Client Reporting: Is it really what everybody thinks it is?

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In very general terms, client reporting is the compilation and presentation of information. In the asset management industry more specifically, it is the illustration of the investments made, the results achieved and the risks taken. The following chart illustrates the analyses a client reporting normally consists of: asset allocation, performance reporting, performance attribution, risk reporting and so forth. Asset management companies offering such a client reporting are considered to be at the forefront of best practice and transparency. But is client reporting really what most people think it is?

Graphic 1 Illustration of typical components of the client reporting

In order to answer this question one has to consider who defines the layout and the content of the client reporting. Typically, it is not the client but the asset manager who compiles the various analyses for the final client reporting. This makes sense as insofar as client reporting is generally considered to primarily illustrate the performance of asset management accounts and is used to evaluate the performance of the asset manager. But let me challenge this by asking the somewhat provocative questions: What performance should actually be illustrated within client reporting? Is it the client's performance or the asset manager's performance? And does the client know what is reported?

Looking at the different analyses mentioned above, the asset allocation is normally not an issue and should reflect the asset manager's and the client's perspective. However, this depends on the investments made and the way they are included in the underlying calculations. For instance if an asset manager uses financial instruments to generate synthetic leverage (using futures or options for example) which is not shown in the asset allocation as it is

based on market values, the observer might not notice this leverage effect and the risk arising from these investments.

When it comes to the return and risk analyses in client reporting, the issue is more complex. Normally, it is the asset manager's performance which is analysed and explained in detail. Performance figures shown in client reportings normally are based on so called time-weighted rates of return which best reflects the performance of an asset manager. To evaluate the performance of an asset manager time-weighted rates of return are seen as best practice, as the timing effect of any external cash flows is neutralized, that is, if the asset manager has no discretion over the external cash in- and outflows into the portfolio. However, for the client, the asset manager's performance is only one aspect. From a client perspective the timing effect should also be incorporated as it is the client who decides on the amount and the timing of the external cash flows. Usually, the return from a client perspective – measured by the money-weighted rate of return – is not illustrated in client reportings.

The following two tables illustrate the timing effect and the difference between time-weighted rate of return and money-weighted rate of return.[1] In table 1, the asset manager's return is +25% but the client made no money because the loss in sub-period 2 (-50'000) compensates the profit (+50'000) in sub-period 1. This leads to a client return of 0% and a negative timing effect of -25%. In table 2, the example is even more extreme. The asset manager return is positive with +10% but the client return is negative with -16.81% as the client lost money (-30'000).

	31.12.2005	31.12.2006	31.12.2007
Market value of portfolio before external cash flows	100'000	150'000	250'000
External cash inflow by client		+150'000	
Market value of portfolio after external cash flows	100'000	300'000	250'000
Profit & Loss from a client perspective for total period			0
Asset manager return (time-weighted rate of return) for total period			25.00%
Client return (money-weighted rate of return) for total period			0.00%

Table 1 Illustration of timing effect – example 1

	31.12.2005	31.12.2006	31.12.2007
Market value of portfolio before external cash flows	100'000	150'000	220'000
External cash inflow by client		+150'000	
Market value of portfolio after external cash flows	100'000	300'000	220'000
Profit & Loss from a client perspective for total period			-30'000
Asset manager return (time-weighted rate of return) for total period			10.00%
Client return (money-weighted rate of return) for total period			-16.81%

Table 2 Illustration of timing effect – example 2

Similar situations can be observed when considering other available return and risk analyses and the question is as well whether the figures are presented from an asset manager or a client perspective. The fact that client reportings normally reflect the asset manager's perspective gives rise to the question whether client reporting really meets clients' expectations. If this is not the case in a typical client reporting, who fills the gap? Who provides the clients with a reporting covering their perspective? In my opinion, closing this gap is one of the big future challenges for

the client reporting industry in the years to come.[2]

Endnotes

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1 The timing effect is the difference between time-weighted rate of return and the money-weighted rate of return. As here the money-weighted rate of return is best calculated by the internal rate of return. For a detailed discussion please see: Stefan Illmer and Wolfgang Marty, “Decomposing the Money-Weighted Rate of Return”, in Journal of Performance Measurement, Summer 2003.

2 Clients who are interested in questions to ask asset managers on client reporting should have a look at the working paper “Guidance for Recipients of Investment Reporting” published by the Regional Investment Performance Subcommittee for Europe, Middle East and Africa (RIPS EMEA).