

The T Standard: A standardized method for the calculation of portfolio performance during a transition

Public comment version

Bob Collie

This paper is Phase I of the standards called for in “Performance Standards for Transition Management” in The Journal of Performance Measurement (2002/3).

It sets out a method for the calculation of portfolio performance, and comparison with a target portfolio benchmark to produce an implementation shortfall measure.

This paper is driven by the perspective of the outcome experienced by the investor, and does not set out to answer the question of the extent to which that outcome should be laid at the transition manager’s door. Neither does it address the question of composite track records. Those are important questions but cannot be addressed until the more basic issue of the performance calculation is unambiguously resolved.

The views of an extensive group of plan sponsors, transition providers, investment managers, consultants and others have been gathered as part of the production of this paper.

The standardized method for the calculation of portfolio performance during a transition is as follows:

1. Implementation shortfall¹ shall be taken as the arithmetical difference between the return on the actual portfolio and the return on the target portfolio.

Example: a portfolio starts with a value of \$121,650,000, and the target portfolio has the same value. The actual portfolio ends with a value of \$119,987,000, while the target portfolio ends with a value of \$120,351,000. The target portfolio is a paper portfolio rather than an actual one.

The return on the actual portfolio is $(119,987,000 \div 121,650,000) - 1 = -1.37\%$

The return on the target portfolio is $(120,351,000 \div 121,650,000) - 1 = -1.07\%$

The implementation shortfall is 0.30% or 30 basis points in this case. This is equivalent to saying that performance against a target portfolio benchmark was -30 basis points over the relevant period.

2. Calculation of returns shall be performed daily.

The performance report to the client should include this daily breakdown.

3. Returns shall be based on time-weighted total portfolio return, using closing prices.

This should include the impact of all factors affecting the portfolio or the benchmark, including corporate actions, target portfolio changes, etc.

Pricing sources used by a transition manager should be consistent and verifiable; this includes foreign exchange rates used to value non-domestic holdings. Pricing sources should be disclosed, as should the treatment of holidays.

4. Returns shall be calculated from the date on which the terminated manager no longer has discretion over the portfolio until the date on which the incoming manager has discretion. Where there is no terminated manager (such as a funding from cash, or a rebalancing event where an existing portfolio is being reduced but not terminated) returns shall be calculated from the earliest reasonable date. (“The Total Transition Period”)

The transition manager will not generally be aware of the termination at the time it occurs, and may indeed not even have been formally appointed. As a result, and because the target portfolio is probably unknown at this point, the calculation of returns should be backdated once this information is available (including corporate actions).

5. The total transition period shall be split into pre-implementation, implementation and post-implementation periods.

The implementation period begins at the close prior to all of the external factors being resolved that are necessary for the transition manager to be able to trade. In practice this normally means the close prior to a certified list of holdings being delivered to the transition manager.

Questions over the accuracy of the certified list should not delay the start of the implementation period unless they are so large as to preclude the start of activity.

It is conceivable that trading (for example, hedging activity) might begin before the certified list is delivered or all of the other external factors are resolved, in which case performance from the close prior to the start of trading to the start of the implementation period (the initial implementation period, which might in the case of hedging activity be termed the hedging period) should be separately broken out.

The start of trading is the point at which the price of any trade is set. For example, some trading strategies involve the trade being processed on one day, but based on a price referenced to the previous day's close. This is equivalent in effect to trading on the close of the previous day. The implementation period therefore cannot be based on the price achieved, since it has potentially been influenced by the trade itself. A further day back must be used as the start of the implementation period.

It is important for clients to understand the relevance of the start of the implementation period when assessing the results of a transition.

The end of the implementation period is the close after trading ends.

6. Changes to the target portfolio and cashflows shall be incorporated with effect from the previous night's close.

The target portfolio is the complete list of holdings desired by the incoming manager(s), including any cash explicitly requested. This includes those securities or instruments that are not actually purchased by the transition manager.

Target portfolios sometimes get changed, for a number of reasons, and these changes should be reflected in the return calculation for the target portfolio from when they are made. To be consistent with the methodology proposed in these standards, this means the target portfolio should be updated as at the close prior to the change in target list being received.

The holdings in the target portfolio for the calculation of its return should not, however, be rebalanced unless indicated by the incoming manager. Even if the target list consists of percentages in specified holdings, the target portfolio should be struck in terms of number of shares at the start of the implementation period and only rebalanced to the indicated percentages if directed by the incoming manager.

7. Where externally-managed pooled funds are involved in the target or initial portfolio, these shall be included in the total return calculation wherever possible, irrespective of how investment/disinvestment is actually handled.

Example: a target portfolio consists at the close on May 10th of 100,000 units of a weekly-valued pooled fund, which is worth \$4,056,000 based on the most recent valuation, which was May 5th, and \$58,946,000 in direct holdings. The total target portfolio value at May 10th is taken as \$63,002,000.

In some situations, costs may be incurred on externally-managed pooled funds that do not hit the transition account, for example, a different NAV may apply to a client exiting a pooled fund than applies to other clients. The transition manager should make every reasonable effort to identify any material costs and include these in the performance calculation. If, despite these efforts, costs remain unknown then this fact should be disclosed.

8. If a transition manager shows, in addition to the results described above, additional results calculated on a different basis, then all differences in the calculation should be clearly disclosed.

The calculation set out above is based on the outcome experienced by the investor. Depending on the circumstances of the particular event, the transition manager may want to provide additional information to throw light on the factors that produced that outcome.

There are a number of ways in which a transition manager might validly argue that a better assessment of his own performance is given by a different calculation than the one described above, either in terms of the time period covered, the holdings included or some other aspect of the calculation.

Example: a firm might show a second set of results, which removes the impact of 'stale' valuations for pooled funds or illiquid holdings.

The basis of such additional calculations should be clearly disclosed and consistently applied. To this end, transition managers are encouraged to identify in advance the basis for any additional results they will be calculating. Clients should pay particular attention to calculations which have not been identified in advance, to calculations identified in advance but not made, to calculations not widely made by other transition managers, to calculations which appear to have been made selectively and to calculations which might exclude performance impacts which *are* attributable to the transition manager. In all cases, these calculations are in addition to the standard calculation as opposed to in place of the standard calculation.

Endnotes:

¹ The term implementation shortfall was first given prominence by André Perold's paper, "The Implementation Shortfall: Paper vs. Reality" in *The Journal of Portfolio Management* (1988). This concept has become a widely-used measure for the success of a portfolio transition event.

This paper does not deal directly with the calculation of performance during events for which implementation shortfall is not the chosen benchmark, although many of the principles set out can and should be transferred across to other benchmarks.

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