# PERFORMANCE PERSPECTIVES
*with David Spaulding*

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## IS IT TIME TO REPLACE THE TERM "DISCRETIONARY"?


Invariably, when I teach a class that includes a section on the GIPS® standards or conduct one of our GPS™ sessions, we will touch on some of the confusing aspects of the Standards. Many are, so to speak, *what they are*, and little can be done, other than to try to provide as much clarity as possible. But some, perhaps, can be made better. One, in particular, is the subject of this brief narrative.

The terms "discretionary" and "non-discretionary" were inherited from the AIMR-PPS® (AIMR Performance Presentation Standards). Because these terms have a long history in the investment community, their meaning is quite well known: they deal with the granting of the authority to trade on someone's account. If I have a discretionary brokerage account, for example, I've granted my broker the right to buy and sell for me, without needing my approval; we contrast this with a non-discretionary account, whereby the broker does not have such authority, and may offer advice, only. This form of "discretion" can be categorized as "legal discretion." If you don't have legal discretion over an account and execute trades without first running them by the client and getting their approval, you can be in serious trouble.

In "GIPS speak," these terms mean something very different. They refer to the case where an account is or is not "representative" of the composite's strategy.

**Why wouldn't an account be representative?**

An account is most likely representative if its strategy aligns with that of the composite, and the client hasn't imposed restrictions or requirements on their account that would cause the account to become … well, non-discretionary!

A frequently cited example is the case where a client requires there to be "no sin stocks" in their portfolio. While the definition of "sin" can vary considerably, no doubt the client will be clear in what they mean, and the manager is expected to avoid it (not in their personal life, perhaps, but definitely in their purchases for the client).

If, for example, your client's view of sin is tobacco, alcohol, and gambling, and your composite's strategy often invests in securities in these sectors, then you may conclude that their absence from this client's account will cause it to not be representative of the strategy. And therefore, you'd label it "non-discretionary." Your firm's policies and procedures need rules which clearly state and define your basis for flagging such accounts as being "non-discretionary."

The Journal of Performance Measurement®



**Is there really a problem with the use of the term "discretionary"**

Since most portfolio managers and their teams recognize the term "discretionary" in the context of the granting of trading authority, their initial response, when dealing with the Standards, is from this context. GIPS essentially assumes that the accounts are legally discretionary, and the term is only used within the context of the account being "representative." Just about every time I deal with a new verification client, they think of the term "discretionary" only in the context of legal authority.

And so, we have a conflict, or confusion, which can be a bit challenging, but which can be overcome with education. But perhaps we can do better than that.

For several years I've suggested modifying the Standards slightly, by qualifying the term "discretion" and "non-discretion" with the term "GIPS." That is, "GIPS discretion," or "GIPS non-discretion." While this would help, perhaps a better solution would be to replace these terms with "representative" and "non-representative." We'd then have something like "all actual, fee paying, representative accounts must be included in at least one composite."

I've had conversations with many folks on this topic, and there seems to be general agreement that the terms "discretion," "discretionary," etc. are confusing. And so, is it time for a change?

Well, "is it time" is probably a misnomer, because the Standards probably won't be changing much any time soon. But, perhaps when they next do, might a change in terminology be in order?

GIPS has changed terminology in the past. For example, we used to speak of "market values," but now "fair values." Would replacing "discretion" with "representative" be worth doing?

We created a VERY brief survey, and ask that you take two minutes (at most) to fill it out. We'll compile the results and post them in the near future. Please visit https://www.surveymonkey.com/r/GIPSdiscretionary. Thanks!

## WHAT DO WE AGREE ON? AS IT TURNS OUT, NOT MUCH!

I recently did a blog post on the subject of using trading days to annualize rates of return.[1] During a recent GIPS® verification, I discovered that a relatively well known software vendor uses trading days, rather than calendar days, to annualize rates of return. I found this to be quite unusual, and so pursued the matter, only to discover that they didn't really know why, as the person who designed their system had long ago left the firm, with no explanation left behind.

I pondered this a bit, and wondered what do we generally, or universally, agree on, when it comes to performance and risk measurement? I suspect the answer is *very little*. Let's briefly run down a list of some major topics.

1 See http://www.spauldinggrp.com/annualizing-rates-of-return-might-trade-days-be-better-than-calendar-days/

## KEEP THOSE CARDS & LETTERS COMING

*We appreciate the emails we receive regarding our newsletter. Mostly, 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.*

- ✓ **annualizing rates of return:** calendar or trade days: well, I believe we do agree on this. Even the vendor noted above concedes that perhaps they need to change their system.

- ✗ **time- versus money-weighting:** there are a few of us who have been pushing for increased use of money-weighting, and to some extent we're making progress. However, we're far from declaring this "universal." Consequently, there are mixed opinions.

- ✗ **is standard deviation a measure of risk?:** the GIPS standards now require the reporting of the 36-month, *ex post*, annualized standard deviation for the composite and benchmark returns, on an annual basis. This is essentially a proxy for risk. But is standard deviation a measure of risk? While our research has consistently shown that standard deviation is the #1 risk measure, it's also true that many performance and risk measurement professionals don't see it as a true risk measure, since volatility or variability aren't valid definitions of risk (and since standard deviation measures volatility or variability). I hesitate to say there's therefore universal agreement that it's a measure of risk. I've come to accept that it is, but only grudgingly.

- ✗ **arithmetic versus geometric attribution:** most of the world has agreed that arithmetic attribution is preferred over geometric; but, there remain pockets (with the biggest being the United Kingdom) that favor geometric. Since the UK has a sizable presence in the world of investing, it's inappropriate to suggest that there's agreement here.

- ✓ **how to compound rates of return:** we have agreement that returns should be compounded and that geometric linking is the way to go.

- ✗ **annualizing across leap years:** as noted above, we agree to use calendar days; but, what happens when our time period includes a leap year: do we divide by 365.25? Or, for that matter, when it doesn't, do we always divide by 365? There's no agreement here, as there are a mix of solutions.

- ✗ **holdings- versus transaction-based attribution:** I believe that most folks in our industry recognize that transaction-based attribution is superior to holdings-based, but this is clear-ly not the case when we look at implementations, as there seems to be roughly a 50/50 split. And, there probably remain some who still believe holdings- is better.

- ✓ **the GIPS standards represent "best practice" when it comes to presenting performance to prospects:** we believe this has become pretty well accepted.

- ✗ **GIPS implementation for asset owners is a good idea:** the relatively recent expansion of the Standards into the asset owner space has yet to "catch on." While we occasionally hear of interest, it's far from being extensive. Many still wonder "why" do it.

This is a very brief list, of course. Perhaps you can think of things we can add that we agree upon, as the things we don't seem to outnumber those we do. Please drop me a note with your thoughts.[2]

2 Please email me at DSpaulding@SpauldingGrp.com

| | |
|---|---|
| Tom Stapleton | UK |
| Steve Shefras | USA (via UK) |
| Joel Buursma | USA |
| Gerard van Breukelen | Netherlands |
| Hans Braker | Netherlands |

## PUZZLE TIME


**July Puzzle**

You buy 100 lbs. of potatoes, and are told they are 99% water. After leaving them outside, you discover that they are now 98% water.

How much do they now weigh?

I'll quote from my source:[3] "This puzzle is known as the Potato Paradox. It merits the paradox designation because the answer, 50 pounds, seems very low. But the arithmetic is quite straight-forward. Originally, the potatoes consisted of 99 pounds of water and 1 pound of whatever else makes up a potato. If that one pound represents 2 percent of the total weight, that total must be 50 pounds."

**August Puzzle**[4]

A monk walks up a mountain trail beginning at 9 AM. He reaches a temple at the summit at 5:00 PM, at which point he settles in for the night. The next day he walks down the mountain beginning at 9 AM, reaching his original starting point at 5:00 PM.

Is there a time at which the monk is in the precisely the same spot on both days?

## FROM A READER

Hi Dave,

I had to comment on the 25 year article - one of the most interesting reads in the newsletter ever!  Great to read how it all started and grew. Also, it is the first I had heard of Frank Desharnais' departure.  I only met "Big Frank" a few times (generally over a beer) but he really was a very pleasant fellow - and far too young. The newsletter always provides something I didn't know!  Glad to see the Puzzler's Dilemma is providing some good material too.

All the best
Anthony [Howland]

3 Source: *The Puzzler's Dilemma*, by Derrick Niederman.

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## THE SPAULDING GROUP'S 2015
## INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

| DATE | EVENT | LOCATION |
|---|---|---|
| October 15-16 | APAC Performance Measurement Forum | Singapore |
| October 20-21 | Fundamentals of Performance Measurement | Los Angeles, CA (USA) |
| October 22-23 | Performance Measurement Attribution | Los Angeles, CA (USA) |
| November 5-6 | Performance Measurement Forum | Prague, Czech Republic |
| November 18 | Asset Owner Roundtable Meeting | Phoenix, AZ (USA) |
| November 19-20 | Performance Measurement Forum | Phoenix, AZ (USA) |
| Nov. 30 – Dec. 4 | Virtual PMAR – An online conference event | |
| December 8-9 | Fundamentals of Performance Measurement | New Brunswick, NJ (USA) |
| December 10-11 | Performance Measurement Attribution | New Brunswick, NJ (USA) |

***For additional information on any of our 2015 events, please contact Christopher Spaulding at 732-873-5700***

# TRAINING…

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## FUNDAMENTALS OF 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 Fundamentals of Performance Measurement on these dates:

October 20-21, 2015 – Los Angeles, CA

December 8-9, 2015 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

CE Qualified Activity CFA Institute

CFA Institute has approved this program, offered by The Spaulding Group, for 12 CE credit hours. If you are a CFA Institute member, CE credit for your participation in this program will be automatically recorded in your CE tracking tool.

## 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 22-23, 2015 – Los Angeles, CA

December 10-11, 2015 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

CE Qualified Activity CFA Institute

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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, close to 3,000 individuals have participated in our training programs, with numbers increasing monthly.

**UPDATED CIPM Principles and Expert Flash cards are now available on our web store. Please visit www.SpgShop.com today to order your set.**

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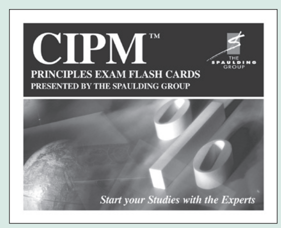


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