

PERFORMANCE PERSPECTIVES

with David Spaulding



VOLUME 15 – ISSUE 1

SEPTEMBER 2017

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 Patrick Fowler at PFowler@SpauldingGrp.com

TRYING TO KEEP UP WITH GIPS: VERIFIER INDEPENDENCE

The folks involved with the Global Investment Performance Standards (GIPS®) must be working overtime, given the massive amount of materials being released for public comment.

At this very moment, there are three guidance statements awaiting comments:

- Risk¹
- Verifier Independence²
- Overlays.³

We recently held a webinar that touched on the risk and verifier independence guidance (I didn't have time to incorporate anything on overlays, so we'll touch on this in the near future). We also went over responses to some of the questions posed for the GIPS Consultation Paper.⁴

Chances are, if you're not a verifier, you might be inclined to skip the GS on verifier independence, especially if you see that there are only two, rather innocuous questions being posed. In fact, you might just answer those, and move along to something else.

However, if you do this you'll miss out on all the fun, since there are other changes being planned that I think you need to be aware of, in case you want to comment.⁵

I'm going to focus on the other items that are marked for revision or introduction, so that you can decide if you feel it's worth sharing your views on.

Policies on Verifier Independence

We see a plan to shift the current recommendation for both the client and verifier to have policies to a requirement for the verifier to have them. The slide from our webinar:



1 https://www.gipsstandards.org/standards/Documents/Guidance/exposure_draft_public_comment_risk.pdf

2 https://www.gipsstandards.org/standards/Documents/Guidance/exposure_draft_public_comment_verifier_independence.pdf

3 https://www.gipsstandards.org/standards/Documents/Guidance/exposure_draft_public_comment_overlay.pdf

4 https://www.gipsstandards.org/standards/Documents/Guidance/gips_2020_consultation_paper.pdf

5 Comments are not limited to the questions posed; the GIPS Executive Committee welcomes comments on all aspects of the proposed materials. Don't be shy!

The Journal of Performance Measurement®

UPCOMING ARTICLES

Residuals on Duration-based Fixed Income Attribution

– João Sousa Dias,
Eagle Investment Systems

GIPS 20/20

– Carl R. Bacon, CIPM, StatPro

The Journal Interview

– Nick Sharp, Ph.D., MSCI

Net-of-Fee Performance Calculations

– Andre Mirabelli, Ph.D.,
Opturo and Krista Harvey,
CFA, CIPM, TIAA

A Measure for Evaluating the Distributions of Ex-Ante Forecast Returns

– Masahito Shimizu,
Tokyo Institute of Technology

Confronting the Challenges of Multi-Level Attribution

– David Spaulding, DPS, CIPM,
The Spaulding Group

Independence policy: partial shift from should to must

Current version: "Both the investment management firm and the verification firm *should* create their own policies and procedures that address independence."

Proposed: "The verifier *must* create and document its own policies and procedures that address independence at both the verification firm and employee level...The [investment] firm *should* create and document its own policies and procedures that address independence."

I think this is a very good idea. Our firm currently does not have a written policy; instead, when things arise we discuss them and make a decision. To develop a formal policy will, no doubt, be better. I plan to chime in that I like the idea.

Frequency to assess independence

The GS proposes to shift this from a one-time (and when changes occur which might require a reassessment) to *every time* there's a verification. Specifically:

Assessment of independence: change in wording / meaning

Current version: "the investment management firm and the verification firm must determine any known independence issues existing between the two organizations."

Proposed: "The verifier and the firm must assess independence...The assessment must be performed prior to the commencement of each verification engagement. The assessment must be affirmed by both the verifier and the firm at the conclusion of the engagement"

We asked the workshop participants to cast a vote on this item, and a slight majority (54%) opposes this change. I agree with the majority on this one, as I don't see the need to go through this exercise every time we do a verification. Consider those firms that have quarterly done!

Memorializing the findings

The EC is proposing that both the verifier and they're client document their decision re. independence. Specifically:

Memorializing the independence assessment

Current version: "The firms *should* document their conclusions."

Proposed: "The verifier and the firm *must* each document the conclusions reached and the rationale for their conclusions. Disclosure alone does not resolve an independence issue."

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Memorializing the independence assessment

"The independence assessment must be affirmed by both the verifier and the firm at the conclusion of the engagement as evidenced by the issuance of the verification report and the representation letter, respectively."

Memorializing the independence assessment

GIPS Verification Report: "The verification report must include a statement to the effect that the verifier is independent from the firm. This can be accomplished by including the word 'independent' in the report (e.g., using the title 'Independent Verification Report'). The verifier may also include a statement acknowledging its independence within the verification report."

Note the wording: "conclusions reached and the rationale for the conclusion." And so, simply documenting "we conducted our assessment and found there is no independence issue" won't work.

While we might favor stating that we did the review and our conclusion, to have to each time state the rationale? I'm not so sure about that.

The memorialization will be done by both the verifier and manager/owner.

The documenting within the "rep letter" and "verification" report is clearly not sufficient, as there's an expectation for the firm/owner and verifier to document their rationale. I find the above pretty simple to implement: documenting the rationale not so much, and will comment accordingly.

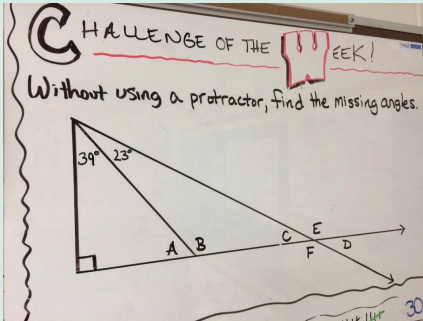
Restrictions on advocacy/support

One item I found a bit troubling is the following: "If the verifier serves as an advocate for the firm (e.g., the verifier promotes the firm through marketing efforts or acts on behalf of the firm in litigation or in resolving disputes w/third parties), *it creates* an independence issue." <emphasis added>

Note that the wording is "it creates," not "it may create."

Consider the following not unusual scenarios:

- A verifier runs a press release announcing a new client
- An asset manager/owner runs a press release announcing that they now claim compliance with GIPS, and furthermore, were verified by The Spaulding Group



August Puzzle

And so, July's was quite challenging, August's is not so much. In fact, it's pretty simple, if you recall your geometry.

We should be able to step through this, in order.

- Recall that the sum of the angles of a triangle must equal 180. And so, $A = 180 - (90 + 39) = 180 - 129 = 51$
- B is the complement of A, and their sum must also equal 180. And so, we already know the solution: 129.
- C is the third angle of a triangle, where we already know the other two: $C = 180 - (23 + 129) = 180 - 152 = 28$.
- D must be the same as C, so it's also 28.
- This leaves E and F, which are complements of C and D, meaning they must each be 152.

And so, the answers are:

A=51
B=129
C=28
D=28
E=152
F=152

The following solved it correctly:

Carl Bacon
Dan Kempf
Hans Braker
Joe Dabney

- A verifier offers testimony, verbal or written, for a client who has been examined by a regulator and assistance has been requested by the client.

From the above passage, each of these scenarios would be deemed "an independence issue."

But why? We recently ran a notice in *Pensions & Investments* announcing that we had been chosen by CalPERS to be their verifier. Does this notice also "promote" CalPERS? I believe it does, thus I guess it would be considered "an independence issue." We frequently see announcements of firms becoming compliant and verified, and naming who their verifier is.

Sorry, but this is something I object to, at least in its current wording, and I will communicate this in my response.

And so, what questions are asked?

I mentioned that this GS has two questions. They are:

Question 1) Are there any other services that, if performed by the verifier, create an independence issue?

Question 2) This GS highlights the relationship between the verifier and the firm. However, the verifier may have other business relationships, including fee arrangements, w/other businesses, such as performance system providers or insurance companies. Should we require that these types of relationships be reviewed for independence issues?

Note that for Question #1, a list of services is provided that would cause an issue, and we're being asked if there are any more to be added.

Please respond!

Whether you're an asset owner, asset manager, or verifier, this guidance will have an impact on you, so please take the time to comment. You have until October 26.

PUZZLE TIME⁶

July

Recall that last month we did not provide the solution to July's puzzle, since we had been late getting it out, thus not providing a lot of time for our readers to respond.

This puzzle stumped almost everyone, including me. I decided to post it, because I thought it would be quite interesting to see who, if anyone, could offer a response. Well, we got one, from Boris Klebanov:

Regarding the puzzle... Yes, I solved it. The two numbers are 4 and 13.

FIGURING OUT NUMBERS

Alan and Bob, two perfectly intelligent mathematicians, are trying to figure out two different numbers. They know that both numbers are integers between 1 and 100, but neither of the numbers are 1 or 100. Alan only knows the product of the numbers and Bob only knows the sum of the numbers:

Alan says to Bob, "I cannot tell what the two numbers are."

Bob replies, "I already knew you couldn't."

Alan then says, "Ah, now I know the numbers!"

Bob replies enthusiastically, "Now I know them too!"

What are the two numbers?

⁶ All these puzzles come from the "Math: An Integral Part of Happiness" page on Facebook.

September Puzzle

Three consecutive numbers multiplied together equal 54,834.

Can you find them?

Meaningful quotations

In the July issue I provided the following:

IS THERE A QUOTE THAT GUIDES YOUR LIFE?

"It's a belief: **Life is always happening for us, not to us.** It's our job to find out where the benefit is. If we do, life is magnificent."

Only one person responded, Anthony Howland:

A quote that guides my life is simple. I read it around 1992 in a magazine...and it's not quoted anywhere on the web (to my knowledge)...

"You don't have to succeed, but you owe it to yourself to try"

It was Romano Artioli, who said it about when he bought Bugatti cars a few years previously.

It was that quote that inspired me to swim the channel – prior to that, I was convinced I would fail so did not see the point of trying! It also helped me set up Performa and has been an inspirational quote to me for the past 25 years. When "old" people are asked what they regret about their lives, they rarely regret things they have done, it is generally things they have not done. With this quote always in my mind, I doubt I will have many regrets!

Thanks, Anthony! I think it's a quotation we all should adopt.

Here is an outline of my solution.

1. *Based first on Bob's reply (that he already knew that Alan couldn't tell what the numbers are), one can conclude that the sum of the numbers (known to Bob) cannot be represented as a sum of two primes (otherwise Alan, who knows the product, would be able to uniquely factorize it and thus find the numbers, contradicting Bob's claim that he knew beforehand that Alan wouldn't be able to figure them out).*
2. *One can compile a list of all integers that cannot be represented as a sum of two primes less than 100. Here the starting segment of this list: 11, 17, 23, 27, 29, 35, ... The sum of the two numbers we are looking for should belong to this list. Both Alan and Bob, being perfectly intelligent mathematicians, must know this fact.*
3. *Given the fact that Bob was able to figure out a unique set of two numbers once he determined that Alan was able to find this set, it is possible to eliminate many possible candidates for the sum, leaving only 17, and, for the sum, retaining only a pair of numbers of 4 and 13.*
4. *As an example, let me explain why: e.g. number 11 cannot be the sum. This number can be written as a sum of two positive integers in several ways. Let's look at two of these ways.*
 - (a) *If the integers were 2 and 9, their product (known to Alan) would be 18, and 18 could be factored only as $2 \cdot 9$ and $3 \cdot 6$; the sum of the factors is $2 + 9 = 11$ and $3 + 6 = 9$, respectively. Of these two sums, only 11 belongs to the list of permissible numbers described above, so Alan indeed would be able to tell what the integers are (2 and 9).*
 - (b) *Also, the integers adding up to 11 could be 4 and 7. Their product, 28, can be factored only as $4 \cdot 7$ and $2 \cdot 14$; the sum of the factors is $4 + 7 = 11$ and $2 + 14 = 16$, respectively. Of these two sums, only 11 belongs to the list of permissible numbers described above, so in this case Alan would also be able to tell what the integers are (4 and 7).*

Since both cases (a) and (b) can potentially take place, Bob, who knows only the sum (11), would not be able to say which of them (if any at all) actually took place (so there is a non-uniqueness issue). Hence he couldn't reply: "Now I know them too!". Thus 11 cannot be a sum of the two numbers.

Using similar arguments, one can eliminate other numbers from the list, leaving, as I said, only 17 as the sum, and 4 and 13 as the numbers adding up to it. I leave out further details, as it would take a lot of space to present a detailed solution.

Thank you for offering the puzzle!

Congratulations Boris: great job!

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.

I reflected on this for quite a bit, but now fully get it. And, I think this is a case that *once you hear the answer, you will think "yeah, I could have solved it, too!"*

We know that neither Bob (+) nor Alan (*) can solve it. But why? I think that this is a critically important step: to ask "why not?" The answer for both is the same: because there isn't a unique solution.

Consider Bob. Let's say his number is 7. Well, $7 = 5+2$ and $4+3$, right? And so, it wouldn't be expected that he could solve it if all he knows is that $X+Y = 7$.

Now, let's consider Alan. If his number is 12, it could be $6*2$ or $4*3$. How could he solve it, if he knows that $12 = X*Y$?

When Bob says "I know you (Alan) couldn't solve it," that provides a key bit of information to Alan. And what is it? That of all the possible solutions to Bob's number, none are prime. If, for example, Bob's number is 7, then if the answer is 5 and 2, then its product (10) has a unique solution, right? However, the product of 4 and 3 (12) does not. And so, if Bob's number is 7, he would know that Alan could, in fact solve it. And, in fact, if Alan said "Bob, well I know the answer, then Bob would be able to discern it, too (it would have to be 5 and 2). But when Bob says "I knew you wouldn't know the answer," it said to Alan "there cannot be a solution to Bob's number that involves prime numbers. From there, I think it's a bit of *leg work*."

Again kudos to Boris! Great job!!! Our friend and contributor, Anthony Howland, will, no doubt, be impressed, as anyone reading this should be.

Dr. David D. Spaulding, DPS, CIPM, will host a unique consulting opportunity on Thursday, October 26, from 9 AM to 5 PM, at the Sydney Marriott Hotel

This session will be limited to 20 individuals, to bring their issues, questions, and concerns to David for advice and counsel.

To learn more and to register, visit:

<http://www.spauldinggrp.com/product/Sydney-Coaching-Dave-Spaulding/>



**THE SPAULDING GROUP'S 2017
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS**

DATE	EVENT	LOCATION
October 16-17, 2017	Fundamentals of Performance Measurement	Los Angeles, CA
October 18, 2017	PMAR West Coast	Los Angeles, CA
October 19-20, 2017	Performance Measurement Attribution	Los Angeles, CA
October 26, 2017	Sydney Coaching with Dave Spaulding	Sydney, Australia
November 9-10, 2017	Performance Measurement Forum	Rome, Italy
November 15, 2017	Asset Owner Roundtable	Orlando, FL
November 16-17, 2017	Performance Measurement Forum	Orlando, FL
December 2017	Performance Measurement for Non-Performance Professionals Webcast	
December 11-12, 2017	Performance Measurement Training	Mumbai, India
December 11-12, 2017	Fundamentals of Performance Measurement	New Brunswick, NJ
December 13-14, 2017	Performance Measurement Attribution	New Brunswick, NJ

For additional information on any of our 2017 events, please contact Patrick Fowler at 732-873-5700

**Dr. David Spaulding, DPS, CIPM, will conduct our
Fundamentals of Investment Performance Class
in Mumbai, India, December 11 & 12, 2017**



To learn more and to register, visit:
<http://www.spauldinggrp.com/mumbai-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 16-17, 2017 – Los Angeles, CA

December 11-12, 2017 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

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 19-20, 2017 – Los Angeles, CA

December 13-14, 2017 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

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.



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.

Houston & Florida recently suffered from Hurricanes Harvey & Irma, and we want to help



We will host a one-day **Fundamentals of Performance** webinar class on November 6th
100% of the revenue will go towards relief efforts

Join us and train your staff while supporting recovery at the same time!
 To learn more, please visit <http://www.spauldinggrp.com/hurricane-relief/>

