PERFORMANCE PERSPECTIVES

with David Spaulding

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This month's newsletter is a *tad* longer than usual. Lots of fodder has come in, and so it made sense to include it.

Doing a "180" on significant cash flows

It was probably about 20 years ago that my colleague, Neil Riddles, and I proposed to the AIMR-PPS® Implementation Committee to allow firms to temporarily remove portfolios from composites in the event of significant cash flows (SCF). We both felt that cash drag could occur, which would be unfair to the manager. This is especially the case when the composite's strategy is one that requires additional time (perhaps weeks or even months) to fully invest the cash, or, in the case of outflows, to raise the cash necessary to meet a client's withdrawal request.

We were successful; and, this option was carried over to the GIPS® standards.

Now, two decades later, I somewhat regret that idea. Or, at least, think that perhaps I'm just not as enthusiastic about it as I was.

Handling significant cash flows can be a challenge, especially when it has to be done manually. Someone needs to monitor withdrawals and contributions, to test if the amount exceeds the composite's threshold. When it does, they need to remove the account, keep it out, and return it in accordance with the firm's timing policy.

During the course of GIPS verifications, we occasionally find times when the firm failed to either move the account out or return it.

Furthermore, the reality is that in many cases, these instances of significant flows probably make very little impact on the composite's return.

I use a "milk metaphor." That is, if you take a glass of water, and put a drop or two of milk in it, chances are the water will turn white. However, if you take buckets of milk, and put it into a lake, the water will remain clear.

Likewise, when a composite has a number of accounts, keeping an account in that had a SCF will likely result in essentially the same composite return.

In addition, if the strategy is fairly liquid, the "cash drag" won't last that long, and so, again, won't have much of an impact.

My suggestion:

Only employ a significant cash flow policy if:

1) the composite has less than 25 accounts
2) and, only if the composite's strategy is one that takes at least several days, if not weeks or longer, to invest new cash or to sell securities to create cash.

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Further, you shouldn't have the policy where a composite has fewer than three or four accounts, because you risk having a break in performance.

More on SCFs

My colleague, Kathleen Seagle, CIPM, passed this question to us to comment on:

"We have a client setting up a new system and wondering if management fees should contribute towards their SCF assessment. They calculate net composite performance using a model fee and net portfolio performance using actual fees.

"What is your opinion on this?"

My initial thoughts: If in a single day, there's a really sizable outflow, and it happens to be the same day as a fee, I guess it would be appropriate to consider it in the SCF test.

Our colleague, John Simpson felt differently:

"If we are talking about GIPS, significant cash flows must be either a specific monetary amount or a percentage of portfolio value. Thus, I think there's two aspects to this:

- determining the amount of external cash flows
- determining the beginning of period value

"In determining the amount of external cash flows, I would say that management fees should not be considered as part of that calculation. Management fees are not client-directed external cash flows. Firms control their fees (and can plan for them). In my opinion, client-directed external cash flows are generally a disruption. Also, I'm pretty sure either the GIPS Glossary or the guidance indicates that firm controlled cash flows are not to be considered... I think that is meant to cover other things, generally (e.g., capital calls) but I would say it applies to fees, as well. Granted, depending on whether fees are paid from the portfolio and whether one is calculating either a gross or net return, we treat the fees as external cash flows, but that is really more accounting trickery than actual client-directed cash flows, in my opinion.

"In determining the beginning of period value, the question could be whether the portfolio value can be net of a fee accrual of some sort. I think this is fine, though I wouldn't require it. The firm might need to specify how they deal with this in their GIPS policies. Inclusion of a fee accrual would give a typically lower beginning value, and thus slightly increase the chance of hitting the threshold. Perhaps a higher chance if performance fees are involved. I don't think the guidance specifies anything, recommended or required, with respect to this, so this may just be a matter of accounting preferences. Though if return calculations are based on values that accrue fees, I would think the denominator for determining significant cash flows should use the same idea."

And, I must concur with John, as I think he makes a very good case.

Kathleen found the following, which supports John's view:

"For the purposes of the GIPS standards, an external cash flow is defined as capital (cash or investments) that enters or exits a portfolio. A significant cash flow is defined as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. The firm may define a significant cash flow as a single flow

Stay tuned...

New changes coming in 2024 to our newsletter as we begin our 20th year!

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or an aggregate of a number of flows within a stated period of time. Transfers of assets between asset classes within a portfolio or firm-initiated cash flows must not be considered significant cash flows and must not be used to move portfolios out of composites on a temporary basis." [source: 3.A.12 discussion in the Firm Handbook].

And John offered the following from the glossary: "The level at which the firm determines that one or more client-directed external cash flows may temporarily prevent the firm from implementing the composite strategy. The cash flow may be defined by the firm as a single flow or an aggregate of a number of flows within a stated period. The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of portfolio assets (based on the most recent valuation), and no other criteria, such as the effect of the cash flow or the number of portfolios in the composite, may be considered. Transfers of assets between asset classes within a portfolio or *firm-initiated cash flows must not be considered significant cash flows.*" <emphasis added>

This is one of the reasons TSG circulates questions like this to all the team's verifiers, to get others' perspective.

Hope you find this of value; please chime in with your thoughts!

Sunset rules in the GIPS standards

We received the following question from a colleague in South Africa:

"I have a client that has had many firm changes. It is more structural changes internally and not all of them had an effect on AUM. They disclose all of these changes which is about two pages long in their disclosures - from 2000 to 2022.

"How long do I need a change in Firm Definition disclosure? I cannot find any guidance on it."

While the following disclosures have "sunset provisions" with the qualifying statement "This disclosure must be included for a minimum of one year and for as long as it is relevant to interpreting the track record,"

- Significant events (4.C.19)
- Composite name changes (4.C.23)
- Retroactive benchmark changes (4.C.32)
- Changes in the return type (4.C.42)

firm definition does not. Therefore, the answer is "forever." I would say as long as the period shown covers these changes. If, for example, the report shows from 2013 to 2022 (10 years), and a change the period shown (e.g., in 2018, for this example), then the disclosure is required.

My thinking. Others may disagree. Again, please let us know your thoughts!

Are you a "superb human being?"

Interesting question, I think. It was posed by a marketing consultant, Jay Abraham, TSG has used, and I thought what he wrote would be of interest to you. We repeat it here, with Jay's permission. Note the emphasis shown is in the original.

David:

I was reading an obituary about the late Piper Laurie - a 91-year-old actress who just died. Her accolades began with a litany of all the Academy Award nominations she'd received for her amazing film role performances.

But - and THIS more than anything else - is what impacted me. It ended with a six-word sentence: She was a superb human being.

That got me thinking and then questioning first myself - meaning am I truly a superb human being? But then I turned the spotlight of examination on a number of friends, colleagues, co-workers, and iconic personalities I'm connected to.

My probably, most sobering question was - are THEY a superb human being?

Is it the fact that you take the time and effort to interact with people in both an attentive, qualitative, and authoritative way? Listening, acknowledging them, and focusing sincerely/empathetically on the (far too highly overlooked) importance of THEIR lives, THEIR issues, THEIR hopes, THEIR dreams, THEIR worldview? Which quite often is much different than the one you're marching to the beat of.

Do you take the time to invest (It IS an investment that pays unimaginable dividends and yield) to examine, explore, appreciate, respect, acknowledge, and understand the frequently very different reality other people are having at the same time as yours?

It's crucially important that you do so - whether it seems relevant to you right now - or not!

Why?

Because all those alternative realities so many people you intersect within your life are experiencing - are the drivers of their beliefs and their behaviors.

If you don't try and appreciate (not necessarily disagree - but not confront also) how differently others see life - you cannot connect, communicate, compel, or collaborate with them.

And - like it or not, you are NOT an island. These are the team members, the suppliers, the prospects, the buyers, the vendors, the referrals, the advocates your life and business are inextricably connected to - and actually unimaginably depend upon.

So, are you a superb human being?

How often do you smile at others?

How often do you perform random acts of kindness or contributions?

Is your life obsessively, compulsively, and toxically intentionally focused on only YOUR success, YOUR prosperity, you getting YOUR biggest house, you getting YOUR financial goals?

Or - are you enlightened enough and astute enough to know that it's not you against the world?

It's you gaining ethical, deserving leverage FROM your world.

And the broader, deeper your world becomes - the more richness you attain.

But not just economic wealth - I'm talking about the far, far more fulfilling richness of a satisfied psychic wealth that comes from a life well lived.

I spent over half a million dollars on therapy in my life. Most didn't pay off.

One was an incalculably, outsized, unimaginably high profit investment. The man turned my entire worldview of relevancy totally upside down! (For the infinite better.)

He told me THIS...

Most people obsess in their life and business over attaining the "end product" like…

"I want to make a million dollars or be the fastest growing company or have the biggest house, the most toys, the most beautiful wife or most handsome husband."

But…. Guess what?

If you're unlucky enough to get those superficial goals, for those superficial and vacuous reasons alone - IT'S ANTI-CLIMACTIC.

The heavens won't open up - the angels won't trumpet - permanent nirvana won't occur. Enduring happiness and unfettered joy will not permanently happen. It will not.

Why?

Because the real meaning of life, are you ready for this..?

It's that..

.. the process is what life is all about.

THIS, MY FRIEND, IS AS GOOD AS IT GETS.

And whether it's attentively talking to someone at a bus stop or in a hotel lobby (and acknowledging them so they feel relevant, significant, and important for a short window of meaningful and memorable time) - or just appreciating how wonderful human beings, fundamentally good human beings (not terrorists or vile/hateful ones) but fundamentally good human beings ARE - IS the true meaning of life.

So, ask yourself...

Am I a superb human being?

Depending upon the answer you'll either be very proud or have some work to do.

Is the world better off because you and your family or business are in it?

Being a superb human being is a lofty, lofty goal - but a worthy one to pursue.

So, in conclusion -

What do YOU stand for? Do you know? Figure it out. It will forever alter your sense of passion, possibility, and purpose.

And it'll make the process of existing as a value-creating human being so very much more satisfying. That's it.

Jay

TSG'S 2023
INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
November 9-10, 2023	Performance Measurement Forum	Porto, Portugal
November 29, 2023	Asset Owner Roundtable	Orlando, FL
November 30 - December 1, 2023	Performance Measurement Forum	Orlando, FL

For additional information on any of our 2023 events, please contact Patrick Fowler at 732-873-5700.