, but this is an option.<sup>2</sup> We would still (as this exercise suggests) consider this account to be discretionary.

Well, I recently encountered a situation with a client who had chosen to classify accounts with frequent cash flows as nondiscretionary. I took exception to this, given my history with this class as well as other comments I've heard over the years.

I then went to my trusty "GIPS Handbook" to see what was written about discretion (in the Composite Definition Guidance Statement (adopted 13 March 2002)). On the second page of the guidance we find "Examples of client-imposed restrictions that may cause a portfolio to be classified as nondiscretionary," which includes "Cash flow requirements (e.g., the client requires large cash distributions on a regular basis)."

Correct me if I'm wrong, but this appears to be a conflict. So, which is right?

I recall more than ten years ago a few verifiers arguing that an account with large flows should be a candidate for being deemed "nondiscretionary," but AIMR (at the time) vehemently opposed this. In fact, there was a Q&A for the AIMR-PPS that addressed this:<sup>3</sup>

*According to the AIMR-PPS standards a portfolio may be considered nondiscretionary if client-imposed investment restrictions hinder or prohibit the application of the firm's intended investment strategy. (AIMR Performance Presentation Standards Handbook, 1997 edition, pg. 30) Can a firm "temporarily" consider a portfolio nondiscretionary if client-driven restrictions are imposed?*

*Yes. If a client imposes investment restrictions, such as trading restrictions or security allocation restrictions, the firm has the choice to move this portfolio to nondiscretionary status or maintain its discretionary status. **Large cash flows do not qualify as client-imposed restrictions.** If a firm chooses to temporarily move a portfolio to nondiscretionary status until the restrictions are removed, the portfolio would be taken out of the*

1 Any comments regarding GIPS are my own and do not represent any of the committees I work on.

2 This was adopted March 2002.

3 See <http://www.cfainstitute.org/programs/standards/pps/faqs/ppsresults.asp>

# The Journal of Performance Measurement®:

## UPCOMING ARTICLES

### A Critical Analysis of Fund Rating Systems

– Noël Amenc, Ph.D.  
Véronique Le Sourd

### The T Ratio – An Information Ratio for Transition Events

– Matthew Clay

### Performance Measurement for Covered Call Option Strategies

– Andrew Kophamel, CFA  
Babloo Sarin

### Measuring Investment Returns: Arithmetic Mean vs. Geometric Mean

– Jim Zhang, Ph.D.

### An equity attribution model with orthogonal risk contributions

– Andrew Colin, Ph.D.

### The Journal Interview

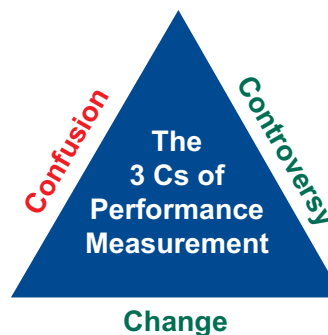
– Neil Riddles

composite until the firm restores its discretionary status. The firm must develop its own definition of discretionary and nondiscretionary portfolios based on the general principle that a portfolio is nondiscretionary if the portfolio has restrictions that interfere with the application of the firm's investment strategy. [emphasis added]

The critical requirements are that the firm apply reasonable, well-documented procedures in a consistent manner when determining whether to include or exclude portfolios with client-imposed investment restrictions, and that there is written client documentation setting forth the restriction.

Source: Standards Reporter, May – Jun 1997

Recall our “3 Cs of Performance”: Controversy, Confusion, and Change. Well, I’m confused!



I was on the IPC Interpretations Subcommittee at the time this guidance was adopted and don’t recall this being included, but it was clearly an oversight on my part. I happen to disagree with it, but it’s here and so we have to allow for it.

This being said, how would one implement such a rule? I’d say that a firm has to be crystal clear as to what constitutes “cash flow requirements (e.g., the client requires large cash distributions on a regular basis).” Is this something that’s stated up front? Perhaps. But what if it isn’t and what if the client simply starts to make such demands, would this then be eligible to be removed from the composite? And if so, for how long? Until they stop making such requests or forever?

I’ve suggested to our client that if they want to use this approach, we’d expect this to be very clear so we can test for it.

We’re curious to hear from you on this subject.

- Do you agree that such conditions should be eligible for nondiscretionary status?
- If yes, have you implemented this rule at your firm? If yes, please provide us with the language you use.
- How would you test for it?

## SPEAKING OF GIPS...

As you no doubt know, during a verification a verifier tests “whether the firm has complied with the composite construction requirements of the GIPS standards on a firm-wide basis” and “whether the firm’s processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards.”<sup>24</sup> I’d like to speak briefly about the process and procedures, specifically in regards to the firm’s written Policies & Procedures (P&P).

## 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.*

We had a recent verification where the firm had quite a large number of composites (well over 50). Several were similar and there were cases when an account might be in two composites. Fine! This isn't unusual. However, there were times when an account might just be in one of these. That's fine, too. But how does one know when an account will be in only one or both?

That was the problem. The firm couldn't articulate clearly the rationale behind these decisions. If this occurs, how can the firm assure their continued compliance?

Your P&P should be written such that if the person (or group) who wrote them all of a sudden is no longer there, their replacement(s) will be able to continue to operate in the same manner as the original group would have. In addition, they should be clear enough so that a verifier, when looking at a situation, would draw the same conclusion.

## COMMENTS ON OUR JUNE NEWSLETTER

Herb Chain of Deloitte offered the following in response to last month's newsletter:

*Good job (as always). Two quick points:*

- 1. The article (front page) starts out re verifying the verifiers, but then veers to the issues with management. I like where it ended up, though. That's where the issues lie. Which brings me to point 2.*
- 2. We (or any of our competitors) do not "insure" – your word – anything. We perform procedures designed to achieve reasonable assurance within a tolerance that management's assertion is fairly stated. If I ever used the term "insure," my quality assurance folks would faint.*

Thanks Herb for pointing out my misstatement.

## THE SPAULDING GROUP'S 2007 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
August 20-21	CIPM Principles Exam Preparation	Boston, MA (USA)
August 22-24	CIPM Expert Exam Preparation	Boston, MA (USA)
August 27-28	CIPM Principles Exam Preparation	Los Angeles, CA (USA)
August 29-31	CIPM Expert Exam Preparation	Los Angeles, CA (USA)
September 17-18	Introduction to Performance Measurement Training	Los Angeles, CA (USA)
October 8-9	Introduction to Performance Measurement Training	Boston, MA (USA)
October 10-11	Performance Measurement Attribution Training	Boston, MA (USA)
October 15-16	Advanced Performance Measurement Training	San Francisco, CA (USA)
October 23-24	Introduction to Performance Measurement Training	New York, NY (USA)
October 25-26	Performance Measurement Attribution Training	New York, NY (USA)
November 8-9	Performance Measurement Forum	Athens, Greece
November 29-30	Performance Measurement Forum	Orlando, FL (USA)
December 3-4	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 5-6	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

*For Additional information on any of our 2007 events,  
please contact Christopher Spaulding at 732-873-5700*

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# TIA

Trends In Attribution

## SYMPOSIUM

October 22, 2007

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#### INTRODUCTION TO 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 Introduction to Performance Measurement on these dates:

September 17-18, 2007 – Los Angeles, CA

October 8-9, 2007 – Boston, MA

October 23-24, 2007 – New York, NY

December 3-4, 2007 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

The Spaulding Group is registered with CFA Institute as an Approved Provider of professional development programs. This program is eligible for 12 PD credit hours as granted by CFA Institute.



#### 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:

October 10-11, 2007 – Boston, MA

October 25-26, 2007 – New York, NY

December 5-6, 2007 – New Brunswick, NJ

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#### ADVANCE PERFORMANCE MEASUREMENT

October 15-16, 2007 – San Francisco, CA

#### 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, over 1,500 individuals have participated in our training programs, with numbers increasing monthly.

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.

The two-day introductory class is based on David Spaulding's book, *Measuring Investment Performance* (McGraw-Hill, 1997). The attribution class draws from David's second book *Investment Performance Attribution* (McGraw-Hill, 2003). The two-day Advanced Performance Measurement Class combines elements from both classes and expands on them.