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.

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PFowler@SpauldingGrp.com

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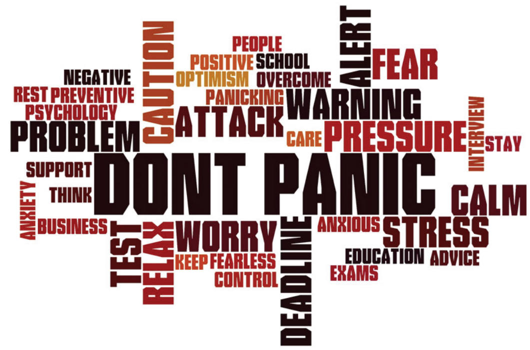
DON'T PANIC!



In a recent LinkedIn post,[1] I mentioned a client recently asked if they needed to comply with the 2020 GIPS® Standards by January 1, 2020. I explained that no, they do not.

There are a few good reasons for this:

- First, you don't have to: you only need to comply when you begin to report your December 31, 2020 figures, which will likely be done after January 1, 2021.
- Second, the revised *GIPS Handbook* is not expected to be available until around 12/31/2020. No doubt, this document will include revised guidance and commentary that compliant firms and institutions will find of value.
- Third, while composite software vendors are no doubt hard at work making adjustments to their system, is there a guarantee they'll be ready by 12/31/2020?
- Finally, we do not see any language that actually encourages firms to adopt early.

The point I want to make here is simply to clarify that you have some time to think about and plan for your adoption of these changes. Below, I address early adoption from both a *what you can do now without fully adopting* as well as *why you should or shouldn't adopt early*.

2020 GIPS STANDARDS: CLARITY ON ADOPTION REQUIREMENTS

The 2020 GIPS® Adopting Release for Firms[2] includes the following:

> Effective Date
>
> The 2020 edition of the GIPS standards has an effective date of 1 January 2020. GIPS Reports that include performance for periods ending on or after 31 December 2020 must be prepared in accordance with the 2020 edition of the GIPS standards. GIPS Reports that include returns for periods ending prior to 31 December 2020 (e.g., year-to-date returns through 30 September 2020) may be prepared in accordance with the 2010 edition of the GIPS standards.
>
> Firms may choose to early adopt the 2020 GIPS standards. If firms choose to early adopt, they must not pick and choose which provisions they adopt. They must comply with all requirements of the 2020 edition of the GIPS standards, including the requirements related to GIPS Reports.

1 https://tinyurl.com/yxl3wjn3

2 https://www.cfainstitute.org/-/media/documents/code/gips/adopting-release-firms.ashx

The Journal of Performance Measurement®

UPCOMING ARTICLES

Portfolio Performance Evaluation: What Difference do Logarithmic Returns Make?
– Ralf Hudert, CIPM; Prof Dr. Michael G. Schmitt, CFA; and Prof. Dr. Michael von Thaden

Seeing the RMD in a New Light: The Required Minimum Distribution in its Implications for Retirement Portfolio Design
– Craig L. Israelsen, Ph.D.

Expected Rate of Return of Investments with Uncertain Timing
– Boris Klebanov, Ph.D.

Performance Attribution of Reserve Managers with Frozen Positions Using Extensions of the Singer & Karnosky and van Breukelen Models
– Ted K. Heemskerk and Gerard van Breukelen

This section was pointed out to me by the GIPS Help Desk (GHD), when I inquired into the subject of early adoption, and whether the trademark disclosure could be adopted without adopting everything.

The GHD was quite helpful, as well as patient with me, as I tried to fully grasp the requirements.

I shared some of this in a recent video,[3] and wanted to go a bit more into it here.

<u>What's "early adoption"?</u>

Well, as the term suggests, it's adopting the revised Standards early. But earlier than what?

There's a bit of confusion here, as the "effective date" (1 January 2020) differs from the date firms must comply (1 January 2021[4]). In the past, these dates were the same. E.g., the 2010 version had both an effective date and a date firms must comply by of 1 January 2011. But here, we have a year between the effective date and the "must comply by" date.

I believe that "early adoption" means to adopt in advance of the effective date, though a case can be made that it is before the date firms must adopt by.

As you will shortly see: it doesn't matter.

<u>The "If" statement</u>

We read "if firms choose to early adopt, they must not pick and choose which provisions to adopt."

A few things about me: I'm a mathematician, a logistician, an analyst, and a literalist. Some of these traits got activated with this statement. We see the "if" statement. Well, I expect to see a corresponding "else." That is, what must be done if one does not "early adopt"? What are the rules, then?

Well, as it turns out, they're the same. That is, firms "must not pick and choose which provisions to adopt." As the sentence continues, "they must not pick and choose which provisions to adopt."

And so, this qualified statement is a bit incomplete, as it should perhaps state that whether firms early adopt or not, they are obliged to *do it all*!

But now, let's take this a bit further.

<u>Firms, in reality, CAN pick-and-choose, at least a tad</u>

3 https://www.linkedin.com/feed/update/urn:li:activity:6564238271944159232/

4 I'm taking some liberties here. There is no "official date" at which point firms must comply. Rather, as the narrative from the Adopting Release explains, firms must adopt when reporting performance for periods on or after 31 December 2021. That seems to be somewhat equivalent to saying "1 January 2021." This also simplifies this narrative and makes comparison easier.

My initial inquiry to the GHD dealt with the new "trademark" provision:

4.C.2	The FIRM MUST disclose the following: "GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein."

Can firms introduce this language into their GIPS Reports without having to adopt everything. And, the GHD responded that they could. Firms are able to add additional information to their current presentations, as long as it is not deemed to be false or misleading.

And so, *to some extent*, firms can adopt parts of the 2020 standards without "triggering" the need to adopt everything.

But what parts?

The following is a list of the items I[5] believe compliant firms can adopt without triggering the requirement to adopt everything from the 2020 version:

- Firms must create composites for both marketed and non-marketed[6]
- Report the composite's inception date (¶ 4.C.13[7])
- Begin to refer to their presentations as "GIPS reports."[8]
- The aforementioned "trademark disclosure"[9]
- Meet the one-year requirement to update presentations[10]
- Provide presentations that reflect disclosures of material errors to their verifier(s)[11]
- Be able to demonstrate how it made every reasonable effort to provide appropriate presentations to prospects[12]
- Create a list of pooled funds[13]
- Indicate where the GIPS materials are in their pitch books[14]
- Gain an understanding of the verifier's policies for maintaining independence and consider the verifier's assessment of independence.[15]
- Provide the same statistics (e.g., 36 month *ex post* annualized standard deviation) for secondary benchmarks as they do for the primary.[16]

5 I want to emphasize this point: that this is my view of what you can start employing early, without being required to adopt the full 2020 Standards. I believe that this list is reasonable and should not create challenges.

6 See Adopting Release for Firms, pages 3-4.

7 Unless otherwise noted, all such references are from the 2020 "Firm" document.

8 We see this throughout the Standards.

9 ¶ 4.C.2.

10 ¶ 1.A.16.

11 ¶ 1.A.20.

12 ¶ 4.A.10

13 ¶ 1.A.22, ¶ 1.A.23.

14 ¶ I.A.37.

15 ¶ 1.A.39

16 ¶ 4.A.4

- "For external cash flows that are not large cash flows, calculate portfolio returns that adjust for daily-weighted external cash flows, if daily returns are not calculated." That is, to only revalue when large flows occur (unless the firm uses a daily method).[17]
- Ensure that the returns calculated using model fees to be equal or lower than those that would have been calculated using actual investment management fees.[18]
- That fees charged for carve-outs to be representative of the investment management fees charged or that would be charged to the prospective client.[19]
- Replace the use of "% of firm assets" with "firm assets."[20]
- In addition to indicating whether their net-of-fee performance is net of performance based fees, to also indicate if it's net of carried interest.[21]
- When not showing the number of portfolios or a measure of internal dispersion because there are five or fewer portfolios in the composite, provide a note rather than leave it blank, indicating that this is the reason no values are shown.[22]
- Report "advisory" and/or "firm and advisory" assets.[23] Note, however, that in this case, until the firm has adopted the required changes completely, they must indicate this as "supplemental information."

Again, this is my interpretation of what firms can adopt from the 2020 version, in advance of adopting all the requirements.

This is quite a long list, but I believe it's safe to say these are "fair game."

Consider also the long list of what firms cannot adopt without adopting all requirements. This includes the use of estimated transaction costs and allocating cash for carve-outs. If you want to take advantage of these other changes, you will most likely need to fully adopt the changes.

I hope this is helpful. Feel free to "chime in" with your thoughts. Thanks!

EARLY ADOPTION OF 2020 GIPS STANDARDS: SHOULD YOU?

Okay, so now that we've addressed the reality that you do not have to comply by January 1, 2020, as well as items you may want to start doing now, there's the question of whether you should look to "early adopt" the full 2020 version.[24]

First, what is early adoption? I'd say it's one of two things:

- Adopting prior to the effective date (January 1, 2020)

17 ¶ 2.A.24.d. This arguably has always been a requirement, simply being made clearer.

18 ¶ 2.A.31.

19 Firms are permitted to use carve-outs with the 2020 version, provided the cash is managed separately.

20 ¶ 4.A.1.h.

21 ¶ 4.C.7.b. Technically, firms have always been required to disclose such information.

22 ¶ 4.C.39, ¶ 4.C.40

23 ¶ 4.A.10, ¶ 4.A.11.

24 I did a video on this, which is available on LinkedIn: https://tinyurl.com/yxzhl7nf

- Adopting prior to the date you're required to (i.e., after December 31, 2020)

The definition isn't as important as the "why." Other than to obtain "bragging rights," the only compelling reason to "early adopt" is to take advantage of one or more of the changes that will help your business:

- The ability to use estimated transaction costs
- The ability to allocate cash for carve-outs
- To avoid creating composite presentations for mutual funds you don't market to separate accounts
- To switch from time- to money-weighted returns for previously ineligible but with "2020" eligible composites
- To use the new portability rules.

"On the flip side," why might you want to wait?

- The revised *GIPS Handbook* is not yet available, meaning, you don't have the revised:
  - interpretative language,
  - guidance,
  - Q&As.

all of which can be helpful to achieve compliance with the 2020 version.

- Your composite software vendor may not have completed the revisions to support the changes.

Relative to the 2020 version, what should you be doing?

- Educate yourselves on the changes.
  - The annual GIPS conference is this month, where much of the program is devoted to the 2020 Standards.[25]
  - Our PMAR West conference[26] in November has a half day devoted to this topic. We're confident you'll find the information provided very valuable.
  - We've already done three webinars on the changes. If you haven't seen them, they've been recorded. To access, go here: https://spauldinggrp.com/gips-2020-webinars/
  - The third installment of our *Ultimate Guide to the 2020 GIPS Standards* will soon be available. We're sure you'll find it "chock full" of valuable information.
  - If you're one of our GIPS verification clients, you'll receive more details on the 2020 changes and what you need to do.
  - Review both the appropriate "chapter" of the 2020 GIPS Standards, along with the corresponding "adopting release(s)."

25 https://www.cfainstitute.org/en/events/conferences/gips-2019

26 To learn more about the conference and to register, please visit https://spauldinggrp.com/pmar-west/

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.

- Develop your very own "Plan to Adopt," so that you know what you'll need to do. Perhaps include the items you can start to include now, as mentioned above.
- If you use packaged software to support compliance, contact your vendor(s) to learn their plans for conversion.
- Contact your verifier for assistance.

ANNUALIZATION OF RETURNS

I just wrote an article[27] that dealt with the subject of annualization of returns. While I did not address the issue of trade vs. calendar days, I did reference a blog post[28] where I do.

I am not aware of many vendors who uses trade days. And since the GIPS standards do not require annualization, we don't frequently encounter this issue. Recently, however, we did; and the differences were material. For example:

# of Days	Cumulative	Annualized	
		Calendar Days	Trade Days
592	2.61%	1.60%	1.46%
592	3.43%	2.10%	1.98%

Is there an "official" method to calculate annualized returns? No. However, it is *more than* common practice to use calendar days. My article touches on other aspects of annualization you might find of interest.

As for the blog post, I realize I failed to include one other shortcoming with using trade days: the mechanics of employing it. Let's start with calendar days. First, we need to know the number of calendar days across the period. In the table above the period was January 1, 2018 to August 15, 2019. I suspect most people could, using one of a variety of means, quickly determine that the number is 592.

Okay, so *how many trade days are between these two dates?*

I have no idea. I'd have to go month by month, see if there are any holidays, and count the work days. And this can vary from country to country (e.g., we, in the USA, just celebrated Labor Day; most other countries do not). And imagine if this period extended across several years!

Perhaps one of the biggest challenges is comparability. As we see in the table above, we could have two managers with the same cumulative returns, but they'd be reporting two quite different annualized returns. And while I have not done any research, at least here it appears that the trade date method yields a lower return.

If you can think of reasons why trade days are superior to calendar, please chime in!

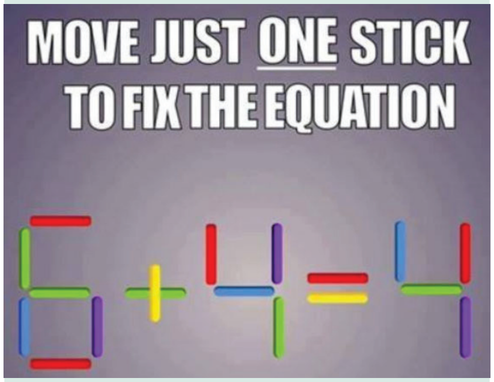
27 Spaulding, David D. "How Best to Annualize Rates of Return." *The Journal of Performance Measurement*. Spring 2019. Note: if you are not already a subscriber to *The Journal of Performance Measurement*®, sign up for a free subscription by going here: https://spauldinggrp.com/free-journal-of-performance-measurement/

28 https://spauldinggrp.com/annualizing-rates-of-return-might-trade-days-be-better-than-calendar-days/

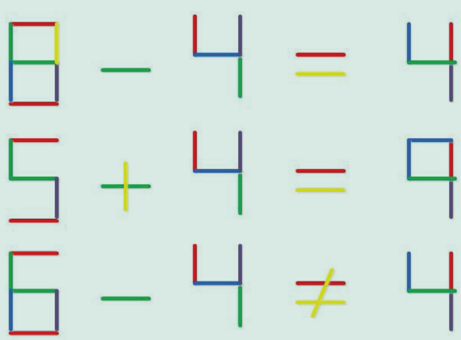
PUZZLE TIME!

<u>July Puzzle</u>

This one was passed to me by a high school friend on FaceBook:



I came up with three solutions:



Amy Garrigues, James Damian, and Patrick Trencansky provided solutions. Patrick found the three I did, while Amy and James each came up with the second one I show.

PUZZLE TIME!

<u>September Puzzle</u>

This month's puzzle is from an "article" by King Liang Ng, CFA, FRM, CIPM, that appeared on LinkedIn; it is posted with his permission.

Modified Dietz calculation has an interesting way of showing return which can sometime create confusion for layman. See the following figure; assume you buy equity 1 day before end of the month and it went up 5%.

	Market Value 31-Mar-18	Purchase on 29-Apr-18	Market Value 30-Apr-18	1 Mth % Return
Equity	0	100	105	150%
Cash	100	-100	0	0%
Total	100	0	105	5%

How did that equity which you buy the day before earn 150%, when you confirm the price only moved up by 5%? You didn't see your total market value go up to 250 as well. Then how about if you sell your equity holding before it reach month end?

	Market Value 31-Mar-18	Sale on 5-Apr-18	Market Value 30-Apr-18	1 Mth % Return
Equity	100	-105	0	40%
Cash	0	105	105	0%
Total	100	0	105	5%

You sell it on the 5th day after earning 5%, and the 1 month return for that equity shows 40%. Again, if you look at your total assets, it only earns 5%.

This is the magic which modified dietz [sic] return performs (or should say money-weighted return performs) because it weighs the transaction according to the number of days left in the measurement period (the lesser the remaining days, the less weightage [sic] it gets). It all boils down to the formula. The denominator for modified dietz return uses beginning market value and day weighted cashflow (which is transaction for equity & cash line). Day weighted means the transaction is multiplied by the percentage of remaining days in the measurement period.

Look at the denominator for modified dietz [sic] formula (which I called "adjusted beginning market value"). This will give you a 3 for equity line as the denominator, and the numerator which is profit and loss (P&L) is 5. Henceforth, you get 150%. This is not wrong mathematically, but just not so intuitive to layman.

Beginning market value	+	Transaction	*	(Number of days in a month - Day of transaction) / Number of days in a month
0	+	100	*	(30 - 29) / 30

	Market Value 31-Mar-18	Purchase on 29-Apr-18	Market Value 30-Apr-18	1 Mth % Return	Beginning Market Value + Day weighted cashflow	Contribution to Return
Equity	0	100	105	150%	3	5%
Cash	100	-100	0	0%	97	0%
Total	100	0	105	5%	100	5%

How would you respond to this? How do you explain the result? Do you concur with the author, or do you have other thoughts?

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CE Qualified Activity CFA Institute

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THE SPAULDING GROUP'S 2019 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
November 20, 2019	GIPS Workshop	San Diego, CA
November 21-22, 2019	Fundamentals of Performance Measurement	San Diego, CA
December 9-10, 2019	Fundamentals of Performance Measurement	New Brunswick, NJ
December 11-12, 2019	Performance Measurement Attribution	New Brunswick, NJ

For additional information on any of our 2019 events, please contact Patrick Fowler at 732-873-5700