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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OH, NO! ANOTHER "DOUBLE ISSUE"?

Sadly, yes. My travels and activities have made it difficult for me to devote the required time to get the May issue out in a timely manner, and so we're doubling up ... again! Hopefully, this won't occur again. "My bad!"

CROSSING THE GAP…HOW?

"Total disregard of consistency"
Thomas Hardy
Far From the Madding Crowd

I've reread this classic in preparation of watching the recently released movie that's based on it, and stumbled upon this quote, which I think befits me quite well at times, and here's an example.

Ten years ago, I broached the subject of "crossing gaps."[1] That is, the idea of allowing the linking of returns for periods separated by voids in investing. For example, if a balanced manager elects to sell out completely all of his/her investments in stocks for a month or two, and then later to buy back in: should the two periods (pre- and post- the gap) be linked together? Or, if an equity manager elects to avoid a particular sector for a few months, would we want them to be able to "link" the two periods together?

At the time I realized that this was a bit controversial, but also that many wanted the ability to link these periods. I believe justification can be made for linking, so the question then becomes:

how?

In my earlier piece, I simply suggested geometrically linking them. However, after reflecting on this a bit more, I came to the conclusion that perhaps I was wrong, and that arithmetic linking would be better. I discussed this in a recent blog post,[2] and will borrow upon that for this lengthier discussion.

1 *Performance Perspectives.* April, 2005. http://spauldinggrp.com/wp-content/uploads/2014/05/Apr05NL.pdf

2 http://www.spauldinggrp.com/linking-across-gaps-how-best-to-do-it/

The Journal of Performance Measurement®

Consider this example:

	Action	# of Shares	Price / Share	Total	Return
12/31/14	Buy	100	10	1,000.00	
1/14/15	Sell	100	11	1,100.00	10.0%
2/14/15	Buy	100	10	1,000.00	
2/17/15	Sell	100	11	1,100.00	10.0%
3/5/15	Buy	100	10	1,000.00	
3/31/15	Sell	100	11	1,100.00	10.0%

Our investor bought in and out of a security three times during the first quarter, each time beginning with $1,000, and each time gaining 10 percent: clearly, an unrealistic example, but one that will hopefully make the point.

If we geometrically link the three returns (10%, 10%, 10%), we will get 33.10 percent. However, if we consider what actually occurred, we made $100 three times on a $1,000 investment; wouldn't 30% be a more accurate representation of what our return was? And this can be achieved by simply adding the three returns (i.e., arithmetic linking).

My blog post received several comments. One was an objection to the whole notion of allowing this, which I fully understand. However, the reality is that there are folks who would like to capture these three periods, so why not?

What about negative returns?

One writer pointed out a possible flaw. What if the three periods each had returns of −50%; if we were to add these, we would have a result of −150 percent: does this make sense?

Let's consider that each time we began with $1,000 and each time lost $500, thus getting our −50% returns. Our total loss for the period is $1,500. If we looked at this investment as follows:

- Invest $1,000; sell position and lose $500.
- Start with the $500 we ended with, and "borrow" $500 more. Invest, sell, and lose $500.
- Start with the $500 we ended the prior period with, "borrow" $500. Invest, sell, and lose $500.

We've lost $1,500 against an initial $1,000, which would be a −150 percent. The additional $1,000 we used to invest was "borrowed."

Trust me, this is provided without a lot of thought, simply to begin a discussion, which hopefully will result in something that makes sense.

If we consider the case where we begin with $1,000 and gain $500 when we sell (a return of +50%). We later begin with $1,000 and this time lose $500 when we sell (a return of −50%). If we geometrically link these values we get −25 percent; however, if we arithmetically link them we get 0.00%; which makes more sense?

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.

<u>What does the cumulative return represent?</u>

Let's say that we do this for the year 2014, where the investor was in and out of a security (or sector, asset class, etc.) multiple times. We then link the subperiods together. How would we characterize it?

Is it the return *for* 2014? I.e., is it the annual return *for* the year?

I don't believe it would be correct to *characterize* this return as an *annual* one, because it's not the return *for* the year.

<u>Crossing gaps with the internal rate of return</u>

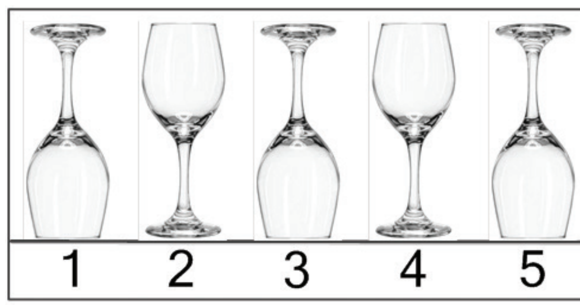
Some have suggested that this wouldn't be a problem; in fact, that the IRR is ideally suited to handle them. We can debate this, and perhaps should, but for now my position is that it's okay, though your input is always invited.

PUZZLE TIME

<u>April Puzzle</u>[2]

Malcolm Smith	UK
Jed Schneider	USA
Neil Riddles	USA

Five wineglasses have been arranged in a row, as shown in the accompanying picture, numbered from 1 to 5.



Two players take part in the game, and they make moves in turns. However, only two kinds of moves are allowed:

1) Any wineglass standing stem side up can be placed the other way round, i.e., stem side down.
2) You can turn two wineglasses standing side by side if the one standing on the right is upside down.

The winner is the player after whose move all the glasses will be standing on their stems. Does the player beginning the game have a winning strategy (i.e., he can always win, irrespective of what his opponent does)?

I think this puzzle may have been a bit confusing, but it's not difficult; I'll quote Malcolm Smith's response:

Yes, the winning strategy would be for the first player to turn over the right hand most glass. If the opponent then turns over one of the remaining two upside down glasses, that would leave the first player with one glass to turn over, and easily win the game. The only alternative for the second player would be to turn over the second and third glasses from the left. That would then leave the two glasses on the left upside down, and those can both be turned over by the first player.

May/June Puzzle

Suppose you have 20 quarts of oil in one container and 20 quarts of vinegar in another. You transfer five quarts from the oil container into the vinegar container, and mix these contents up as best as you can. You then take five quarts of that mixture and transfer them to the oil container.

The question: is there more oil in the vinegar or more vinegar in the oil?[3]

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

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

DATE	EVENT	LOCATION
July 14-15	Fundamentals of Performance Measurement	Chicago, IL (USA)
July 16-17	Performance Measurement Attribution	Chicago, IL (USA)
August 24-25	CIPM Principles Prep Class	Chicago, IL (USA)
August 26-28	CIPM Expert Prep Class	Chicago, IL (USA)
September 16	Portfolio Risk	San Diego, CA (USA)
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

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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:

July 14-15, 2015 – Chicago, IL

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

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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:

July 16-17, 2015 – Chicago, IL

October 22-23, 2015 – Los Angeles, CA

December 10-11, 2015 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

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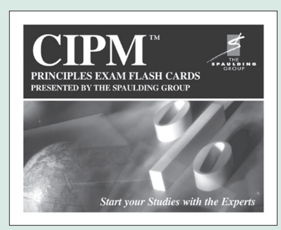
IN-HOUSE TRAINING

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.

Our performance experts have created a study aid which can't be beat: ***flash cards!*** These handy cards will help you and your associates prepare for the upcoming CIPM Principles Exam. Unlike a computer-based study aid, you can take them anywhere to help you test your knowledge.



Benefits of Flash Cards:

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