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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THE COSTS OF BENCHMARK DATA – THINGS YOU NEED TO KNOW!

In last month's issue, we mentioned that Patrick Fowler and Chris Spaulding joined me in October for the closing bell ceremony at NASDAQ. This event was part of the **NASDAQ Institutional Insights Forum**. At that event, I chaired a panel discussion on benchmark costs. We, along with BNY Mellon, State Street, and Northern Trust, are launching the "Custodian Guidelines for Transparency in Benchmark Cost." We think this is such an important topic that we're devoting most of this issue to it. We are very pleased to be associated with these custodians, as well as NASDAQ, in bringing these ideas to the market.

<u>A little background:</u> Around three years ago, we held a closed-door forum for leaders in the custody space, at their request, to discuss what was fast becoming a significant issue across the segment: *the rising cost and complexity of licensing for benchmark data*. The overarching theme heard throughout this gathering was that benchmark data fees had turned into a significant portion of the cost to provide analytic services, yet banks had no control or input on the benchmark decision making process for clients.

These trends have not abated; in fact they have increased. This has caused a number of organizations to take action. In the following interview with representatives from BNY Mellon, State Street, and Northern Trust, each will walk through their perspective on the topic and the changes being implemented. As part of these group discussions, a common approach of increased transparency was agreed upon, which led to the formation of the following principles each have agreed to adopt and implement over time, henceforth called:

<u>Custodian Guidelines for Transparency in Benchmark Cost</u>

- Provide transparency to end-clients on the relative cost of benchmarks.
  – The total cost of using benchmark data may also be taken into account, including index provider licensing fees, and the resources involved to collect and process the related files and data
- Conduct a free customized benchmark cost analysis upon request from clients that would demonstrate the relative cost of benchmark data options.

But Principles by themselves are not enough. In order for clients to realize savings and affect change, there needs to be credible low-cost alternatives available. This is where NASDAQ has stepped in and agreed to license their Global Index Family at no cost

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to custodian banks adopting these guidelines. This includes founding adopters BNY Mellon, State Street, and Northern Trust, who will all offer NASDAQ Global Indexes as a reporting option, for which fee reductions can often be realized.

This topic will be further explored in our Spring 2015 issue of *The Journal of Performance Measurement*, as well as at our PMAR conferences next year.

I hope you enjoy the transcript!

Note: The following insights reflect impressions as to general practices in this area, but do not constitute legal advice or create any contractual commitments, obligations or duties of BNY Mellon, Northern Trust, or State Street. These comments are generally applicable to asset owners receiving analytic services and may be relevant for others as well.

1. *Could you walk through, from the custodian point-of-view, how the benchmark decision process occurs from start to finish and ongoing?*

Joseph P. Nardulli, Northern Trust (JN): The custodian is not involved in the benchmark decision process. The decision rests with the asset owner, or perhaps a consultant they hired. Sometimes the asset manager may make the recommendation or the decision if it's tied to an established investment strategy. In many cases, the custodian is not even made aware of the benchmark until after the investment mandate has been approved and funds have been invested. This makes data sourcing a potential problem if you do not already have a contract in place. Timelines are short and there is no leverage to negotiate.

BNY Mellon (BNYM): We agree that custodians are not generally directly involved in the benchmark decision process. Custody clients or their advisors direct us to measure the performance of their assets as compared to a client designated benchmark. As custodian we do not determine or advise on the appropriateness or adequacy of a selected benchmark. While the Custodian will generally have the rights to use designated benchmark data, in some instances, typically with respect to more specialized benchmarks, additional licenses may be required. In those instances facts and circumstances around licensing may lead to a client may ask us to report against a different benchmark.

Lisa Massena, State Street (LM): The process starts and ends with clients. They set strategy, select relevant measures including indices, and instruct their custodian to secure licensing rights for the indices they need to produce required analysis and reporting. To meet clients' current and future needs, custodians subscribe to many indices and index families - both in bulk and as one-offs - generally as a cost pass-through.

2. *What models are applied to custodians for use/redistribution of index data and how has that changed over the last 5 to 10 years?*

JN: Each vendor usually has unique terms and conditions but, generally speaking, we need two licenses, one to store the data and use internally and another for redistribution. In some cases the cost to redistribute data is higher than the cost to acquire data. More asset owners are requiring more data for better institutional governance - investment risk monitoring, better understanding of their performance, etc. As the need for more granular data has risen over the past years, so has the cost of acquiring it.

In addition to the growing cost, restrictions on use and distribution of data have significantly impacted how custodians can serve their clients. Many traditional processes employed by custodians to make data fit-for-purpose have been restricted or come with new fees.

BNYM: We agree that each vendor licenses their data in accordance with unique terms and conditions. The terms governing redistribution of the longstanding well-established indices has not changed substantially over the last 5-10 years, but there have been changes to terms governing how that data and the constituents can be used. Historically, custodians were permitted to derive other data and report that derived data to their clients, such as index weights or characteristics. However, the permissible use of such derived data has become more limited in recent years. In some cases derived data is now characterized as "custom calculations" that either only the vendor can provide or in other cases, a new license and additional costs are associated with permissible continued use of the same calculations.

LM: We follow a three-tiered model for pricing indices:

- For custom indices and indices requested by a single client, costs are passed through directly to the client.
- Costs for broadly used indices are generally incorporated into standard service fees
- Premium indices - at the constituent level and/or more thinly used – may be passed through to clients in whole or in part

Market data licensing and costs tend to undergo cyclical changes. At certain times over the last 15 years, we've seen providers offering a wide variety of data at low or no cost to encourage use. We've also seen providers enforcing strict licensing and usage limits to capture full value of the data they offer. These cycles have a meaningful impact on what custodians can offer and how they must price those services.

Another significant change over the past few years is the rapid growth in volumes of daily and monthly indices that are provisioned for client use. For major custodians, this is a support service that requires sophisticated tools and/or data aggregators, managed by focused proprietary teams.

The ability to manipulate the indices from vendors has decreased over the years where currency changes and the ability to roll up constituents were common and now are restricted to the vendor to do this work and, in some cases, charge a premium for it.

3. How has your organization historically managed the cost of benchmark data?

JN: Sourcing index data has traditionally been a cost of doing business in the custody world. The client needs an index as a benchmark, you have to go out and get it. Years ago, this wasn't necessarily an issue; data was reasonably priced relative to the cost of providing the service and most mandates were of the plain-vanilla type. Now, asset owners demand much more data; sectors, countries and the constituents themselves for deeper analysis. Index customization is increasingly required and restrictions prevent custodians from making the data fit for purpose in any way.

BNYM: Historically, general benchmark data costs were not isolated and identified independently in our fees schedules. More recently we have added a general charge

THE 2015 RIMES BUY-SIDE SURVEY

Now in its third year, the RIMES Buy-Side Survey investigates data management trends for investment managers, hedge funds, custodian banks, insurance firms and pension funds. Every year, RIMES hosts over 30 Forums around the globe, engaging with its clients and other key decision makers: these have highlighted some important topics. This year's survey explores these topics. RIMES is hoping to gain the best possible picture of issues such as data quality & governance, incoming regulation and the growing cost of data.

Complete the Survey:

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You should note that the privacy of your personal information will be kept strictly confidential.

To read last year's survey findings:

www.rimes.com/rimes-2014-buy-side-survey

for standard or premium data, as well as line item expenses associated with certain additional vendor data required by a specific client.

LM: For standard and total level indices, data costs have generally been bundled into overall service fees. As index volumes, costs and usage restrictions have grown, it's become important to help clients manage the costs associated with their own benchmarking decisions. We work continuously to negotiate competitive, cost-effective agreements with data providers to keep costs low for clients.

4. *Can you go into further detail on the commercial models for custom indexes and how you are treating those?*

JN: There is no standardization of what is even considered a custom index. Removing sectors, countries or constituents are all generally considered custom. But even common ones, such as a broad market ex tobacco index are considered custom regardless of how many consumers require it. Some vendors consider basic index blends and even currency translations to be custom. If we are servicing a client in Singapore and they want an index that is Singapore dollar-based, some vendors would require a contract and additional fees to calculate the index in an alternate currency. Directly or indirectly, these issues can increase the total cost for asset owners.

BNYM: The nature of what is defined as custom has been changing over the years. As examples, blending of two of more indices from the same vendor is now considered custom by some vendors and the ability to apply hedging has become more restrictive. Commercial models for custom indices vary by vendor. The most common model is for the client to contract directly with the vendor for the data, pay the vendor and arrange the data to be forwarded to its custodian for inclusion in client reporting. In other cases a custodian may contract with the vendor for the custom data at the request of specific clients.

LM: We define a custom index as one that is created specifically for a single client to meet their unique measurement requirements. These indices are generally provided on a cost pass-through basis.

5. *To what extent do clients understand the complex licensing environment for benchmark data and how it impacts the services they need to monitor and control their investment processes?*

JN: There is wide range of understanding across asset owners. Clients that employ more complex investment programs or those that have their own internal asset management arms may be somewhat aware of the changes in sourcing index data over the last 5 - 10 years. However, the average asset owner is likely unaware, as they never had to be aware before.

Clients may soon be made aware as there is a changing environment where index vendors are actively pursuing licensing asset owners for the first time. Given the restrictions in place and the increase in custom index requests, we have no choice but to get our clients involved with the index vendors, which is not something we want to do.

Lack of standards in commercial models and continuing changes in policies have inhibited the understanding of how data can be used. Due to this, Northern Trust has focused on leveraging our expertise to help clients navigate the changing landscape and get a better view of their total cost of ownership. We are continuously exploring new options in the market to ensure we have a wide range of products to offer, and for the best value.

BNYM: Some clients understand the complexity of the licensing environment. There are many variables to be managed in connection with maintaining proper control over the data, taking into account the types of clients (plan sponsors, money managers etc.), the location of clients, the data used, the level of data provided, the actual data fields, the timing of the data, the products provided and individual vendor client arrangements. We have dedicated personnel in an office of data management whose role it is to manage data vendor relationships, and oversee the use of data in accordance with the terms of the various data licenses. This said, it is not always possible to provide, without additional cost or conditions being imposed, certain additional data. Certain clients, who may not have independent relationships with vendors themselves, may not fully appreciate restrictions and costs imposed by data vendors.

LM: In general, asset managers who are heavy users of indices are often very aware of the costs and complexities associated with index data licensing, metering, and management. These clients are often subject to direct licensing requirements regardless of the sources of their index data. Many asset owners may be unaware of the growing expense of index data and what that means for them. Not only has the cost from the index providers increased every year, the cost to source, package and deliver the data has gone up as well, putting pressure on our ability to deliver improved services at lower costs.

6. *Given the exponential growth in benchmark data fees, how is your organization beginning to change its approach with clients?*

JN: We're trying to create more awareness. Both internally within our organization, so partners know the terms of use and what is available to us and also in direct engagement with our clients. We are being asked more frequently to speak about the impact of vendor policies on a proposed service or reporting requirements.

BNYM: Our contracts govern terms by which clients receive vendor data and the fees and expenses associated with such data. We seek to engage in open and on-going dialogue with our clients about data terms and costs.

LM: We're working with clients to educate them about the various fee schedules from vendors and how the benchmarks they choose will impact service costs and potentially the fees they pay. We do find that clients are increasingly asking for information about overall program costs and considering where they can make changes; at the same time, benchmarks changes tend to occur slowly, and in areas where clients are confident in the interchangeability of their choices.

7. *What do you think the institutional investment consultant's or asset allocator's role should be in examining the downstream embedded cost of benchmark selection?*

JN: I think it should be part of their remit in servicing their clients. They should be aware of all vendor options when it comes to selecting an appropriate benchmark for a plan, mandate or strategy. The cost implications of using one benchmark or vendor over another should be factored into the decision and transparency provided to the

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.

asset owner. This will allow for more choice and perhaps the chance to lower fees by selecting options that have lower costs depending on the reporting requirements.

BNYM: Educating clients about benchmark attributes, availability and costs will be valuable to clients and asset allocators alike.

LM: Index acquisition and usage costs are a part of the total cost of ownership of any investment portfolio that will be measured relative to "the market." By understanding the range and cost of indices that could be used to measure a given investment strategy, professionals can help investors make smart decisions that can improve net performance.

8. *What is the driving force behind your joint announcement with the Spaulding Group and your peers to offer the NASDAQ Global Index Family as a reporting option for your client-base?*

JN: As we continue in our efforts to provide transparency on the embedded cost of various index options, it is imperative for us to offer credible lower cost alternatives that clients can consider. We welcome the opportunity to work with anyone who can provide quality and value for our clients. The NASDAQ Global Index Family matches up well with current competitive options we offer, and the zero dollar commercial arrangement with them enables us to explore fee reductions based on index selection.

BNYM: We welcome the approach by any index vendor to offer investors greater choice and value. For our asset owner clients determining to adopt this benchmark, BNY Mellon performance and risk services will be available with no additional fees for that index data.

LM: Over the past several years our broad global client base has challenged us to provide high quality indices at a fair price. A number of providers have responded favorably, offering competitive indices at compelling rates. This gives our clients access to more options when striking the balance between investment mandates and cost. Clients are also seeking transparency into costs associated with their benchmarking requirements. We are pleased to work together with the Spaulding Group on this initiative and pleased to provide clients with access to the NASDAQ indices as part of a diverse and robust offering.

9. *How can clients lower their current fees in practice?*

JN: If a client is willing to adopt a highly-comparable alternative we can replace a higher cost index with the lower cost alternative. Due to our transparency effort, we can potentially lower the index fee without impacting any other services we are contracted for.

BNYM: Clients may consider both how benchmark data is to be utilized and from which data vendor it is to be obtained as having the most direct bearing on cost. More restricted use can lower fees.

LM: As outlined in the industry guidelines, clients should contact their custodian rep and ask for a benchmark cost analysis, which outlines how much they can save by switching to alternative options. Where index fees are bundled into service packages, clients can request transparency on index costs to help custodial providers maximize value to the client and minimize service costs.

10. In coming to a mutual understanding with your peers on guidelines for illustrating the difference in embedded benchmark cost and increasing transparency to end-clients, what message are you trying to send?

JN: Education and awareness are the keys for all institutions that service the asset owner. Everyone who touches the data will require a license so understanding what services the end-client requires to satisfy institutional governance is an important first step.

Benchmark costs and analysis should be part of the investment decision-making process, not an afterthought, especially in cases where a custom benchmark is needed. Understanding the total cost of ownership of index data and alternatives available in the market is vital and may result in reduced costs.

BNYM: A large part of the industry is facing the same challenge with how to deal with increasing data costs. As a service provider we are trying to be as transparent as we can with our clients on the costs and limitations associated with their benchmark choices. We hope that over time that our clients will become more aware of the market data environment and the cost impacts of their decisions, ultimately leading to more efficient index production and distribution across the industry.

LM: Our goal is to ensure that clients have cost-effective access to the indices they need, and to ensure they're paying only for their own consumption. Fair pricing practices are an important part of this approach - and cost transparency helps everyone make good decisions.

We thank our colleagues from Northern Trust, BNY Mellon, and State Street, for sharing their insights with us, and for participating in this important initiative. We also thank NASDAQ for helping us bring this topic to the industry.

PUZZLE TIME

Since we're getting this issue out quicker than normal, and the November issue went out later than usual, we haven't given our readers time to respond (so far, we've only heard from two). And so, rather than give the answer to that puzzle, we'll hold off until January, when we'll reveal it then, as well as the one for this month!

The missing present from Santa's Sleigh

Santa took off from the North Pole on his long around-the-world journey. Unfortunately, Mrs. Clause discovered that he had left a present behind. Instead of summoning him back, she decided to take off in her G650, which travels at 20 times the speed of Santa's sleigh.

She departs the North Pole when Santa is 180 miles away. How far from the pole will she catch up with Santa, so that she can give him the present?

BEHIND THE SCENES AT TSG

Steve Sobhi

My name is Steve Sobhi and I'm the Vice President in charge of development for the Western region.

I have been with The Spaulding Group for two years.

Working for TSG, I enjoy the challenge of always learning something new about our industry and beyond. Not to mention, being part of an organization who knows how to make investment performance measurement even more fun than it already is.

I was born and raised in Houston, TX and now live in beautiful Southern Oregon with my wife, Amaya, and our "funny farm" of four legged children.

Outside of work, I enjoy spending time with my family, travelling, and enjoying Oregon's great wines and vineyards. My latest travel adventure was an unforgettable trip to the Chianti region of Italy. I think my next adventure will be exploring my wife's roots in the Scottish Highlands.

Also, I love giving back to the community I live in. I currently serve as board President for The Southern Oregon Humane Society as well as Chairman of the Housing and Community Development Commission for the City of Medford (OR).

I have Bachelor of Science in Accounting from Boston College (Go Eagles!) and am an Expert Level CIPM candidate.

One other fun fact that is bound to make you smile is that, as a kid, my mom and I had a stint as professional clowns.

Season's Greetings!

We're closing out 2014; we hope it's been a great one for you both personally as well as professionally.

We wish you a Merry Christmas, a Happy Chanukah, and a Happy New Year!

Chris Thuku, CIPM

Performance Manager
T. Rowe Price

Bio:

Chris is a Performance Manager at T. Rowe Price, an asset management firm headquartered in Baltimore, Maryland. His current responsibilities include leading a team that is responsible for servicing the performance and analytics needs for the firm's 700 billion plus dollars in assets.

Prior to joining T. Rowe Price, Chris worked as a Performance Manager at Stanford Financial overseeing the performance measurement, attribution and composite maintenance functions. Prior to working at Stanford he was a Senior Performance Analyst at Investors Bank and Trust (now State Street).

Chris has an MBA from the University of Massachusetts and a degree in Economics from Kenyatta University, Kenya.

CLIENT'S CORNER

1. How long have you been involved in performance?

I have been involved in the performance industry for over 10 years working in different capacities for both asset manager and custodial firms.

2. What do you enjoy most about it?

Our firm's investment professionals are constantly investing in new instruments, new markets and creating new products to meet client needs. These ever-changing investment needs come with their measurement and reporting challenges. Naturally our performance team is tapped to solve for these problems because of the breadth of knowledge we possess. Working in performance gives me the opportunity to create innovative solutions to overcome the challenges. It is this ability to apply my creativity that I enjoy most about performance.

3. What role does The Spaulding Group play at your firm?

The Spaulding Group is an integral part of our performance team's training and development. We engage The Spaulding Group for GIPS training and we are members of the Performance Measurement Forum, Performance Think Tank and are perennial attendees of PMAR.

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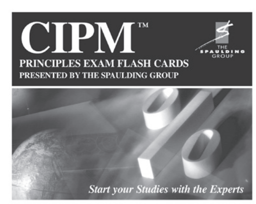

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