PERFORMANCE PERSPECTIVES

with David Spaulding

VOLUME 17 – ISSUE 2 OCTOBER 2019

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

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http://www.SpauldingGrp.com

THE START OF 17 YEARS!

Last month's issue marked the start of the 17th year of us doing this newsletter. And over that time, I've only missed a few months (this year's series of misses was, fortunately, an anomaly).

I do the writing, for the most part, and Patrick Fowler handles the production, working with our graphic artist, Cybill Conklin. The design has changed a few times, but has remained constant for more than a decade (meaning my photo should probably be updated!).

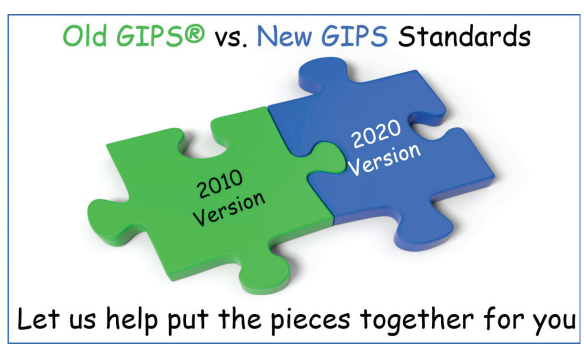
The most challenging part has become the puzzle. Since our readers seem to enjoy it (some virtually jumping upon it when Patrick distributes the latest issues), we strive to have one in every issue. Some are obviously more challenging than others. We've been fortunate that a few readers have submitted suggested puzzles from time-to-time. In almost every case, we've used them.

I try to be candid in my comments, though at times I'm perhaps <u>too</u> candid. I never wish to offend anyone, and hope my writing is tactful.

We greatly appreciate the feedback we receive, and encourage you to offer suggestions for posts and topics to cover.

A 2020 GIPS® ROAD SHOW

My colleagues and I have conducted several webinars and in-person events on the 2020 GIPS standards, and will continue to do this over the coming months. A few have been in collaboration with the CFA Institute, while others have been with colleagues from law firms and vendors.



We greatly appreciate the interest these events have garnered, as well as the questions that arise.

This latest edition of the Standards has definitely gotten a great deal of attention; much more so than the prior versions.

The Journal of Performance Measurement®

UPCOMING ARTICLES

PRIVATE EQUITY VALUATIONS

In the September 21-22 edition of *The Wall Street Journal*, Jason Zweig pointed out the massive difference in valuations for WeWork, from what the latest round of funding had it at (over $40 billion) to what the market thought it was at the time of the IPO (around $24 billion) to the most recent figure (about $8 billion).

While this might appear to be an aberration, and perhaps its magnitude is, Jason points out that in reality, the valuations at the time of the IPO can often be significantly lower that what the asset was priced at.

This should not call into question all valuations of p/e, but should at least cause some increased interest in how the numbers are arrived at. I suspect a great deal more will be said about this topic.

ON NET-OF-FEE RETURNS

Founder and CEO of Agecroft Partners, Don Steinbrugge, was quoted in a recent article[1] on hedge funds and compliance with the GIPS standards. He was particularly critical of the treatment of fees: "If you have two funds there could be major discrepancies in performance between the managers. For example, if you have two managers who have identical gross performance, fees as a % of NAV and fee schedules, but then you have different performance it's because the fees used to calculate net performance are net fees of the fund not those listed in the presentation."

I have been a critic of net-of-fee returns for decades. The Standards understandably recommend gross-of-fee, but there's recognition that there is value in net-of-fee. However, the problem stems from how that net-of-fee return is derived.

In an ideal setting, the maximum fee is charged against all accounts. Now, the result has some meaning. The problem, of course, is that the manager would argue that the reported return is lower than it actually is, had actual fees been used.

If we use actual fees, we are typically dealing with a *blend* of fees, that can range from zero to the composite's maximum fee. If, as Don Steinbrugge points out, two managers with identical gross-of-fee returns are drawing from a pool of assets with quite a different mix of fees, the resulting net-of-fee return will be quite different. This may in turn result in the prospect choosing the one with the lower net-of-fee results, not realizing that the difference is actually meaningless.

In an ideal world, the net-of-fee return will be based on the fee that the prospect would be paying. If, for example, a manger's fee schedule ranges from 1.00% to 0.25 percent, and the prospect has been assured that their fee will be 0.40 percent, wouldn't it be better to have the reported returns be net of this value?

1 Hampson, Rebecca. "How Quickly Will Hedge Funds Adopt The 2020 GIPS Standards?" *AlphaWeek*. October 14, 2019.

The AIMR-PPS® standards recommended this issue: "The AIMR-PPS standards recommend that performance results be presented gross of fees because a firm's fee schedule is usually scaled to size of assets. Therefore, performance results after deduction of an average management fee will not be representative of results for a portfolio that is much larger or much smaller than the size of the portfolio represented by the average fee."[2]

The AIMR-PPS required firms that reported net-of-fee returns to "also disclose the weighted-average fee to enable a prospective client to compute composite performance on a gross-of-fee basis."[3] This disclosure also helped the investor to better understand the meaning of the return.

In a word, there's a need for greater *transparency* when it comes to the calculation of the net-of-fee returns. The Standards have moved forward a bit with the 2020 edition, as it now requires firms that use model fees to reveal what those fees are.

I will have more to say on this subject in a forthcoming article for *The Journal of Performance Measurement*.®

PUZZLE TIME

September Puzzle

Last month's puzzle is from a LinkedIn article by King Liang Ng, CFA, FRM, CIPM; 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%

2 *AIMR Performance Presentation Standards Handbook, Second Edition*. AIMR. 1997. Page 73.

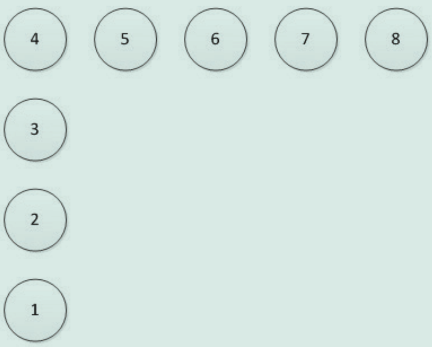
3 Ibid. Page 73.

PUZZLE TIME!

October Puzzle

This month's puzzle was presented to me by our 10-year old grandson, Brady.

The following graphic shows eight coins, five on the horizontal and four on the vertical. Move just one coin so that there are five on both.



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?

I was a bit surprised that no one chimed in on this. The problem with King's math for this table is that he derived a return for equities when it was present for only two days (the 29th and 30th).

	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%

This is definitely not unique. I discovered that Advent did (don't know if they still do) calculate returns for a security that was sold, after the sale date. E.g., if you hold something from January 1 to January 20, and then sell it out completely, they can derive a full month return for January, a full quarter return for the first quarter, etc.

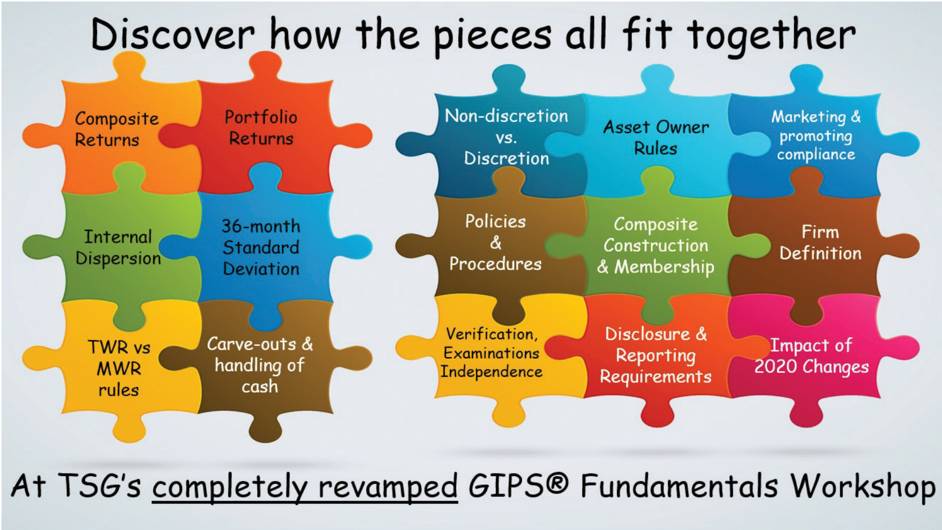
The weighting factor in the Modified Dietz formula (# of days in the period, minus the day of the flow; divided by the # of days in the period) can make a significant impact on the result.

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.

Returns should be calculated and reflected for only the period an asset is held. If you don't hold an asset for a full month, quarter, year, etc., then don't synthetically extend it by adjusting the weighting factor, otherwise you'll get nonsensical results.

We thank King for posting this, and for allowing us the opportunity to critique it. If you care to offer your thoughts, please do!



UPCOMING WORKSHOP!

The Spaulding Group has invested a massive amount of time to completely revise its GIPS® Fundamentals Workshop, to incorporate the myriad of changes introduced by the 2020 changes.

The result is an even better experience for our students.

This class will be taught by John Simpson, CIPM on November 13 in San Diego. John has over 30 years' industry experience, with more than half of it as a GIPS verifier.

Come and discover just how all the various pieces of these critically important Standards fit together.

To register and to learn more, please visit

https://spauldinggrp.com/product/fundamentals-gips-workshop/

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

DATE	EVENT	LOCATION
November 11-12, 2019	PMAR West Coast	San Diego, CA
November 13, 2019	Asset Owner Roundtable	San Diego, CA
November 13, 2019	GIPS Workshop	San Diego, CA
November 14-15, 2019	Performance Measurement Forum	San Diego, CA
November 14-15, 2019	Fundamentals of Performance Measurement	San Diego, CA
November 21-22, 2019	Performance Measurement Forum	Madrid, Spain
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

TRAINING...

Gain the Critical Knowledge Needed for Performance Measurement and Performance Attribution

TO REGISTER:

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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:

November 21-22, 2019 – San Diego, CA
December 9-10, 2019 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

CE Qualified Activity CFA Institute

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:

December 11-12, 2019 – New Brunswick, NJ

15 CPE & 12 PD Credits upon course completion

CE Qualified Activity CFA Institute

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.