SS19 Performance Evaluation

The following information relates to Questions 1-2

Carol Lancaster of Trident Funds is discussing portfolio performance evaluation with a new employee, Mary Clark. Clark asks Lancaster why there is a preference for using a time-weighted rate of return (TWR) instead of a money-weighted rate of return (MWR). Lancaster informs Clark that MWR always has an upward bias relative TWR whenever the fund receives large contributions during a particular period. Consequently, TWR is the preferred metric.

Clark also asks Lancaster about the strict appraisal criteria used to evaluate the different managers employed by the Fund. Lancaster states, “The Fund is willing to risk firing good managers, a Type II error, in order to prevent retaining poor managers, a Type I error. But I would prefer if the Fund would relax the appraisal criteria.”

Lancaster then introduces Clark to a typical micro attribution model used by the Fund to evaluate a manager’s ability using the information in Exhibit 1.

Exhibit 1				
Micro Attribution Model Data				
Economic Sector:	Portfolio Weight (%):	Sector Benchmark Weight (%):	Portfolio Return (%):	Sector Benchmark Return (%):
Sector 1:	15	10	1.16	0.82
Sector 2:	25	25	1.69	2.31
Sector 3:	40	30	-0.62	-0.38
Sector 4:	14	15	4.98	2.95
Sector 5:	5	20	3.10	0.69
Cash:	1	0	0.45	---
Buy/hold Return:			1.21	1.13
Trading / other Costs:			-0.04	0.00
Total Return:			1.17	1.13

The value-added return produced by the manager is segmented into: a pure sector allocation return, a within sector allocation return, and an allocation/selection interaction return. Lancaster states that each portion of the value-added return is examined, but that particular emphasis is placed upon the within sector allocation return because it strictly measures the manager’s ability to select securities.

1 Lancaster’s statement about the money-weighted rate of return (MWR) is most likely:

A. Correct.

B. Incorrect, because the MWR is always equivalent to the time-weighted rate of return (TWR).

C. Incorrect, because the MWR can have downward and upward bias relative to the time-weighted rate of return (TWR).

Solution: C.

The MWR can have upward (downward) bias relative to the TWR when large contributions are made just prior to a period of strong (weak) performance.

2 The pure sector allocation return (%) for Sector 1 is closest to:

A. -0.05.

B. -0.02.

C. 0.02.

Solution: B.

Pure sector allocation return = (portfolio weight – benchmark weight) x (benchmark return – benchmark total return) applied to Sector 1.

= (15% - 10%) × (0.82% - 1.13%) = -0.02%

The following information relates to Questions 4-5

Redlands Asset Management (RAM) is an active equity manager specializing in the Asian Pacific region. The firm was founded by Carol Schroeder, CFA at the beginning of 2006, with several members of her family serving as the firm's first clients providing the initial managed assets for the firm.

Schroeder has compiled the information in Exhibit 1 and plans to use it to market RAM to institutional investors.

Exhibit 1			
Redlands Asset Management GIPS Compliant Performance **Asia-Pacific Composite. (1/Jan/2006 thru 31/Dec/2008)**			
Year	**2006**	**2007**	**2008**
Return Gross of Fees	44.8%	66.9%	80.7%
Benchmark Return	43.1%	60.2%	85.6%
# of Portfolios	5	15	33
Composite Dispersion		6.7%	5.1%
Period Ending Total Assets ($ millions)	350	760	1,630
% of Firm Assets	14%	25%	52%

Notes:

1) Performance results are presented gross-of fee so that they represent the return on assets reduced by any trading expenses incurred during the period.
2) The Asia-Pacific composite includes two non-fee-paying accounts of the Schroeder family.
3) A complete list and description of composites and their strategies, including any that have been discontinued within the last five years, is available upon request.
4) Portfolio valuations are computed monthly and are denominated in US dollars.
5) RAM uses cash-basis accounting for the recognition of interest income on its holdings of preferred stock.
6) The pricing source was changed prior to the end of the reporting period because, in management's opinion, performance was not fairly represented. The new source has significantly improved the firm's results.
7) RAM trades securities in illiquid markets with substantial political and economic risks so trades are recorded on a settlement date basis to ensure that these trades have been completed before they are included in performance calculations.
8) The composite presented above has been GIPS verified.

3 Which of the following performance presentation notes contains an error or omission that is most likely to prevent RAM from being in compliance with the GIPS standards?

A. Composite list availability.

B. Non-fee paying accounts disclosure.

C. Disclosure concerning discontinued composites.

Solution: B.

The percentage of the composite which non-fee paying accounts represent should be disclosed.

4 Does RAM's performance presentation most likely meet GIPS standards concerning dispersion?

A. Yes.

B. No, the method chosen must be disclosed.

C. No, the standard deviation must be presented.

Solution: B.

The GIPS standards require firms to disclose which dispersion measure is presented.

5 Southwest Capital Advisors LLC manages a fixed-income composite in accordance with an enhanced indexing strategy which makes strategic use of high-yield and emerging market

bonds in addition to investment grade bonds issued in developed markets. The Merrimack Company, a family office, has a portfolio that is included in the firm's fixed-income enhanced indexing composite. Merrimack informs Southwest in writing that, due to changes in its investment policy, the portfolio can no longer hold high-yield or emerging market bonds. In accordance with the GIPS standards, Southwest decides to switch the Merrimack portfolio to another composite. The historical performance of the portfolio must be:

A. reflected in both composites.

B. switched to the new composite.

C. retained in the enhanced indexing composite.

Solution: C

Provision I.3.A.7 states, "Portfolios must not be switched from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes it appropriate. The historical performance of the portfolio must remain with the original composite."