PERFORMANCE PERSPECTIVES
with David Spaulding

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GIPS 2020 EXPOSURE DRAFT...REVIEWED AND COMMENTED ON!

I'm pleased to report that I made it through the rather lengthy GIPS® 2020 Exposure Draft, and even submitted my responses!

This document reflects a massive amount of change. And while there are over 40 formal solicita-tions for comment, the number of proposed changes exceed this, meaning: you need to look for anything marked "new" to see what is being recommended.

You are permitted to comment on anything you want. In my letter, for example, I not only responded to the requests for comment, but commented on "new" items, as well as other things related to the Standards.

I won't attempt to cover everything here, but will hit upon a few things that I feel are quite worthy of your review and thought.

<u>My favorite things...</u>

1) <u>Expansion of the use of money-weighting</u>. Historically, firms must use time-weighted returns unless they're managing private equity or real estate, and even then, only under cer-tain conditions. This requirement has been changed, so that if the manager controls the ex-ternal cash flows (plus additional criteria, see below), you're required to use mon-ey-weighting. This is something I raised nearly 20 years ago, so I'm thrilled that it's being added (or proposed to be added!).

2) <u>Ability to estimate transaction costs</u>. Today, the Standards require that gross- and net-of-fee be net of *actual* transaction costs. This is a problem for anyone managing bundled or wrap fee portfolios, where a single fee includes all fees and expenses: the transaction costs can-not be broken away. Therefore, firms can't report a "true" gross-of-fee return. But with this change, firms will be allowed to use estimated transaction costs. Wonderful! Now, how to calculate them? Well, that's another story, which we'll take up in another issue.

3) <u>Document reorganization</u>. The Standards are getting quite a "facelift," as the requirements for separate account asset managers, pooled fund managers, and asset owners will be seg-regated. This will result in a longer document, but also one that should prove much easier to navigate.

4) <u>The return of carve-outs</u>. The ability for firms to *allocate* cash for carve-outs appears to be coming back! This is, no doubt, a compromise, as many non-USA performance profes-sionals objected to what we, in the States, were doing under the AIMR-PPS® with carve-outs. As before, the carved-out segments of a portfolio must be managed in the same fashion as a portfolio that is only invested in the strategy. The only "twist" from the past is that firms must maintain separate composites for the carve-

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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

outs and non-carve-outs, and must make the non- version's presentation available whenever showing the carve-out presentation. I think this is a reasonable compromise.

5) Use subscription lines of credit? Then returns with and without their effects must be shown. I believe this is mainly targeted to the private equity industry, but perhaps this prac-tice is being employed elsewhere, as well. Some p/e managers are apparently using the committed capital collateral to obtain lines of credit for initial investments. The result is a higher internal rate of return (IRR). This is felt to be inappropriate by some of their clients. This change will require compliant managers to show returns with and without the effect of these credit lines. Good idea!

My not-so-favorite things:

1) Proposed portability rule change. It is being proposed that when a compliant firm acquires a non-compliant one, that they be able to bring the firm into compliant on a *going forward* basis; that they will have the *option* to go back in time, and for whatever parts of the ac-quired firm they wish. To me, this is inappropriate. Consider (compliant) Firm A acquiring (non-compliant) Firm B. This change will allow B to become compliant without the trouble of getting their historical records in shape. What's the problem? Well, if Firm B wants to claim compliance today, they must have a minimum of five years (or since inception). This change allows them to totally circumvent this rule. Might B simply arrange a merger with a compliant firm to save them the trouble? Seems unfair and simply wrong to me. I disagree!

2) Requirement to provide list of funds appropriate to specific prospect. For pooled (e.g., mutual) fund managers, they will be required to make available a list of funds that are ap-propriate to specific clients. This seems like a major challenge for global managers, who serve multiple markets (e.g., retain, high net worth, institutional). They will, I'm sure, be required to develop and maintain many lists. Seems quite costly to me.

3) Option to use Modified Dietz instead of the IRR. The language in the Standards has changed from "IRR" to "Money-weighted." This was apparently done to permit a host of money-weighted methods, including Modified Dietz. And while Mod Dietz is a perfectly good "first order approximation" for the IRR,[1] and is also often quite a good approximation to the actual IRR that's derived, there are times when it fails miserably (I have seen cases where it generates results like −101% (i.e., you lose everything plus some)). And so, I think this is a mistake. The IRR is easy enough to calculate, why make this potentially error resulting change?

4) MWR requirement requires an additional criterion. In addition to the requirement for the use of money-weighting to be that the manager control external cash flows, they must also meet one additional criteria. Why? Shouldn't cash flow control suffice? This was the opin-ion of most who commented on the GIPS 2020 Consultation Paper.[2]

1 Recall that the IRR is an iterative method, that requires trial-and-error to solve. It needs a "first guess" (i.e., "first order approximation), and firms typically use the Modified Dietz to provide it.

2 https://www.gipsstandards.org/standards/Pages/guidance_comments_gips_2020.aspx.

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.

5) Error Correction – disclose material errors to everyone! Today, if a firm encounters a "material" error, they are to make every reasonable effort to provide existing clients and ac-tive prospects who saw the prior version of the presentation (i.e., the one with the material error) with a corrected presentation, with a disclosure of the error. If they're able to do that, then they need not include the disclosure when reporting to prospects who did not see the prior version (with the error). What is proposed is that firms must provide the presentation, with the disclosure, to everyone, and to do this for a minimum of 12 months. Why? Are they supposed to have a "guilt complex" and feels it necessary to seek a *mea culpa* from everyone they meet who is interested in the strategy? This seems totally unfair to me.

Okay, so that's some of my favorite and not-so-favorite items. But, before getting off this topic, let's briefly consider a few other changes worth noting:

- The downgrading of composite creation date and elevation of composite inception date. As you no doubt know, compliant firms today must disclose the composite creation date. This is one of those confusing disclosures: for some reason, many think it means "creation date," when, in fact, it means the date you *created* the composite. Okay, so this has been a requirement since the AIMR-PPS days. But now, the GIPS Executive Committee (EC) is suggesting that this requirement be downgraded to a "recommendation," and *out of the blue* composite inception date be required. Creation date has meaning, as it alerts prospects how old a strategy's presentation is (is it something they just recently put together, or has it been around a while?). I favor creation date staying a requirement, and inception date being made a recommendation.
- Percent of firm assets going "bye bye". Today, compliant firms must report composite assets and *either* total firm assets or the percent of firm assets the composite represents.[3] Going forward, it's proposed that firm assets and composite assets be required, with the percent of firm going away. Hurrah! I never liked the percent option.
- Let's be timely! Today, some firms take quite a while to get their presentations updated once a new year begins. E.g., we have seen firms who still haven't shown their 2016 re-turns! This is, we believe, because the firm wants to wait until their verification is done, and sometimes this takes longer than perhaps it should. The EC proposes that firms get their presentations updated within six months of year-end. I think 12 months would be better.

Please take the time to review this document,[4] and let the CFA Institute and EC what you think. Remember: you can do this anonymously!

3 At one time, all three were required, which suggested there must be a shortage of calculators, because if you have two of them, you can derive the third..

4 https://www.gipsstandards.org/standards/Documents/gips_2020_exposure_draft.pdf

PUZZLE TIME!

September Puzzle

We thank our friend Ivana Bertuzzelli for a guest submission.

0 0 0 = 6	6 6 6 = 6
1 1 1 = 6	7 7 7 = 6
2 2 2 = 6	8 8 8 = 6
3 3 3 = 6	9 9 9 = 6
4 4 4 = 6	10 10 10 = 6
5 5 5 = 6	

Make each equation true using common mathematical operations.

1. You cannot introduce any new digits (for example, $\sqrt[3]{}$ is not allowed).

2. You must have the result be equal to 6 (you cannot use the ≠ symbol).

(0! + 0! + 0!)! = (1 + 1 + 1)! = 3! = 3×2×1 = 6

(1 + 1 + 1)! = 3! = 6

(2^2) + 2 = 4 + 2 = 6
or*
2 + 2 + 2 = 6

3 × 3 − 3 = 9 − 3 = 6

SQRT(4) + SQRT(4) + SQRT(4) = 2 + 2 + 2 = 6
or*
4 + 4 − SQRT(4) = 6

5 + (5/5) = 5 + 1 = 6

6 × (6/6) = 6 × 1 = 6
or*
6 + 6 − 6 = 6

7 − (7/7) = 7 − 1 = 6

8 was a challenge for me:

[SQRT(8 + 8/8)]! = [SQRT(8+1)]! = SQRT(9)! = 3! = 6
or**
8 - SQRT(SQRT(8+8) = 6

SQRT(9) × SQRT(9) − SQRT(9) = 3 × 3 − 3 = 9 − 3 = 6
or*
9 − [9/SQRT(9)] = 6

10 took me a bit, but in the end didn't actually prove difficult:
{SQRT[10 − (10/10)]}! = {SQRT [10 - 1]}1 = {SQRT(9)}! = 3! = 6

A bit of a challenge, definitely!

<u>October Puzzle</u>

Since September was so difficult, and in honor of Halloween, we offer the following (hoping it's a bit easier):

NOTES:

* = alternatives provided by Jon Gordon
** = submitted by someone who sadly missed one.

One reader offered the following: for the 0 ? 0 ? 0 = 6 solution:
(e0 + e0 + e0)! = 6

He also offered a solution using ϖ, which failed the one requirement about introducing figures. Both e and ϖ are numbers, right? And so, they fail.

For 10 he did offer an interesting solution, which would count:
(LOG(10) + LOG(10) + LOG(10))! = 6

Since he failed to get all 11, however, he won't be named. Oh, darn!

And one reader got creative with the final one:
1.0! + 1.0! + 1.0!

I guess he was stumped. Because 1! is 1, so the solution to this would be 3, not six. I'm sure he meant to add a "!" for the total, but left it off. But even then, it would have, I'd say, failed, as it altered the number (10), which would in a sense be analogous to introducing a new number. Sorry.

We got three submissions within the first 24 hours of releasing last month's newsletter, so I was sure we'd get more; but, we didn't. And of these three, only one managed to get all 11 correct: Jon Gordon! Congrats!

Yes, this <u>was</u> tricky. Thanks, again, Ivana! (Oh, and BTW, did <u>you</u> solve it?).

THE SPAULDING GROUP'S 2018 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
November 14, 2018	Asset Owner Roundtable	Luxembourg
November 15-16, 2018	Performance Measurement Forum	Luxembourg
November 28, 2018	Asset Owner Roundtable	Orlando, FL
November 29-30, 2018	Performance Measurement Forum	Orlando, FL
December 5-6, 2018	Fundamentals of Performance Measurement	Mumbai, India
December 11-12, 2018	Fundamentals of Performance Measurement	New Brunswick, NJ
December 13-14, 2018	Performance Measurement Attribution	New Brunswick, NJ

For additional information on any of our 2018 events, please contact Patrick Fowler 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, close to 3,000 individuals have participated in our training programs, with numbers increasing monthly.