PERFORMANCE PERSPECTIVES

with David Spaulding

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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).

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Is it really "best practice"?

Consider this issue a preliminary look into a future article on the subject of "best practices."

"Recommendations" in the GIPS® Standards are classified as "best practice." And so, firms and institutions that claim compliance are *recommended* to follow these *recommendations* (do I get points for such great wording?). Interestingly, very few of my verification clients follow any of them. In some cases, I do believe there would be good reason to adopt them, but in a few I'd almost scream "**please don't!**"

I'll touch on one such recommendation in this issue, and will begin with some background. What I will share comes from the GIPS Handbook for Firms. Starting on page 123, we find a discussion on the aggregate method to derive composite returns. I am "on the record" as strongly opposing this approach. At the most basic level, it violates the Standards' own definition of a "composite return," which is "the asset-weighted average of the performance of all portfolios in the composite.[1]" The aggregate method's return is not the "asset-weighted average of the performance of all portfolios in the composite"! So, why is it still permitted and not, at least, discouraged?

Another issue I've had is that with this approach, there are times when the composite's aggregate method's generated return is not within the range of the individual portfolios! I brought this to the attention of the GIPS Executive Committee 12 years ago this month.[2] And so, I was, to an extent, pleased to see this point acknowledged in the Handbook, where we find "When using the aggregate method, a manager may encounter a situation in which the composite return falls outside the range of portfolio-level returns for a given period."

This statement is followed by a reason: "This scenario can occur if the policies used to calculate portfolio-level returns do not flow through to the aggregate composite-level return calculation policies. 'Flowing through' to the composite means that if any portfolio is valued during the month because of a large cash flow, the entire composite would also be valued and the sub-period return calculated for both the portfolio and the composite."

This discussion continues,"A firm may establish large cash flow policies, however, such that only those portfolios in the composite that experience a large cash flow during the month are valued at the time of the large cash flow and any portfolios that did not experience a large cash flow are not valued during the month. In such a situation, the composite return may be outside the range of portfolio-level returns for a given period."

The Journal of Performance Measurement®

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And concludes with a solution: "To prevent this situation from occurring, the firm should consider establishing a policy wherein all portfolios in the composite are valued if any portfolio in the composite is valued during the month because of large cash flows."

Is there any evidence that doing this will avoid having a composite return outside the range of the underlying portfolios? No, and perhaps for good reason, because it doesn't. In my letter to the EC I provided several examples, including this one:

Case #3						Asset-wtd		Asset wtd + wtd cf	
	BMV	Mid--pd CF	Mid-pd MV	EMV	ROR	Weight	Wtd ROR	Weight	Wtd ROR
A	100,000	0	101,000	104,000	4.00%	0.3333	0.0133	0.3175	0.0127
B	100,000	0	102,000	104,000	4.00%	0.3333	0.0133	0.3175	0.0127
C	100,000	30,000	95,000	136,840	4.00%	0.3333	0.0133	0.3651	0.0146
Total	300,000	30,000	298,000	344,840			4.00%		4.00%
Aggregate Method		Revalue for flow =			4.43%				
		Don't revalue for flow =			4.71%				

I mentioned in my letter that to revalue the entire composite will "improve the aggregate method," but as can easily be seen here, it does not avoid the composite's return being outside the range of the underlying portfolios.

Consequently, I would not recommend that firms take on the added work of revaluing all portfolios but rather to recommend they move to either the asset-weighted (using the beginning values) or asset-weighted plus weighted flows approach.

The aggregate method not only violates the Standards' own definition of what a composite return is, but can, at times, yield nonsensical results. As I explained in my letter, "The real culprit is the aggregate method, which, it turns out, measures the wrong thing: it tells us how the 'composite did,' rather than how the 'average account did.'"

One additional shortcoming of this method, identified by my colleague, Jennifer Barnette, that could cause a firm that uses it some serious problems: the composite's return might be higher than that of any of the underlying portfolios! That might not sit well with regulators nor is it even kosher for the Standards! Jennifer also pointed out that if the firm elects to revalue all portfolios when one has a large flow, they would technically violate the GIPS rule that prohibits more frequent valuations than what is specified for the firm's large cash flow threshold policy. This won't sit well with regulators, either.

One might ask, would daily valuations solve the problems noted above? The answer is "no," since calculating returns daily is equivalent to revaluing when flows occur, and calculating interim returns between the revaluation dates; and the above example demonstrates this will not work.

<u>What if your vendor only offers the aggregate method?</u>

There is at least one portfolio accounting system, and perhaps more, that only supports the aggregate method. I would try to get them to offer the [actually simpler] asset-weighted method, to alleviate these problems. Another alternative would be to bring in a composite system that will interface to your portfolio accounting system, and not only provide a better calculation for composite returns, but probably some enhanced features your current system lacks.

Please feel free to share your thoughts. More to follow on "best practices."

Endnotes

1. See page xiii of the "Firm" chapter of the Standards.
2. If you would like a copy of the letter, please contact my assistant, Jean Bryer at JBryer@SpauldingGrp.com

We are excited to announce that the first meeting of the **Broker Dealer Performance Measurement Networking Group** will take place on November 16th, 2022, at the Omni San Diego. This interactive membership group of performance measurement professionals will meet twice a year in North America. The goal of the group is to share knowledge, and collaborate on solutions to everyday challenges.

A full agenda can be found here: Inaugural Broker Dealer Symposium

If you are interested in trying the group out, please contact:

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or

Patrick Fowler at:

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

DATE	EVENT	LOCATION
November 10-11, 2022	EMEA Meeting of the Performance Measurement Forum	London, England
November 15-16, 2022	Fundamentals of Performance Measurement Training Class	San Diego, CA
November 16, 2022	Asset Owner Roundtable Meeting	San Diego, CA
November 16, 2022	Broker/Dealer Symposium – First Meeting	San Diego, CA
November 17-18, 2022	North American Meeting of the Performance Measurement Forum	San Diego, CA

For additional information on any of our 2022 events, please contact Patrick Fowler at 732-873-5700.

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