EIPC Guidance on Performance Attribution Presentation:

A Step Towards Standardization of Performance Attribution

Working Paper - Nummer: 14

2004

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in: Journal of Performance Measurement;

Summer 2004; Volume 8; Number 4;

page 46 – 62.

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Version as of 07.06.2004

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European Investment Performance Committee (EIPC) takes a closer look to presentation of investment performance attribution analysis and develops a Guidance on Performance Attribution Presentation. This sets another example of self-regulation in the industry and demonstrates a further step towards standardization in this area. What areas of performance attribution analysis can really be standardized? The authors, who initiated and realized this Guidance at the EIPC, explain.

Only a couple of decades ago, performance attribution techniques were perceived to be over sophisticated and rather academic analysis methods, which were barely understood by many investment managers, much less clients or other third parties. Today we are observing a different situation where the term “performance attribution” has become a common “buzz word”, and there are even efforts to develop standards for performance attribution. Has it really become as simple as it looks?

Unfortunately not. Recent years have brought a lot of new models, concepts and more knowledge in the area of performance attribution. The significant progress in the IT support of performance analysis has contributed to a broader dissemination and a greater acceptance of attribution techniques. At the same time, increased understanding of attribution makes investment managers realize that a “perfect” performance attribution analysis remains a very difficult, costly and nearly impossible exercise. A significant achievement is, nevertheless, that now we know what general steps need to be taken, what parameters need to be defined and what issues can be expected to implement a meaningful performance attribution. This leads us to define a sort of a standardized framework or at least general guiding principles for performance attribution analysis. Let’s look at it in more detail.

Evolution of the idea of standardization of performance attribution analysis

Discussions in the investment management industry on whether performance attribution analysis can be packed within a standardized framework started a few years ago. These discussions were a logical consequence of the general trend in the industry towards transparency and standardization, such as performance presentation standards, ethical standards of practice, etc.

The idea of a performance attribution standard was born within the Spaulding Performance Measurement Forum, where the Forum members launched first debates on the necessity of developing such a standard.

In early 2002 the Working Paper „Guidance for Users of Attribution Analysis“ by the EIPC was released[1]. This document contained a questionnaire for users of performance attribution to assist them in interpreting performance attribution presentations and was a first attempt to develop a standardized framework for understanding performance attribution analysis.

In late 2002 – early 2003 the draft of attribution standards by D. Spaulding was published[2]. In his paper David attempted to introduce some definitions and also to propose standards both on attribution calculation methodology and disclosures. This document triggered further discussions on attribution standards in the investment management industry, e.g. at the Spaulding Performance Measurement Forum, at the Swiss Round-Table Performance Attribution[3], etc.

The position of the investment management industry with respect to standardization of performance attribution can be best presented with the results of the recent market studies. The 2002 Spaulding Performance Measurement and Attribution Survey showed significant support for attribution standards (51% of investment managers, 79% of plan sponsors, 75% of investment consultants). The 2003 Swiss Investment Performance Survey of PricewaterhouseCoopers conducted among investment managers in Switzerland showed that 68% of respondents supported the idea of performance attribution disclosure standards and 62% of respondents also supported the idea of performance attribution calculation standards[4].

In 2003 the EIPC decided to take the initiative and to further address the demand of the investment management industry for specific guidance with respect to presentation of return and risk attribution analysis, which resulted in creation of the EIPC Guidance on Performance Attribution Presentation. EIPC is a regional sub-committee of the Investment Performance Council (IPC) and consists of representatives of more than 20 European countries. This status of EIPC ensures a broad representation of opinions and also a greater acceptance of such a guidance in the investment management industry. The Guidance was developed by a dedicated working group of investment performance specialists within the EIPC.

What can be standardized?

Before we start talking about standardization of performance attribution analysis, let's try to think about the subject of this standardization in more detail.

Problem 1

First of all, let's consider the term "performance attribution". Strictly speaking, a classic definition of performance defines it as a combination of return and risk. Here lies the first issue – saying "performance attribution" most people will probably mean "return attribution", i.e. the risk component of the attribution analysis is often neglected. So, a true performance attribution standard needs to cover both return and risk components.

Problem 2

Secondly, it is a common knowledge that attribution analysis is subject to certain general fundamental principles, which are crucial for meaningful attribution results. The most important principle is that attribution analysis must follow the investment decision process / mirror the investment style of the investment manager and measure the impact of active management decisions. Attributing factors that are not part of the investment manager's decision process adds little value. It is essential that the attribution analysis mirrors the actual decisions made by the investment manager.

This leads to the conclusion that attribution analysis in its substance is always a unique process. Before standardizing attribution analysis, someone first needs to standardize all those various investment management approaches. Consequently, there is a wide variety of return attribution models and methods with respect to calculation of attribution effects, attribution levels, portfolio rebalancing and trading assumptions, etc. Furthermore, there are numerous other peculiarities of attribution analysis, such as different methods of calculation of excess returns, linking of attribution effects, etc.

Similar issues exist with respect to risk attribution analysis. Even the first step in the risk attribution analysis - risk measurement - can pose comparability problems due to different methodologies. For example, frequency of observations used for calculating risk measures may cause different volatility results for the same instrument. When calculating tracking error, investment managers may use either the arithmetic or geometric way to calculate excess returns. Besides methodological issues, there may also be different assumptions with respect to the underlying data. For example, comparability of risk-adjusted performance measures, such as the Sharpe ratio, depends on a choice of the risk-free rate.

The next step in the risk attribution analysis - risk decomposition - includes decomposition into sources of systematic and specific risk or into various factors affecting a portfolio's risk. If this analysis is performed ex-ante, this may pose a problem that providers of risk analysis systems often implement their proprietary models for risk forecasting, which may be difficult to accommodate within a standardized framework.

Conclusion

Given the above, it appears to be rather impossible to standardize attribution analysis in terms of calculation, models or concepts. Nevertheless, exactly because of this there is a demand for a certain standardization in this area. It should be feasible to create a standardized framework for understanding of performance attribution reporting, which would consist of descriptions of most typical circumstances surrounding the attribution analysis. Such a standard would not define models and formulae but focus on transparency and disclosure.

Scope and objectives of the EIPC Guidance on Performance Attribution Presentation

The purpose of the EIPC Guidance on Performance Attribution Presentation is to establish a reporting framework, which provides guidance for a fair presentation of return and risk attribution results with full disclosure. The Guidance was approved by the EIPC in January 2004.

This Guidance has the following salient features:

- EIPC deliberately decided to use the term "Guidance" as opposed to "Standard" to emphasize the impossibility of creation of a true comprehensive standard in this area at this stage.
- The Guidance is a pure *disclosure* standard. It applies only to the disclosure contents of the attribution reporting. Except for general guiding principles, it does not address methodological issues with respect to calculation of attribution results, nor attempts to present any prescriptive definitions. EIPC believes that setting any standard on performance attribution should primarily contribute to increasing the understanding of attribution through the necessary disclosures and transparency of the methodology and investment process. For details on various performance attribution methods and concepts, users should refer to the dedicated performance literature available[5]. Being a "disclosure guidance", the Guidance can be generally applied to all types of investment portfolios (equity, fixed income or balanced).
- The Guidance does not require investment managers to present performance attribution. However, if managers do present attribution analysis, they are encouraged to provide full disclosure and to apply the provisions of the

Guidance. As the importance of a particular piece of information may vary depending on the situation, EIPC believes that differentiation in the disclosures between required and recommended may be too subjective, i.e. the word “must” is applied consistently through the Guidance.

- The Guidance distinguishes between *return* and *risk* attribution and contains separate provisions in this respect.

The Guidance consists of the following major areas:

Definitions

The Guidance introduces a number of basic definitions (e.g. excess return, return attribution, risk attribution, etc.) to provide the user with an explanation on the terminology as it is used in this Guidance. The Guidance does not attempt to establish any absolute or dogmatic definitions and recognizes that there may be various views and interpretations of these matters within the investment management industry.

Guiding Principles

The Guidance introduces some fundamental principles of the attribution analysis, e.g. mirroring the investment management process of the investment manager. In addition, the Guidance appeals to investment managers, who do not prepare attribution analysis in a transparent manner in compliance with the Guidance, to refrain from presenting attribution results to external parties.

Disclosures

This is the largest part of the Guidance. Disclosures are defined separately for *return* attribution and *risk* attribution for the following specific areas:

- *Investment process*, e.g. a disclosure on the manager’s investment management style, selected benchmark, etc.
- *Attribution model*, e.g. a disclosure on attribution factors, methods of calculation of attribution effects, excess returns, linking results, treatment of residuals, etc.
- *Underlying input data*, e.g. disclosure on methods of calculation of portfolio and benchmark returns, valuation aspects, etc.

Illustrative attribution report

The Guidance includes an example of an attribution report to illustrate the provisions.

Relation to performance presentation standards

When developing this Guidance, the EIPC discussed a question whether performance attribution analysis should be included in the scope of performance presentation standards, e.g. Global Investment Performance Standards (GIPS). The decision was that it was still premature to expand the GIPS framework to cover attribution analysis. Firstly, there are still many other important areas in GIPS that need further development. The other problem is of technical nature, which is that GIPS principles are focused on composites, while performance attribution analysis is usually performed on a portfolio level. For attribution analysis to become practicable and meaningful on a composite level, certain prerequisites have to be fulfilled first. For instance, all portfolios should fully match the investment strategy of the composite, performance data should be consistent for all portfolios in the composite, etc.

Therefore, the Guidance is not currently seen as a part of the GIPS compliance framework but is considered as a part of a broader ethical code of conduct for investment managers. Firms claiming GIPS compliance and presenting performance attribution analysis are encouraged to follow this Guidance. Obviously, attribution analysis results may also be presented as supplemental information to a GIPS compliant performance presentation.

The full text of the EIPC Guidance on Performance Attribution Presentation is attached to this article and can also be downloaded from the website of the Spaulding Group at http://www.spauldinggrp.com/EIPCPerformanceAttributionGuidanceFinal.pdf .

Endnotes

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1 *The EIPC Guidance for Users of Attribution Analysis published in 2002 can be downloaded from the AIMR website at http://www.aimr.org/standards/pdf/EIPC_attrib_guid.pdf*

2 *"A Case for Attribution Standards" by D. Spaulding, Journal of Performance Measurement, Winter 2003.*

3 *Details on the Swiss Round-Table Performance Attribution can be obtained from the website www.pwc.ch/spps in the area "Performance Attribution Roundtables"*

4 A *brochure with the 2003 Swiss Investment Performance Survey of PricewaterhouseCoopers can be downloaded from http://www.pwc.com/ch/eng/ins-sol/publ/bank/spps_survey.html .*

5 *For example, we recommend a recent book of D. Spaulding "Investment Performance Attribution", McGraw-Hill, 2003, as well as various articles in the Journal of Performance Measurement*