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The CutterAdvantEdge
Commentary on Investment Systems and Operations

One Step Ahead, One Step Behind: Performance Measurement and Attribution

It has been fascinating to follow the arc of performance measurement standards from the original publication of the AIMR PPS in the mid-1990s to the CFI Institute's current-day GIPS. The standards have spawned entirely new businesses including verification, and entirely new systems for automating the associated processes. In a short span of time, the industry has cooperatively developed performance measurement standards, and has made significant strides toward self-regulation in meeting those standards. In contrast, industry-wide standards for performance *attribution* remain elusive. To be effective, an attribution methodology must closely match the unique aspects of a portfolio manager's strategy. So while some standards have emerged, particularly on the equity side, they haven't been widely adopted on the fixed income side, largely due to the complexity of the instruments.

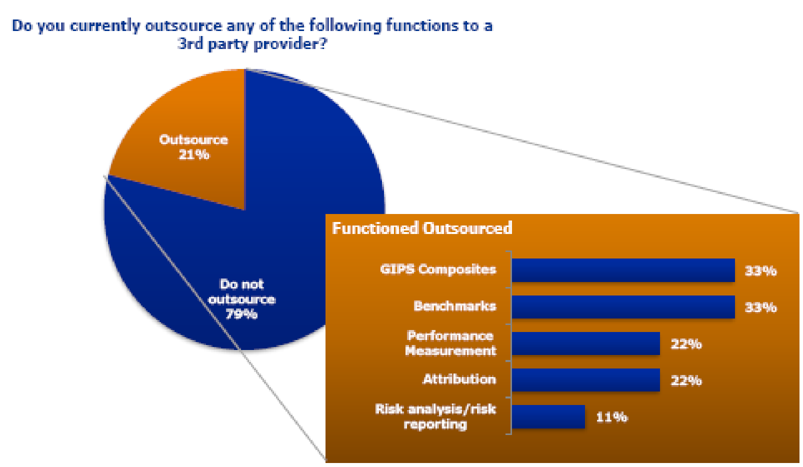
In a Q4 2010 CutterBenchmarking report on performance measurement and attribution, asset management firms indicated that they are rethinking their performance practices because of the following market dynamics:

- Increasing scrutiny of performance measurement and attribution by clients and regulatory agencies
- New GIPS requirements effective January 1, 2011
- Continuing market complexity and volatility

Their rethinking includes weighing the benefits of assigning staff broad responsibilities against the benefits of specialized responsibilities, reviewing opportunities to offer more detailed return calculations on a daily basis, and preparing for increased scrutiny of performance measurement and attribution and the associated methodologies.

Higher expectations drive increased specialization and decentralization

In a 2008 CutterBenchmarking study similar to the Q4 2010 report cited above, 73% of firms reported that their performance team was centralized in the organization, with broad responsibilities from return calculations to GIPS compliance. But 2008 was a different era, when efficiency was paramount. Today the market is more complex, with higher expectations from clients and greater invasiveness from regulatory agencies. Now, only 50% of firms have a centralized performance team managing the same scope of functions as in 2008.



Demand for more detailed performance data, delivered more frequently, is driving the need for deeper, more specialized knowledge of asset types. In turn, the need for more specialized knowledge is driving increased decentralization, with expertise and responsibilities distributed across a wider net of contributors. Particularly affected by decentralization are GIPS compliance and attribution functions (see the section, *Attribution: The last frontier?*).

Demand for more detailed performance data, delivered more frequently, comes often from end users, of which there are several types:

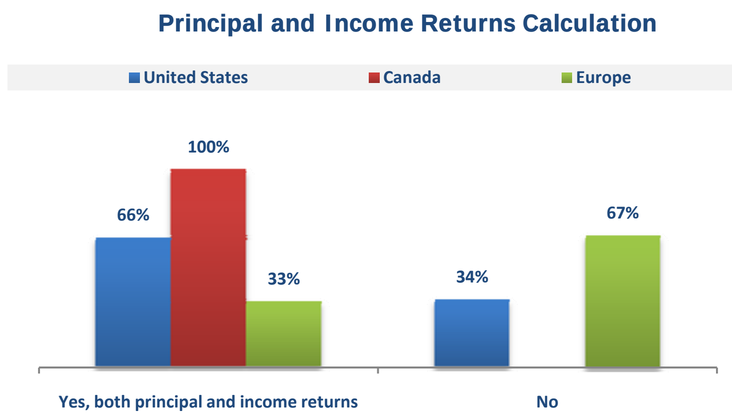
- More highly engaged individual investors
- Client companies, producing RFPs with more sophisticated questions, requiring answers from resources with more specialized knowledge

- Front office managers asking to be more actively engaged in producing performance results that will better inform their investment decisions.
- Staff members who have become more regionalized, who can now specialize in the nuances of supporting regional clients and regional assets

Demand for increased frequency and detail

Three years ago, only a small fraction of buy-side firms were capable of—or even interested in—calculating performance on a daily basis or drilling down into granular detail. But the world has changed, and our recent survey results indicate that 82% of firms now calculate performance daily, with the change driven primarily by investor demand. The survey also produced the following findings:

- 42% of firms overall can calculate performance in any currency, with the percentage rising to 89% for European firms
- 36% of firms overall are calculating net and gross of fees daily, with the figure increasing to 80% for larger firms
- 62% of firms overall can calculate principal and income returns, with significant differences by region. The percentages are 100% for Canadian firms, 66% for US firms, and just 33% for European firms.
- 33% of firms overall can measure returns with finer granularity



Commoditization and Outsourcing

The survey results reveal that core performance functions are becoming commoditized, which makes the efficiencies of outsourcing more enticing. Increasingly, asset managers are assessing how an outsourcing partner could reduce demand on internal employees for commodity-type processing, enabling them to focus on high touch, high value tasks involving engagement with clients and prospective clients. We expect the trend toward outsourcing performance functions to continue.

Attribution: The last frontier?

In many ways, performance attribution is independent of performance measurement. While performance measurement has become much more automated, performance attribution is lagging behind. Performance measurement teams are usually part of—and dependent upon—Operations, but performance attribution teams typically reside within the investment management division, and they are often autonomous.

Historically, attribution has been the domain of portfolio managers, who rarely shared attribution data with clients. But the past two years have dramatically changed market dynamics. Now, clients more often view asset managers as “hired help,” and they demand attribution information to compare their capabilities against the competition’s. We anticipate client requests for attribution information to become the norm in 2011.

Historically, firms have calculated performance attribution for equities using established, well-documented methodologies, such as Brinson, Hood, & Beebower; and Brinson Fachler. These standard methodologies provide a uniform framework for comparisons across investment professionals. But in 2010 we saw asset managers shifting to custom methodologies and proprietary models for attributing equity performance. The firms making the change are doing so in part to differentiate themselves with unique strategies and security selections. The large firms surveyed were the least likely to make the switch, preferring to stick with industry standard methodologies for equity performance attribution. Perhaps the large firms have procedures and automation in place that preclude their use of proprietary models. Lastly, fixed income portfolio managers seem to have little choice but to use custom attribution methodologies that conform to their complex investment strategies. With so many unique methodologies for FI performance attribution, we don't expect to see converged methodologies in widespread use for FI performance attribution any time soon, if ever.

*In April, CutterResearch will present **Performance Measurement and Attribution Practices** via webcast to our members. This research examines current practices around performance measurement and attribution, including GIPS compliance, organization models, and types of solutions in place to support a wide range of assets.*