VOLUME 18 – ISSUE 1 JANUARY 2022

Getting Back to it

It's been over a year since I crafted a newsletter. No real excuse. It's not like there wasn't a lot to write about. I guess it's just that I've been busy and distracted. But, it's a new year and we'll make an attempt at regular postings.

Accepting Things Perhaps We Shouldn't

"And that's often the problem, isn't it? In writing and in so many things: that we accept things we're taught without thinking about them at all."

Benjamin Dreyer
Dreyer's English

Benjamin Dreyer, a professional copywriter, spoke at last year's annual GIPS® conference. It was the #1 session I was interested in watching, but I wasn't actually that thrilled by it. Perhaps what I was expecting was unrealistic.

Regardless, I decided to purchase *Dreyer's English*, and from the first page I was hooked: what a great book!

Now, as I write this, I've only reached Chapter 3, but Chapter 2 includes the quote toward its end. And, it struck me how much this acceptance of things that we are taught, perhaps without thinking about them, occurs in life; and my focus will be on how it occurs with the GIPS standards.

I will identify several items which are taught, recommended, and in one case, required, which I'd do without.

1) Composite Returns

The Standards require firms to asset-weight the returns of the underlying composites. This comes from the old AIMR-PPS® standards that had the same requirement.

But why asset-weight? As I recall, the idea was that the composite's return should look like that of a portfolio. Go figure.

There were two groups who, at the time, strongly lobbied against this: the Investment Council Association of America (ICAA; now the IAA, or Investment Advisors Association) and IMCA (the Investment Management Consultants Association). Both felt that by asset weighting, larger accounts would count for more, which could influence how managers invested. Despite their argument, the Association for Investment Management & Research (AIMR; now CFA Institute) wouldn't budge: asset-weighting was to be used.

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We are actively involved as members of the CFA Institute and other industry groups. The Spaulding Group has also led the charge for the industry in the handling of error correction, attribution guidelines/ standards, and Investment Performance Measurement Analyst Certification (since handed over to the CFA Institute and now called the CIPM program).

Several of our senior staff regularly speak at and/or chairs industry conferences. Our founder and CEO, David Spaulding, is a frequent author and source of information to various industry publications. Our firm continues to make huge contributions to our industry, in terms of valuable content, innovative ideas, and volunteer activities.

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At the time (roughly 1992), I didn't have an opinion. Today, I do.

Why are we not calculating equal-weighted returns? I.e., why not simply take the average composite return? Wouldn't that make a whole lot more sense?

I've done GIPS verifications where a composite might have one HUGE account, and several small ones. The small ones might have modest differences from the large account; but the composite's return? Well, that equaled the large account. I.e., the returns of the smaller accounts had no effect, no influence on the composite's return.

What sense is there for asset-weighting?

I tried to get the *deciders of such things* to consider making a switch with the 2020 version. Well, that, of course, didn't occur. Asset-weighting remains.

And so, just consider this first item some venting on my part. Now, to recommended or allowed items you should rethink doing.

2) Aggregate Method

As to asset-weighting, there are three allowable methods:

- asset-weight using the starting values
- asset-weight using the starting values plus weighted cash flows
- aggregate all accounts into one.

The 2020 GIPS Standards for firms states "The composite return is the asset-weighted average of the performance of all portfolios in the composite." But that is not what results from the aggregate method. Rather, the aggregate-generated return is the return of the composite, in no way is this the "asset-weighted average" of the composite's portfolios.

The aggregate method does not provide the return of any individual portfolio, or the return of the "average" portfolio. Rather, it provides the return of the composite. But, the firm isn't managing the composite in its strategy; it isn't managing the composite as a portfolio; it isn't investing in the composite based on anything *per se*. Rather, the manager is investing in the individual portfolios. There are times when the aggregate return can be nonsensical. In fact, one can easily argue that the aggregate method fails to meet the criteria of a composite return!

There are times when the aggregate return will not even look like the returns of the underlying portfolios: it can be above or below all of them![1]

It is unfortunate that the aggregate method is permitted; and, in fact, it may be the most commonly used, because some popular systems use it, and these systems are not popular because they use the aggregate method, there are other reasons for their popularity.

I always encourage my verification clients to avoid this method and to use one of the others which do, in fact, produce an asset-weighted average of the performance of all the composite's portfolios.

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.

3) Accruing Fees

As with just about every version of the Standards we find "The firm should accrue investment management fees"[2] in the 2020 version. Why?

Well, I have it on good authority[3] that when they came up with this idea, it was based on the belief accrued fees would be more accurate. And this is, as far as I know, the reason why it remains a recommendation. That said, I have demonstrated[4] this is not the case; that is, accruals do not yield more accurate returns. In fact, one might argue that they result in less accurate returns, and are perhaps even worthy of being labeled "hypothetical," since fees are not paid this way.

Anyway, I discourage the accruing of fees if you're basing the decision simply on this recommendation.

That said, if you do it for some other reason (e.g., so that your monthly returns always show differences between gross and net), that's fine. You're obviously entitled to arrive at good reasons for this practice. I'd just ignore the recommendation.

4) Error Correction Levels 1 & 3

The error correction guidance suggests four levels of errors:

- #1 Immaterial, that you won't bother to fix
- #2 Immaterial, that you'll fix
- #3 Immaterial, that you'll fix and create disclosure for in your GIPS report
- #4 Material, that you'll fix, create disclosures for in your GIPS report, and distribute to those who saw the prior version (i.e., with the material error(s)) that are still active prospects or who have since become clients.

And so, why would you do #1? If you find an error, even if it's immaterial, why not fix it?

And, as for #3, why would you do this? By definition, the error is "immaterial." I.e., no one cares! If they cared, it'd be "material." And so, why do you feel it necessary to tell people who didn't know about it in the first place? Do you have a guilt complex?

I strongly suggest not adopting these, and simply adopting #2 and #4: these make sense. It's a cleaner way to operate.

CALL FOR ARTICLES

The Journal of Performance Measurement®, now in its 26th year of publishing, is currently open for article submissions on topics including performance measurement, risk, and attribution, and we're interested in both academic and practical/real-world articles. All articles are subject to a double-blind review process before being approved for publication. For more information and to receive our manuscript guidelines, please contact Douglas Spaulding at DougSpaulding@SpauldingGrp.com

5) Distributing GIPS Composite Reports To Existing Clients

At one time, the folks who oversaw the Standards thought about requiring compliant firms to give GIPS reports to clients who have portfolios included in the composites. Fortunately, *cooler heads prevailed*. However, this idea surfaced as a recommendation.[5] I opposed this from the start.

Why would you do this?

Chances are, roughly half your clients will have returns below the composite's return: might they call and ask you "why?" Of course, you could respond, "Well, the composite's return is an average,[6] and with all averages, roughly half the members will be above and half below. You happen to be below: someone had to be, right?

Well, this probably won't go over well. Why are you going to do this?

Granted, some firms do; even some of my verification clients do. If you feel it's a good idea, great! But if you're doing it because the Standards recommend it, I'd suggest you stop. Of course, if a client asks for the report, you're obligated to give it to them. But otherwise, don't bother.

6) Asset Weighted Standard Deviation

This, too, is a subject I've addressed in the past.[7]

The idea of an asset-weighted standard deviation came about during the AIMR-PPS days: someone on the committee apparently suggested that since the composite return is asset-weighted,[8] shouldn't the dispersion be, too? I expect whoever said this was greeted with applause for such an ingenious idea. And so, they crafted a method to do this.[9] And, the Standards actually recommended this approach. As a result, most firms adopted it.

Fast forward to a few years ago, the following dawned on me: what the heck does this formula actually measure? How does one explain what it means?

Simple answer: there is no answer to this. No one knows. No one can explain it. And so, why are you still using this method?

The GIPS standards do not recommend it. In my comment letter on the 2020 version, I pleaded[10] that they prohibit the method going forward. As with many of my recommendations, it did not get applied: oh, well; I've gotten over the rejection.

I do think it's unwise to produce a number you cannot explain. If you have an explanation, please send it to me.

Well, that's it ...

At least for now.

Please chime in with your thoughts, ideas, criticisms, reflections, insights, etc.

The Spaulding Group Is Excited To Welcome Wendy Wee To Our Team!

We are so very excited to welcome Wendy Wee to our firm. Some of us have known Wendy for a couple decades, as she worked for two of our clients (Turner Partners and Coho Partners). She's an accomplished industry veteran, and a joy to work with. She will support our verification team. Our firm is strengthened because of Wendy's presence.

References

Spaulding, David. 2011. "An Analysis of the Aggregate Method to Calculate Composite Returns." *The Journal of Performance Measurement.* Vol. 15, Issue #2

Spaulding, David. 2015. "Why do we abuse, misuse, and confuse standard deviation?" *The Journal of Performance Measurement.* Vol. 19, Issue #1

Spaulding, David. 2018. "Accruing advisory fees: does it make sense?" *Performance Perspectives Blog*. March 13, 2018. https://spauldinggrp.com/accruing-advisory-fees-make-sense/

Endnotes

1. Spaulding (2011).
2. ¶ 2.B.4.
3. I exchanged emails with the former chair/co-chair of the AIMR-PPS working group, Chuck Tschampion, who confirmed this.
4. Spaulding (2018)
5. ¶ 1.B.5.
6. Unless you're using the aggregate method; see above for more on this.
7. Spaulding (2015)
8. Unless, of course, if you're using the aggregate method.
9. Actually, the original method was determined to be flawed, so it had to be re-jiggered.
10. Perhaps a bit of hyperbole: perhaps I didn't plead, but I did try to strongly make the case.

THE SPAULDING GROUP'S 2022
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
February 16-17, 2022	GIPS For Asset Owners Training with State Street	Online
May 10-11, 2022	PMAR North America	Philadelphia, PA
May 23, 2022	AORT North America	Nashville, TN
May 24-25, 2022	North American Forum	Nashville, TN
June 16-17, 2022	EMEA Forum	Amsterdam, Netherlands
Fall, 2022	North America Forum/AORT/Broker Dealer	San Diego, CA

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