VOLUME 18 – ISSUE 12 DECEMBER 2022

Things we find confusing ... part I

Sub-portfolio returns

I had a conversation the other day with someone who mentioned their managers are objecting to the returns she's producing for various holdings. While I attempted to get the details, the only thing I got so far was that she is, understandably, using time-weighting.

"Understandably" because everyone [or virtually everyone] does this.

In my opinion, it's less than ideal [I'd say "wrong," but I'm working on getting out of that habit *].
To me, the preferred approach would be money-weighting, which, in my book means using the internal rate of return, or simply IRR, for those of us who have a close relationship with this formula.**

Why?

Well, recall that we use time-weighting to eliminate or reduce the impact of cash flows. And why is this? Because in most cases, the client controls them, so why should the portfolio manager be penalized or rewarded for bad or good cash flow timings?

And since the manager controls sub-portfolio cash flows (a.k.a., internal flows), shouldn't he/she be impacted by them? If the manager makes a good decision (e.g., buying more of a stock when it drops during the month, and rises prior to month-end), shouldn't this be included in the return? Shouldn't they be rewarded for their timing?

And so, my opinion is quite simple: use the IRR for sub-portfolio performance, which includes returns on securities.

What "time-weighing" means

I'm teaching a graduate course on investment analysis for Rutgers University; actually, it's two courses simultaneously, as I've got 29 students in my class, some of whom are MBA/Finance majors, while the others are pursuing a Masters in Quantitative Finance.

My text is the classic *Investments*, 12th edition, by Bodie, Kane & Marcus.

I'll confess to having owned an earlier edition for a number of years, though I've rarely even cracked the cover. But now I'm forced to read it. And during said reading, I've discovered a few errors, one being how they explain what we mean by "time-weighting."

The Journal of Performance Measurement®

UPCOMING ARTICLES

Highlights from the 2022 GIPS Conference
- Jennifer Barnette, CIPM and Ashley Reeves, CIPM

Evaluating Benchmark Misfit Risk
- Stephen Campisi

The Journal Interview
- Todd Jankowski, CFA, CFP

TAMPS, Third Party Platforms, and Model Marketplaces
- Noreen Beaman

Measuring Target Date Fund Performance
- Ron Surz

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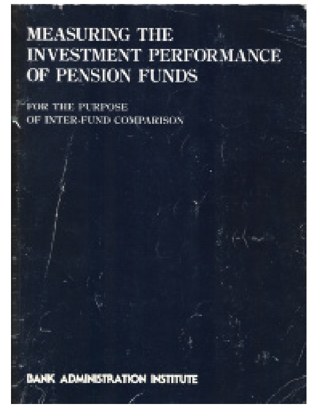
https://spauldinggrp.com/free-journal-of-performance-measurement/

On page 814 we find the statement "the geometric average is the constant annual return over the 20 years that would provide the same total cumulative return over the entire investment period .. Each return has an equal weight in the geometric average. For this reason, the geometric average is referred to as time-weighted average."



Sorry, but incorrect. No doubt, many believe something like this to be true.

The term "time-weighting" originated in the 1968 Bank Administration Institute's *Measuring the Investment Performance of Pension Funds.* We find the following:

"The recommended rate is called 'time-weighted' because it is simply the weighted average of internal rates of return for the subperiods between cash flows with each weight being only the length of its corresponding subperiod."

The committee that worked on this standard were attempting to find a way to link subperiod returns. They identified three ways to calculate performance (the exact method, linked IRR [which today we refer to as "modified IRR"], and regression [which no one does]). Why they didn't think of geometric linking is unknown to me.

I learned from Nobel Laureate Eugene Fama, PhD, who was a member of the committee, that the members worked remotely on the document. I guess someone came up with this idea, and it made intuitive sense (doesn't it?). That said, no one does it this way: we geometrically link the sub-period returns.

How the term for a linking method became the name of the return itself is also unknown to me.

The true meaning of the term is unknown to most performance analysts, because few have access to the BAI book [I've had a copy for 35 years].

The SEC Marketing Rule & attribution

Are you getting tired of discussions, reports, talks, etc. on this rule? I am. But, it's too important to ignore, so we will continue to discuss it.

The question: must an SEC-registered firm now calculate attribution using net-of-fees?

No.

Okay, I'll say a bit more about this.

Since attribution isn't performance, but rather, an explanation of performance (actually, an explanation of excess return), gross is sufficient.

That said, not everyone agrees.

And so, if you're one of those (or you work for one of those) who disagrees with this, and believes you must now calculate it using net returns, *how do you do it?*

The Institute of Performance Measurement

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Our Institute classes:

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[Performance Measurement Attribution]

[Fixed-Income Attribution]

[Masterclass on the GIPS® Standards for Asset Owners with State Street (Free)]

This was a topic at our recent Performance Measurement Forum meeting*** in San Diego. Not surprisingly, some members are showing attribution both gross and net. The way some do it net is by using a "fee effect," which is the difference between the gross and net return for the portfolio. Pretty simple, I think. Should work.

I have this labeled Part I because I'm sure I'll think of more to say, though you're welcome to suggest topics.

12 months, 12 issues

Wow, we did it!!! In 2022, we were able to produce an issue of this newsletter for every month: we haven't done this since ... [I'm embarrassed to say] 2014. We'll try to keep this up in 2023. Wish us luck!

I had planned to include puzzles, but finding them just takes a bit too long; I'll try to incorporate some in 2023.

Happy Holidays!

THE SPAULDING GROUP

Notes

* I'm listening to Dale Carnegie's classic, H*ow to Win Friends and Influence People.* He has an entire section devoted to avoiding arguments, not that saying something or someone is wrong would necessarily start one. But, to *soften* one's tone is advisable; and that's what I am attempting to do. As for the book, I read it 25 years ago, and regret not doing so again sooner, either the *old fashioned way* or by listening to it. As I've mentioned in the past, I'm a huge fan of Audible, and regularly listen to books while exercising and driving. Since I recently drove from Ontario to Florida, I had plenty of time to listen, though admittedly much of that listening was devoted to music: I can only listen to books for so many hours.

** I've threatened to have "I Love the IRR" tattooed on my arm for years: who knows, 2023 might be the year!

*** to learn more about this group, please visit https://spauldinggrp.com/events/performance-measurement-forum-asset-owner-roundtable/

THE SPAULDING GROUP'S 2023
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
April 26, 2023	Asset Owner Roundtable	Phoenix, AZ
April 27-28, 2023	Performance Measurement Forum	Phoenix, AZ
May 22-23, 2023	Fundamentals of Performance Measurement Training	New Brunswick, NJ
May 24-25, 2023	PMAR North America	New Brunswick, NJ
May 23, 2023	Launch of Women in Performance (Cocktail reception) https://spauldinggrp.com/events/women-in-performance-group/	New Brunswick, NJ
June 22-23, 2023	Performance Measurement Forum	Edinburgh, Scotland
November 9-10, 2023	Performance Measurement Forum	Porto, Portugal
November 29, 2023	Asset Owner Roundtable	Orlando, FL
November 30, 2023	December 1 – Performance Measurement Forum	Orlando, FL

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

Train Your Entire Performance *staff for half price!*

HERE'S THE PROBLEM

Your staff needs training in performance, risk, attribution, or the GIPS® standards, but you're not able to give them the training they need.

HERE'S THE REASON

Your training budget isn't big enough to cover the expense to send your entire team to offsite training. And, even if it was, you can't have your entire team offsite at the same time.

THIS MEANS

Either you have to take the time to create a program internally and continually update it, which is time and labor intensive, or your team is forced to learn what they need on the job, which means they aren't adding as much value as they could.

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- ✓ Improved morale, investing in your staff shows them your commitment

*It's hard to find such focused training around the topic of performance measurement along with experienced instructors who can get into the details of various calculations. I recommend this two-day training course for firms looking to provide a good foundation on this topic." **– Rajiv Mathur, Kaiser Permanente***

AVAILABLE CLASSES:

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