

To: AIMR-PPS Standards - Wrap-Fees
Copy To: Tom Bowman
From: R. Stewart Eads, CFA
Subject: Guidance Statement on Wrap-Fee Performance
Date: October 25, 2002

While working at NASA at Huntsville, AL in the early 1960's I once heard Dr. Wernher von Braun say that "simplicity is the ultimate in sophistication". Dr. von Braun was one of the German rocket scientists who came to the U.S. after World War II and he was a very key factor in putting a man on the moon in 1969. His statement has guided much of my professional career. Many people tend to overly complicate systems and procedures either because they do not have the ability to distill a system down to its bare essence or they think "more complicated" makes it appear that they work hard.

I believe that AIMR is guilty of over complicating wrap fee performance measurement. Consider allowing portfolio managers to report wrap fee performance "gross" of all fees. Then, any wrap fee sponsor can tell "its" prospective client that the figures are "gross" and then tell the client what the wrap fee will be. Does that not solve much of the problem? Many money managers have a contract only with the wrap fee sponsor, not with the end client. The money manager's client is the wrap sponsor. Often, the wrap sponsor generally does not consider the wrap fee amount to be information to share with the money manager. To the wrap sponsor, the money manager is a subcontractor. The money manager gets some small fraction of the wrap fee as its fee.

To make gross wrap fee performance compatible with performance of non-wrap (fee and commission) accounts one can do the following. A firm can calculate its typical "high" portfolio turnover and combine that with the typical "high" annual percent commissions. Both figures should be supported by comprehensive data recalculated annually and maintained for inspection. For example, if turnover is 30% per year, that is 60% round trip. If typical commissions on trades are at 1%, then annual commission costs are at approximately 0.6% ($0.6 \times 1.0\%$). If 0.6% is removed from annual gross wrap account performance figures (or 0.15% quarterly) you have captured the essence of fair wrap performance for that manager comparable to a non-wrap account.

A prospective client can approach a given money manager from several different directions. The client can come in through the "wrap fee" route or by the "fee and commission" route. Some clients can put only the minimum under management or, say, ten times that amount. Generally, a client will get lower percent fees with more money under management.

Point: A client wants to see a performance figure that represents the innate skill of the manager in buying, selling and holding securities in conjunction with commission costs. Commission costs are a product of the

manager's security turnover level combined with the percent commission cost per trade. Given these figures, the client can decide who is truly a good money manager. Anyone can take the results a step further to see how a wrap fee would subtract from return results (albeit with a double hit from commissions).

Is a wrap fee of 2.0% higher than one at 1.5%? Not if the higher fee includes more services worth 0.5% per year. The services behind various wrap fees are not created equal. AIMR's approach seems to assume that a 2.0% wrap fee is necessarily higher than 1.5% and that the services behind the wrap fee are all the same. One wrap sponsor may get into estate planning under the fee while another one may not. Should a money manager have its wrap performance penalized because it works with a wrap sponsor with a higher wrap fee that includes more or different services than a lower fee service? The same money manager may work with several wrap sponsors with differing wrap fee levels. Under the AIMR plan, why is the money manager bearing the brunt of ancillary services such as estate planning in the wrap performance calculation?

I am a long-time CFA, AIMR and Atlanta Society member. I appreciate AIMR's efforts in furthering the professionalism of the investment business. However, I find aspects of AIMR's approach to wrap fee performance to be somewhat naive, lacking in a good understanding of the relevant issues and overly complicated.

Sincerely,

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President

MBA, Wharton, 1966
MSEE, Georgia Tech, 1964
BEE, Georgia Tech, 1962
Continuing investment education at University of Chicago, Stanford University and seminars at Q-Group, Barr Rosenberg, etc. etc.

NASA, 1964/1965
CIA (Director's office), 1966-1969
The Hartford Group (Investments), 1969-1972
Wellington Management Co., 1972-1987
Eads & Heald Investment Counsel, 1987-

Plus, when AIMR first published an incorrect formula for calculating standard deviation of annual returns, I am the one who sent AIMR the correct formula.