FORUM BUZZ™

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Lisbon, Portugal

The 19th Performance Measurement Forum™ was held in the historic city of Lisbon, Portugal. Famous for its explorers, seafood, ceramic tiles and Port wine. Portugal is an exciting country with a great deal to offer the traveler. The Forum meeting was a lively one with great debate and discussion on a myriad of topics. After member introductions, we got down to "business as usual" with a candid discussion on "problems and concerns" that our members are facing. We were then treated to an inside view of the Merrill / Unilever case from Mark Tapley, our keynote speaker.

After his presentation, Peter Luntang Christensen, Head of Risk at Danske Capital led a discussion on risk where Peter argued for the need for standardization of risk measures and risk attribution techniques. After our open discussion session (which we never seem to have enough of) we broke for dinner, where we were treated to an excellent authentic Portuguese meal and learned that while Port is a mainstay in the U.K. as an after dinner drink, in Portugal White port is used as an aperitif. Not that we had any.
We started off day two with a presentation from Jose Menchero (Dietz Award Winner) on "The Attribution of Short Positions." After Jose, we had the chance to view performance from a pension plan perspective with a presentation from Arian Elan, Head of Performance at Shelll Pension Funds.

Phillip Gregoire of Orfival, then facilitated a discussion on "Attribution Choices – Selecting Position or Transaction-based Methods" where many different view points were witnessed.

It is always a real treat and lends insight when we are able to have a local representative attend and present at our forum meetings and we were privileged in Lisbon to have the local EIPC representative, Joao Cantiga Esteves speak with us on the state of Portugal with regards to investment performance measurement and GIPS implementation. Ian Thompson of SAMS then led a discussion on fixed income attribution and we wrapped up with a discussion of the certification of investment performance measurers and how the forum would play an active role in the formation of this certification. Look for more information on this important topic in the months to follow.

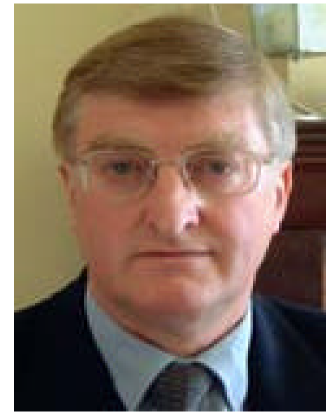
2004 Meetings

6-7 May 2004 - San Francisco, CA
9-10 June 2004 - Edinburgh, Scotland
10-11 November 2004 - Madrid, Spain
9-10 December 2004 - Orlando, Florida

Is that Lisbon Street too steep? Better take the Elevator.

Individual Problems & Concerns

As we have learned from past forums, there is never a shortage of problems. Here is a list of the most current and pressing issues as discussed in Lisbon. CornP Reniers of Robeco was very happy with the development of bigger and faster systems, but touched on the problems with the reliability of benchmarks. Particularly of interest were the Morningstar ratings, which CornP explained that the methodology of defining categories is better in the U.S. than it is in Europe because you do not have the problems with different country classifications. CornP was not pleased with the European classifications at Morningstar. Carl Bacon suggested that it is time to raise the profile of performance measurement and to acknowledge the contribution to the investment decision, risk control and legal processes. He would also like to see some standards for risk controls. Grant Strang of KPMG expressed his concerns with the huge pressures from costs and budgets that are forcing more and more firms to outsource their performance measurement teams. Kjell Sverre Hatlen is having problems with turnover of key employees as well as trouble switching over to a new system. Olivier Bomboire is concerned that we are underutilizing attribution while Martin Schlieman would like to see attribution developed with international accounting standards. Peter Christensen expressed that problems still lie in the data and not so much in the systems. He would also like to include risk in the investment process. Gary Neale has also seen the push to outsourcing and has witnessed the profile of the performance measurer increase greatly over the past three years in London. He also explained that they are being asked to run too many projects and the systems just cannot handle it due to scalability. They are being asked to produce more and more numbers with less staff and less budget.



Mark Tapley: Keynote

Keynote Address: Performance Surprises: Ex-ante Tracking Error Surprises and the Reliability of Risk Models

Mark Tapley began his presentation by explaining that tracking errors are inherently unreliable. He asked the question, “what can we do about it?” He then took us on a little tour of how we got where we are today, taking us back to the emergence of risk as a quantifiable thing and the first risk models in the sixties and seventies up to the disappointments and the emergences of doubts that exist today. Mark also explained the two types of risk that asset owners must manage, policy risk and active risk, with policy risk being 5-6 times as large as active risk. Mark then presented a brief chronology of the events behind the case starting in January 1997, when the new mandates took effect. Merrill was than dropped in December 1997 and in October 1999 Unilever issued its claims of negligence. In December 1999 Merill issues its defense and finally in December 2001 the settled out-of-court (rumoured to be for $110 million), "Without admission of liability."

Mark drew some conclusions to why Merrill underestimated the Unilever portfolio risk including: the high frequency monitoring on the downside, unexpected security return dispersion, excess return persistence, i.e., trending. The Barra model appears to underestimate active risk in concentrated portfolios and Barra did not have a multi-asset model. Some lessons that can be learned from the case: risk models are both more important and less reliable than many thought.

Risk

Peter Christensen explained that risk is multifaceted, means different things to different people, has no fixed price over time, is often diversifiable, and can be managed. The drivers for the risk management culture include: an increasingly complex industry and periods with negative market-conditions and heavy losses. Peter also explained the risk management is real-time/ex ante. It needs to be integrated into the portfolio construction process, managed interactively in a structured process by using more than one risk model and take advantage of the modern software systems available. Risk management is also adding value by preventing unacceptable loss.

In his discussion, Peter explained that risk management is a case for the corporate culture, not only the investment engine. It is something that everyone needs to be thinking about and be aware of. In his conclusions, Peter focused on the need for standardization of risk measures and risk attribution techniques as well as for documentation of methodologies. He also confided that risk management is not an exact science. You can manage risk, but you cannot manage the return.

Performance Attribution with Short Positions

This presentation was so well received at our San Francisco meeting that we asked Jose to come over to Lisbon and present it to our European members. The article from which this presentation is derived also won *The Journal of Performance Measurement's* Annual Dietz Award. Be sure to look it up in your Winter 2002-2003 edition if you have not read the article already.

In his presentation, Jose explained that although seemingly complicated, attribution of short positions could be quite simplified; the secret was in ensuring your process was correct and you handled every step properly. Jose explained the keys to this methodology, which included explicit inclusion of cash positions, and independent treatment of the long and short sides of each sector. He also explained how this methodology could be applied to include the effect of stock index futures and can be easily extended to a multi-period arithmetic or geometric analysis.

Performance Prepared from a Pension Perspective

For the past several forum meetings members have been asking for a representative from a pension plan to present at a forum. With the help of Elske van de Burgt we were able to contact a representative. Arian Eland is with Shell Pension Fund and is based out of the Netherlands. They are responsible for approximately 12 Billion Euros under management and manage 80% of that in-house. Through their performance system, they are able to calculate daily data on performance, excess attribution and market exposure at any level. Arian explained that Shell is going through GIPS compliance, not to go after prospects but for internal house cleaning and historical data.

Attribution Choices – Selecting Holdings or Transaction-based Methods

It is sometimes difficult to convey to speakers and potential discussion leaders exactly what we are looking for when we ask an expert to present at the forum. This was not the case when Phillipe Gregoire of Orfival led his discussion; in fact, we should have taped it and used it

CornP Reniers of Robeco & Peter Luntang Christensen out looking for some Port in Lisbon.

as the standard for facilitating discussions going forward. You could really tell that Phillipe is an educator as he worked the room like a ringleader, probing responses from his excited crowd as he worked the collective thoughts out on the white board. Phillipe explained that we need transaction based attribution to enhance the accuracy of the results and that transaction based is better than daily position based attribution as long as the portfolio is not rebalanced on a daily basis. I still do not know if we came to a conclusion but it sure was exciting to see the discourse between the participants.

GIPS Implementation in Portugal

Working with the EIPC has been a blessing in many regards for the Forum. It allows us to visit countries that we would perhaps never have visited and it provides us with a solid base for discussions and speakers. Jono Cantiga Esteves, the Portuguese representative to the EIPC helped with the hotel arrangements and he also was kind enough to present at the forum on the current state of Investment Performance Measurement in Portugal. Jono explained the developing crisis with the shortage of social security contributors relative to pension payments. On the GIPS front, Portugal is looking to adopt GIPS to increase their market, to gain a competitive advantage (or less disadvantage), for better management tools and for providing better quality reporting to better serve the investors. Portugal is still in the early stages of implementation.

Fixed Income Attribution

Dr. Ian Thompson of Strategic Asset Management Systems led the final discussion of the day with his thoughts on Fixed Income attribution. In his presentation he explained why it is necessary to use a different approach when dealing with fixed income as opposed to equity, provided us with some different models, challenges and themes for discussion. In his overview of fixed income decision factors, Ian explained that management of multi-currency fixed income portfolios tend to focus on: currency market exposure, duration exposures to different markets, yield curve positions within markets, sector exposure, and selection within sector exposure as the main sources of value. Management decision factors include: changes in the level of interest rates, changes in the shape of the yield curve, changes in yield spreads among bond sectors, and changes in yield spreads for a particular bond. Dr. Thompson explained that different sectors will have different levels of risk premium associated with them, as viewed by the spread above the yield curve. The relative prices or yields between sectors may change due to: altered perceptions of creditworthiness, markets sensitivity to default risk, change in market valuation of some characteristic of the sector, changes in the supply and demand conditions.

Ian also pointed out the similarities between equity and fixed income attribution in that the basic principles of asset allocation and stock selection still exists (selection effects still need to be calculated), currency is still calculated for multi-currency portfolios, what we know as local allocation for equities is broken down into various factors for fixed income (duration, spreads, allocation to sectors for corporate bonds, allocation to credit ratings for corporate bonds), and a true relative attribution paradigm is also still desirable. Dr. Thompson outlined some of the challenges for fixed income attribution including: outperformance/ underperformance is often smaller than for equities, multiple processes within fixed income, the use of more complex instruments, the investment strategies are often more complex, it is often culturally/organizationally quite distinct and there is a lack of index available (although this is improving).

Certification of Investment Performance Measurers

Five years ago David Spaulding was toying around with the idea of a certification program for investment performance measurers when AIMR announced that they were going to be coming out with it themselves. Therefore, the idea was pushed off to allow AIMR to pursue the idea. Five years later we are no closer to a certification and The Spaulding Group was curious how the forum would react to the suggestion. The answer? Overwhelming support and encouragement for the project. Six forum members from the Lisbon meeting have already offered up their services to assist with the testing criteria.

After the December meeting of the forum, we will move forward with the initial set-up and implementation of this idea. A non-profit organization, separate from The Spaulding Group, will be organized. From here, we will work with our forum volunteers to set-up an advisory board to move the project forward. Stay tuned for further information. If you are interested in volunteering your time and/or resources to this idea please contact Patrick Fowler at: *PFowler@SpauldingGrp.com*

Some Thoughts from Lisbon:

"Very good opportunity for open discussion with fellow industry professionals."

"Good topics & discussions, excellent information sharing.

"Very good interaction between people."

"Interactive and informative, several new faces/members."

"Wide coverage of relevant topics."

Topics for Edinburgh

The agenda for Edinburgh is still forming, suggestions from Lisbon include Risk, Hedging and more open discussions. Please contact Patrick if you would like to suggest an additional topic.

FORUM MEMBERS:

AEGON USA
ALLIANCE CAPITAL MANAGEMENT
AMERICAN EXPRESS
ASHLAND ACCOUNTING
BANC ONE INVESTMENT ADVISORS
BASE-TWO INVESTMENT SYSTEMS
CAPITAL GROUP
CLAY FINLAY
CREDIT SUISSE ASSET MANAGEMENT
DEUTSCHE ASSET MANAGEMENT
DPG MBH
DST INTERNATIONAL
EAGLE INVESTMENT SYSTEMS
ERNST & YOUNG
FIDELITY INVESTMENTS
FIRST RATE INVESTMENT SYSTEMS
FMC
GOLDMAN SACHS
GRANTHAM, MAYO VAN OTTERLOO
GUARDIAN
HANSBERGER GLOBAL INVESTORS
INTEGRATED DECISION SYSTEMS
JP MORGAN
J & W SELIGMAN
MORLEY FUND MANAGEMENT
NEUBERGER BERMAN
NICOLAS APPLEGATE
ORTEC INTERNATIONAL
PICTET ASSET MANAGEMENT
PRUDENTIAL
RBC GLOBAL SERVICES
ROBECO GROUP
RUSSELL/MELLON ANALYTICAL SERVICES
SAMS
STATE FARM INSURANCE COMPANIES
STATPRO
STOREBRAND INVESTMENTS
STW FIXED INCOME MANAGEMENT
THOMSON VESTEK SYSTEMS
TURNER INVESTMENT PARTNERS

Thank you very much for helping make the Forum the success that it is.

Wishing You and Your Families Happy Holidays and a Prosperous New Year!