VOLUME 5 – ISSUE 9 MAY 2008

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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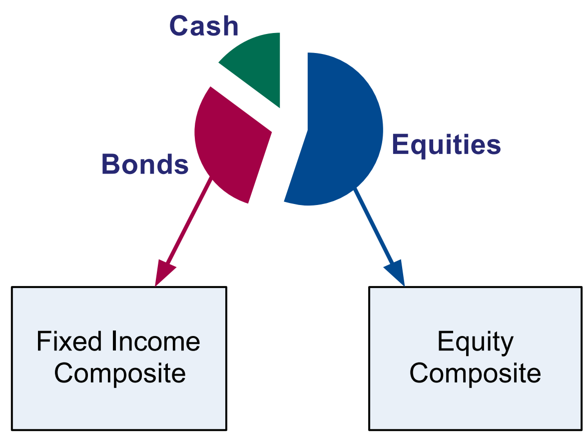
THE END OF CARVE-OUTS?

There seems to be some confusion about what the future state of carve-outs is. Recall that carve-outs provide a firm the option to split away a portion of an account and place it into a composite. The best example is where we take the equity part of a balanced portfolio and place it into an equity composite, and take the fixed income portion and include it in a fixed income composite. We must include a portion of the cash along with the assets from each of these asset classes.



The planned change to GIPS® will disallow the currently permitted practice to *allocate* the cash, using some objective method; this change is effective January 2010. After this date "carve-out returns are not permitted to be included in single asset class composite returns *unless the carve-out is actually managed separately with its own cash balance*."[1]

This statement does not say that you can no longer use carve-outs, only that you must manage the cash separately. And what does this mean? That you have separate cash for each of the carved-out pieces. This can be accomplished by having separate "cash buckets" or having the asset classes set up as subportfolios. Each approach will suffice.

IS VaR VOODOO?

Value at Risk is a risk measure that tells us the maximum amount of loss that one can expect over a certain time horizon, given a certain degree of confidence. At our U.S. Performance Measurement Forum meeting last Fall in Orlando, one of the attendees posed a question as to whether or not VaR is "voodoo." In some environments such a question might result in ostracization or worse for spewing such blasphemy. However, given the openness of our sessions, this individual wasn't challenged; rather, he received some encouraging support for this idea.

1 See paragraph 3.A.7 of the February 2005 GIPS.

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As a result of this discussion, we decided to have a session at this year's Performance Measurement, Attribution and Risk (PMAR) conference devoted to this topic. And rather than simply have an individual present his or her beliefs on the reasons why one should question the value of VaR, we decided to make this a debate; it's this year's "Battle Royale." While the best person to take on the "voodoo" side of the argument is no doubt the individual who first posed the question, because of personal reasons he wasn't able to join us. As a result, *the lot fell to me* to take on this role.

We searched for someone to take on the opposing role, which we deemed to be a conclusion that VaR can be viewed as "science." We were quite fortunate in persuading Robert Mackay, Ph.D. to join us. Dr. Mackay is a Senior Vice President at NERA, where he specializes in providing securities and financial markets litigation support and risk management advisory services. To put it mildly, Dr. Mackay is an expert on VaR. He served as Project Advisor to The Group of Thirty's Global Derivatives Study Group. In its seminal report, *Derivatives: Practices and Principles*, the Study Group recommended key risk management principles for derivatives dealers and end-users. Based on a follow-up survey, the Study Group found that its recommendations had become standard industry practice for dealers and also for many large end-users. (To read his full bio, please visit http://www.nera.com/Expert.asp?e_ID=1232). To say the least, I have my work cut out for me.

THE BLACK SWAN

In preparing for my battle against Dr. Mackay, I stumbled upon Nassim Nicholas Taleb's *The Black Swan*. I'm finding it to be an excellent book in so many ways. Not only is it very well written, it's providing me with some great material for my debate.

But one of the most significant passages has to do with the subject of erudition. On page 48 Taleb references Pierre-Daniel Huet who was deemed "the most read person in his day." He had such an insatiable appetite for learning that "he had a servant follow him with a book to read aloud to him during meals and breaks and thus avoid lost time." The author states that "erudition is important to me. It signals genuine intellectual curiosity. It accompanies an open mind and the desire to probe the ideas of others. Above all, an erudite can be dissatisfied with his own knowledge."

As one who very much enjoys reading on a variety of topics, I found such comments encouraging. While I would never claim to be an erudite person, the desire to continue to learn is one that we all should possess. Unfortunately, too many take comfort in spending their leisure time watching television rather than picking up a book. I encourage you to read Taleb's book and to discover other ways to expand your own intellect.

SO MANY MODELS…SO MUCH CONFUSION

One thing that attribution isn't lacking is models. But along with the models comes some confusion. Some believe that, for example, linking models (such as Cariño's, Menchero's, Laker's, Frongello's) are "attribution models," similar to the Brinson-Fachler model. They're not. The same problem occurs with trying to understand the notion of a model being "geometric" as well as the "multi-currency" models. Each model plays a role, but these roles can be different.

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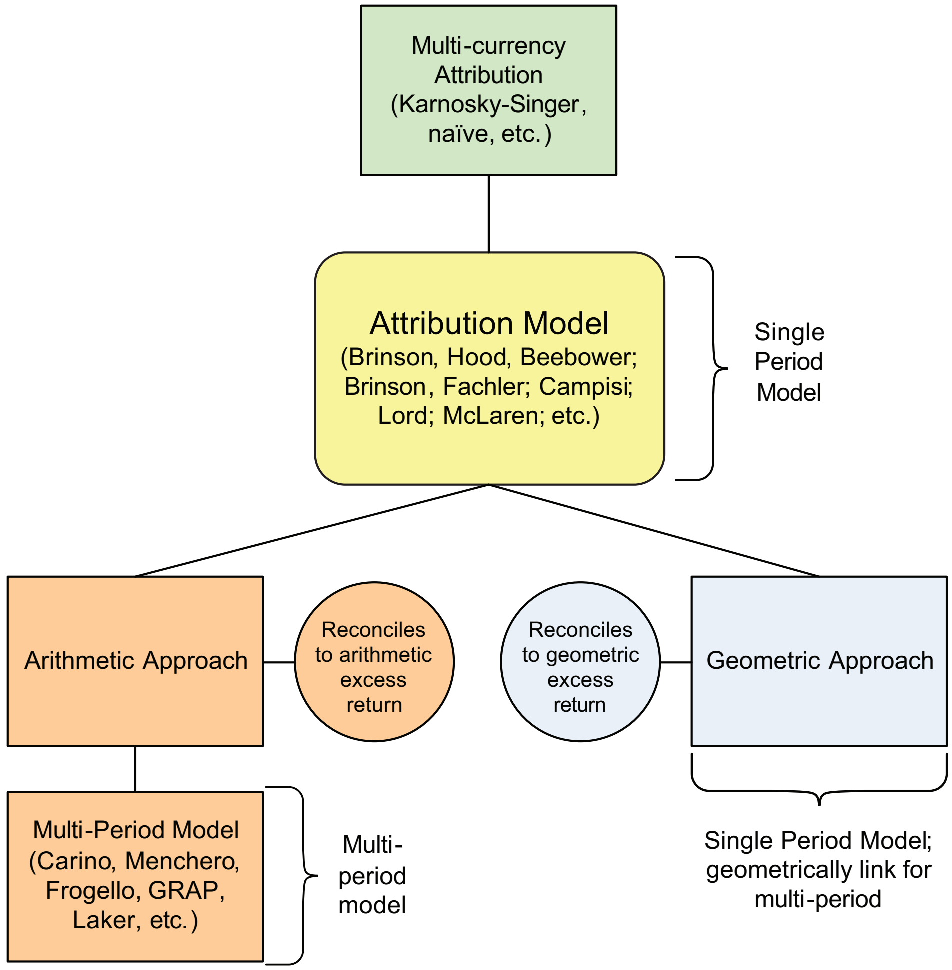

In the accompanying graphic, I've attempted to distinguish between the different types of models. At the center we have pure attribution models, such as Brinson, Hood Beebower[2]; Brinson, Fachler[3]; and the Campisi[4] model. I'm unaware of any of these models being designed as a "geometric" model, *per se*, but there are no doubt some out there; most (all?) are designed to reconcile to an arithmetic excess return. If you want a geometric version (i.e., to reconcile to a geometric excess return), then you have to make some modifications to the model. Carl Bacon, for example, accomplished this with the Brinson Fachler model.[5] I would suggest that ***any*** attribution model can be converted to its geometric equivalent.

We next contend with the notion of single versus multi-period attribution. Attribution models are designed to calculate the attribution effects for a single period. If we wish to *link* these effects in order to achieve multi-period attribution and are using the arithmetic

2 Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower. 1986. "Determinants of Portfolio Performance." *Financial Analysts Journal.* (July-August: 39-44).

3 Brinson, Gary P. and Nimrod Fachler. 1985. "Measuring non-U.S. Equity Portfolio Performance." *Journal of Portfolio Management*. (Spring: 73-76).

4 Campisi, Stephen. (2000) "Primer on Fixed Income Performance Attribution." *The Journal of Performance Measurement*. (Summer: 14-25).

5 See Bacon, Carl. (2002). "Excess Returns – Arithmetic or Geometric?" *The Journal of Performance Measurement*. (Spring: 23-31).

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.

approach, we will need to engage a multi-period model, such as Cariño[6], Menchero[7], Laker,[8] Frongello[9], etc. Because geometric model effects naturally link, they don't require such tools; arithmetic models, on the other hand, are "linking challenged" and must have some help to have the multi-period effects reconcile to the multi-period's excess return. Most of these linking models can be used with any of the attribution models to achieve multi-period results.

If we wish to account for the currency effect which arises when we're invested across multiple currencies, we need to employ a currency model such as the Karnosky, Singer[10] model. While this model has been shown relative to both the Brinson, Hood, Beebower and Brinson, Fachler[11] models, one would expect that it can be employed against any of our "pure" attribution models. For the most part, attribution models are presented from a purely domestic perspective; while there are exceptions (e.g., McLaren[12]), most will require a multi-currency model to introduce a currency effect. And even when the attribution models include a currency component, I suggest that one can ignore it if they favor a different approach to handle currency or if they are managing in a single currency and therefore don't require this effect.

In summary, we need models to calculate attribution effects for a single period, models to convert them to multiple periods (for arithmetic), and models to provide a currency effect. Keeping them straight can be a challenge, but it's important to understand that we have quite a degree of flexibility when we employ attribution. And a lot to think about!

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We're pleased to announce that our new website is now available for PerformanceJobs.com. Take a visit and you'll also see that we already have jobs posted. We're very excited with the initial interest this new venture has caused and look forward to it becoming the major resource for individuals seeking employment as well as firms looking to hire.

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6 Cariño, David. (1999) "Combining Attribution Effects Over Time." *The Journal of Performance Measurement.* (Summer: 5-14).

7 Menchero, Jose. (2000). "An Optimized Approach to Linking Attribution Effects Over Time." *The Journal of Performance Measurement.* (Fall: 36-42).

8 Laker, Damien. (2002). "A View From Down-Under." *The Journal of Performance Measurement.* (Summer: 5-10).

9 Frongello, Andrew. (2002). "Linking Single Period Attribution Results." *The Journal of Performance Measurement.* (Spring: 10-22).

10 Karnosky, Denis and Brian Singer. (1994). *Global Asset Management and Performance Attribution.* Charlottesville, VA: The Research Foundation of the Institute of Chartered Financial Analysts.

11 See Bacon, Carl. (2004). *Practical portfolio performance measurement and attribution.* John Wiley & Sons: West Sussex, England.

12 McLaren, Andrew. (2002). "A Framework for Multiple Currency Fixed Income Attribution." *The Journal of Performance Measurement.* (Summer: 59-80).

THE SPAULDING GROUP'S 2008 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
May 21-22	Performance Measurement, Attribution, & Risk (PMAR) Conference	Philadelphia, PA (USA)
June 12-13	Performance Measurement Forum (Europe)	Paris, France
July 14-18	Performance Measurement Boot Camp	New Brunswick, NJ (USA)
August 25-26	CIPM Principles Prep Class	New Brunswick, NJ (USA)
August 27-29	CIPM Expert Prep Class	New Brunswick, NJ (USA)
September 22-23	Introduction to Performance Measurement Training	Boston, MA (USA)
October 7-8	Introduction to Performance Measurement Training	New York, NY (USA)
October 9-10	Performance Measurement Attribution Training	New York, NY (USA)
October 7-8	Introduction to Performance Measurement Training	San Francisco, CA (USA)
October 9-10	Performance Measurement Attribution Training	San Francisco, CA (USA)
October 22	Trends in Attribution Symposium (TIA)	Philadelphia, PA (USA)
November 13-14	Performance Measurement Forum (Europe)	Amsterdam, The Netherlands
December 4-5	Performance Measurement Forum (North America)	Orlando, FL (USA)
December 9-10	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 11-12	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2008 events, please contact Christopher Spaulding at 732-873-5700

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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.