AIMR-PPS – The "Holy Grail" of Performance Measurement?

Introduction

The CFA Institute, an investment industry trade group formerly known as the Association for Investment Management and Research (AIMR), establishes and interprets the AIMR Performance Presentation Standards (AIMR-PPS) in North America. In more than a decade since their introduction, an increasing number of investment managers have voluntarily complied with the new standards that promote comparability of performance reporting.

Since 2001, the institute allows firms to claim compliance in advertising materials without showing performance results. In many instances, firms attempt to promote the standards as proxy for better investment practices or ethical conduct. In other cases, confusion arises when claims of compliance imply a different return calculation methodology, or when claims were made on individual accounts instead of on firm-wide composites.

Although the standards have evolved over time, the fundamental intent of the CFA Institute remains intact - to provide a fair representation of a manager's discretionary investment capabilities by avoiding cherry-picking "model", or "representative" accounts. Since performance measurement is a very important aspect of investment process, we would like to present a few points that may help to better clarify what it means to be AIMR-PPS compliant.

Note: effective in 2006, the institute's Global Investment Performance Standards (GIPS) will replace AIMR-PPS as its global performance presentation standards.

Standards reporting is on the aggregate level

Firms report AIMR compliant data at "composite" levels, not on individual accounts, unless an entire composite consists of a single account. A composite is a group of accounts with similar characteristics. As a practical matter, an account in a composite with strong performance may perform poorly. This is because no two accounts are exactly alike, but every account must be in a composite. For example, if a portfolio with three-month average maturity is included in a "short-duration" composite that consists mostly of one-year average maturity accounts, it will likely have different returns from the composite. Perspective investors should evaluate the dispersion of composite returns, preferably the full distribution of all accounts in a composite, instead of relying on aggregate level returns.

AIMR-PPS are presentation standards, not new methodologies or ethical standards

After drafting the standards in 1987, AIMR had a six-year public commentary period to incorporate established industry practices and ethical standards. The new standards did not represent a different calculation methodology, nor did they suggest better accuracy or higher ethical conduct – they merely standardized them. A tongue-in-cheek industry joke illustrates the point: "Performance presentation standards do not make cheating impossible, they only make sure that everybody is cheating the same way."

Compliance with the standards is voluntary but retroactive

While presentations compliant with the AIMR-PPS are often preferred, on-going revisions to the standards and their operational requirement of retroactive compliance place investment managers at various stages of standards implementation. Compliance is not mandatory. Neither the CFA Institute itself, nor regulatory agencies such as the Securities and Exchange Commission (SEC), require managers to comply with the standards at this time. A new manager with no performance history is able to claim standards compliance immediately, while established firms are required to claim retroactive compliance for up to 10 years, including all current and closed accounts. This laborious process is one of the main hindrances for firms with longer track records to claim standards compliance.

Claims should be verified

Investment managers who elect to become compliant may claim compliance after following necessary steps. A "claim" does not provide compliance assurance, since many requirements of the standards can be rigorous and tricky. The CFA Institute does not review, nor verify, the accuracy of a firm's claim. Rather, it established procedures for third parties to verify such claims. When presented with the claim, investors should request from the manager a verification letter prepared by a third party that is knowledgeable about the standards, along with a listing of all of the firm's available composites and disclosure notes.

The AIMR-PPS are total return performance standards

Lastly, the AIMR-PPS apply to calculation and presentation conventions that measure marked-to-market returns, which include unrealized gains and losses. For a variety of investment portfolios, including internal government investment pools, insurance and pension portfolios, that report adjusted book values-based returns, the CFA Institute makes no reference, judgment, or recommendations as to the proper standards to follow. Therefore, these fixed income portfolios with buy-and-hold strategies are generally outside of the realm of the AIMR-PPS.

Conclusion

As popular performance presentation standards, the AIMR-PPS appear in advertising messages with increasing frequency. While promoting comparability of returns among managers, the standards address only a subset of the multi-faceted nature of performance measurement.

As important as adhering to a common set of reporting standards, all investment managers should strive to improve the quality of information presented. Consistent with requesting pertinent performance data, perspective investors should evaluate a manager's long-term investment excellence, which often comes from diligent macro market and credit research, efficient and relative value trading, thoughtful securities selection, and prudent portfolio risk management.

December 30th 2005

Lance Pan, CFA
Director of Investment
Research & Strategy
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

Research Disclosure:

The information contained in this report has been prepared by Capital Advisors Group, Inc. ("CAG") from outside sources, which we believe to be reliable; however, we make no representations, express or implied, as to its accuracy or completeness. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. CAG is under no obligation to make changes or updates to this report and therefore disclaims any liability should the information or opinions contained herein change or subsequently become inaccurate. Past performance is no guarantee of future results.

© 2005 Capital Advisors Group, Inc. All rights reserved. This report may not be reproduced or distributed without CAG's prior written consent.