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

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BETTER EARLY THAN LATE

Okay, I'm a bit early this month to make up for being a bit late last month. AND, because given the July 1 deadline for comments on the GIPS 2010 exposure draft, we wanted to make sure we had one more chance to encourage you to participate.

GIPS 2010

If you've been reading this newsletter for a while you're aware of some of the "hot buttons" for me. I will briefly summarize the main ones and encourage you to comment:

- the Error and Correction Guidance statement was revised from the original draft and a requirement was added that firms disclose the appearance of material errors on their presentations for a year, even though the errors had been corrected and those who received the erroneous ones had been given corrected copy. This guidance goes into effect this coming January and language has been added to GIPS (¶4.A.29) to reflect it.
- there's a new recommendation (¶0.B.2) that firms provide their clients with the presentations their accounts are in on an annual basis. I oppose this change as it will add cost and many challenges to the firm, and provide no benefit.
- I suggest that the disclosure draft has some misleading wording when the suggestion is made that the proposed new requirement that firms not show a presentation to prospects with assets below their minimum is a change from a recommendation to a requirement (¶3.A.9). The recommendation, as it reads today, deals with "marketing" to prospects below the minimum and suggests that firms shouldn't do this. Marketing and showing a presentation are hardly the same thing. While I would support amending the current recommendation and making it a requirement, I oppose the proposed requirement. What would you show the prospect, a representative portfolio? And what if the prospect asks to see a copy? Since you're not permitted to give it to them, you'd have to refuse their request, hardly a good way to start a relationship.
- ¶4.A.20 expands the composite description to include all key characteristics and risk. This is problematic, as it can open up a wide range of details that might be a bit overwhelming. I oppose this proposed change.
- ¶5.A.8 requires the disclosure of the percent of proprietary assets. Proprietary assets include assets of the firm, owners, and senior management. This will become an accounting nightmare, especially when a firm has mutual funds in which their management and owners might have invested. And, with respect to the issue of "seeded" portfolios, why require firms to make such disclosures? Is this to require them to show how many failures they had, as if trying something and failing is such a bad thing? The risks, costs, and added inconvenience, with no clear benefits, suggests that this should be opposed.

The Journal of Performance Measurement®:

UPCOMING ARTICLES

Determining the Optimal Mutual Fund Style Classification Methodology
– David M. Blanchett, CFA and Craig Israelson, Ph.D.

101 Ways to Measure Performance
– Philippe Cogneau, and Georges Hübner

Risk Attribution
– Philippe Grégoire, Ph.D.

Refining the Sharpe Ratio
– Craig L. Israelsen, Ph.D., Brigham Young University

On Turning Three: Reflections on the CIPM® Program
– Philip Lawton, CFA, CIPM, CFA Institute

Performance Analytics Systems – In House or Vendor Package
– Kyle Ringrose, CFA, Wilson HTM Investment Group

A Global Investment Attribution Analysis Based on a Symmetrical Arithmetic Attribution Model
– Yuri Shestopaloff, Ph.D., SegmentSoft Inc.

A Comparison of Plan Sponsor Attribution Methodologies: Multi-Level Brinson Attribution vs. Macro Attribution
– John D. Simpson, CIPM, The Spaulding Group, Inc.

- Finally, we have the proposed requirement to show annualized standard deviation for the past 36 months. Admittedly I've been on the fence on this one because I recognize how challenging risk is and know that everyone can produce standard deviation. However, I've, in a manner of speaking, *fallen off the fence* onto the side that says "no"! My reasons are several:

  – Standard deviation is a measure of volatility. Risk isn't volatility. Risk is the potential to lose money or to not meet an objective. Standard deviation doesn't speak to this.

  – Standard deviation evaluates both the above and below average volatility, as if above average is bad. Downside risk would be a better metric.

  – Standard deviation assumes a normal distribution. It's been shown by countless studies that returns are usually not normally distributed. They typically have "fat tails" and are negatively skewed. The measure then becomes inaccurate.

  – Annualizing standard deviation results in a measure that cannot be interpreted; it's only use is for comparison purposes. While (in a normally distributed universe) standard deviation shows the percentage that a range holds, this doesn't apply with annualized values.

  I'm sure I can think of more reasons to reject this suggested requirement, but this is sufficient for now.

Please prepare your comments and send them in. If you disagree with me, fine! Tell the GIPS Executive Committee what you support (as I have; I don't oppose everything that's been suggested and commented in an earlier newsletter (www.spauldinggrp.com/images/stories/PDF/feb09nl.pdf) about several items I favor.

I was asked if it's okay for you to send a note in that simply says "I agree with David Spaulding." I don't see anything wrong with this, if it's true. I will, of course, be flattered. Ideally, you should craft your own letter, but if you don't have time, then something like this is probably fine.

Note that you:

1. Don't have to write a long letter...you can comment on just one item if you want, but ideally should comment on the ones that you find most important.

2. Don't have to identify yourself or your firm: you can submit your comments "anonymously."

3. Have until July 1 to get your comments in.

4. Should e-mail your comments to standards@cfainstitute.org with a subject of "GIPS 2010 Exposure Draft Comments." You should attach your comments to your e-mail.

MY NEW BLOG

I mentioned in the last newsletter that I have launched a blog…I failed to include its address, though: http://investmentperformanceguy.blogspot.com/. Note that you are invited to offer comments and they can be done anonymously.

ATTENTION:

To help aid those looking for employment PerformanceJobs.com is waiving its listing fee from now until July 31, 2009. If your firm has any jobs it would like to post on PerformanceJobs.com please contact us today!

PERFORMANCEJOBS.COM WEBSITE

Visit PerformanceJobs.com and you'll also see that we have several jobs posted. We're very excited with the initial interest this venture has caused and look forward to it becoming the major resource for individuals seeking employment as well as firms looking to hire. If you know of someone who is looking for a career in investment performance, please direct them to our site and encourage them to submit their resume today.

PERFORMANCE JOBS.COM

LINKEDIN

We are getting much more active on the Linkedin network. We've launched a group for members of the Performance Measurement Forum (www.spauldinggrp.com/forum), which is moving along quite well (with membership approaching 40!). This group will provide members the opportunity to engage in discussions on various issues throughout the year; such sharing will no doubt answer questions, provide insights, foster the broadening of ideas and perspectives, and much more.

If you are on Linkedin (or plan to be) and wish to "connect" to me (or any other members of our firm), feel free to send us a note.

FROM OUR READERS

Stephen Campisi offered the following:

I am disappointed in the elimination of after-tax requirements in GIPS since this does a disservice to individual investors while giving a free pass to the money managers who should be providing this important information to the investors they are supposed to serve. And I must respectfully disagree with your assessment of why this has occurred. For years the industry has tried to avoid showing their clients the TRUE return they receive after taxes, and their main argument has always been the "complexity" of the tax code and their inability to produce a correct calculation. It's hard to take this argument seriously, since these are the same people who have conquered the complexities of option pricing, and have managed to produce sophisticated algorithmic trading programs that integrate massive amounts of data in real time across the globe. If they considered the production of true after tax returns to be important, they could and would find a way. The reason that the industry has blocked any requirements for after tax reporting of return is simply this: taxes take an additional 200 bps of return from investors, and this has the effect of taking one-half of their wealth over time. This is not a difficult analysis to produce. Using after-tax returns restated by Larry Siegel in the Journal of Portfolio Management I produced a series of after tax portfolios and simply compared these after tax portfolio returns to the typical pretax "efficient frontier" that we typically see from money managers. The results were staggering: you see a 200 bps gap between the pretax and after-tax curves. This is only the impact of a passive portfolio, since this study used indexes. Imagine the additional tax burden from the realization of gains from active trading. We might see an additional 100 bps deducted from the investor's return. Add 100 bps of fees and an additional 300 bps for inflation. The result is a difference of 700 bps of return, which is probably about what the average investor is earning on a balanced portfolio strategy. So, the poor individual investor is taking all the risk and simply maintaining his current level of wealth, while the industry is leading him to believe that he is getting ahead. Instead, the only ones getting ahead are the money managers who continue to collect their fees for managing this (literally) poor investor's money. So tell me, how does this process serve investors when we are allowed to pretend that taxes don't matter enough to make a sincere effort to evaluate and report their impact?

I understand that there is some complexity involved in this task of calculating after tax returns. And I'll admit that my analysis was not "fine tuned" for each investor's unique circumstances. The results are still correct even though they are not "precise" by the definition of those who simply want to prevent the disclosure of this important information. For comparison, imagine that a meteor is hurtling toward the earth and it looked to be about the size of New Jersey – would we ignore its coming impact because

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 could not state its mass precisely, or because we could only estimate where it would land? I don't think so. Your remaining arguments don't seem to justify giving the money managers a free pass on reporting the impact of taxes on the returns they produce for clients. You say that few clients pay taxes. I disagree; everyone I know pays taxes. So do corporations. You say that there are few tax aware managers. I agree, but the fact that managers don't consider the impact of taxes doesn't mean that taxes don't matter. Neither does it eliminate our responsibility to report this impact to clients. The fact remains that the markets are down significantly, and it's even more important than ever that investors earn a real return on their money so that they have a reasonable chance of meeting their financial goals. As the saying goes – "It's not what you make, it's what you keep." If the muni bond guys can get their arms around the after tax benefits of their sector, I think the rest of us (including the GIPS committees) can exercise some leadership in defining the goal of providing a fair representation of the return that an investor truly receives. One of the leading financial magazines publishes a scorecard of mutual fund performance each year, comparing pretax and after tax returns of mutual funds. It's shocking to see the leading funds move to the bottom rankings after the impacts of taxes are considered. So, I guess the industry can get their arms around calculating after tax returns. They should be required to show these true returns to their investors. We may not be able to accomplish this task "perfectly" but this is no reason to avoid a critical topic and potentially mislead the investors we are supposed to serve.

And from Neil Riddles:

As always, I enjoyed your Performance Perspectives.

As far as the negative Sharpe (and other risk relative) ratios, I think the idea that they make sense is silly. True, if you take on a lot of risk then the return received is less certain so you could argue that you are less certain of getting a negative return. However, I believe the industry sees the risk part as bad so taking on a lot of risk only compounds the problem of a negative return. Consequently, I think the negative Sharpe Ratios and their ilk make no sense.

I think the better way to address the situation is to recognize that the return received is only one of a number of possible outcomes. If you split the distribution into good outcomes and bad outcomes (i.e., downside risk) then you can compare the likelihood of a good return with the likelihood of a bad outcome. The numbers should always make sense when looked at in that way. It is a different statistic but I believe a better one.

THE SPAULDING GROUP'S 2009 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
July 21-22, 2009	**Introduction to Performance Measurement Training****	**New Brunswick, NJ (USA)**
August 24-25, 2009	CIPM – Principles Level Preparatory Training	New Brunswick, NJ (USA)
August 26-28, 2009	CIPM – Expert Level Preparatory Training	New Brunswick, NJ (USA)
September 15-16, 2009	Introduction to Performance Measurement Training	Boston, MA (USA)
September 17-18, 2009	Performance Measurement Attribution Training	Boston, MA (USA)
October 20-21, 2009	Introduction to Performance Measurement Training	San Francisco, CA (USA)
October 22-23, 2009	Performance Measurement Attribution Training	San Francisco, CA (USA)
November 12-13, 2009	Performance Measurement Forum	Rome, Italy
November 18, 2009	Trends in Attribution Symposium (TIA III)	Philadelphia, PA (USA)
December 3-4, 2009	Performance Measurement Forum	Orlando, FL (USA)
December 8-9, 2009	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 9-10, 2009	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2009 events, please contact Christopher Spaulding at 732-873-5700

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Trends In Attribution

SYMPOSIUM

November 18, 2009

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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:

July 21-22, 2009 – New Brunswick, NJ**

September 15-16, 2009 – Boston, MA

October 20-21, 2009 – San Francisco, CA

December 7-8, 2009 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

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CFA INSTITUTE PROFESSIONAL DEVELOPMENT QUALIFIED ACTIVITY 12 CREDIT HOURS

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:

September 17-18, 2009 – Boston, MA

October 22-23, 2009 – San Francisco, CA

December 9-10, 2009 – New Brunswick, NJ

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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 2,000 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.

****Attend this training and receive a $600.00 travel credit.**