



Preparing for January 1, 2010

The holidays are past and we know everyone is busy finalizing 2008 numbers, but before we get too far into the New Year, you should start planning for some upcoming changes in the Global Investment Performance Standards (GIPS®) that will take effect on January 1, 2010. While that may seem to be far, far away, now is the time to start preparing for the upcoming changes as policies and systems may need to be changed.

GIPS-compliant firms must consider five changes that become effective January 1, 2010: (1) cash may no longer be allocated to carve-out segments; (2) portfolios must be valued at month-end; (3) portfolios must be revalued on the date of all “large” cash flows; (4) composites must be calculated at least monthly; and (5) error correction policies must be established.

Carve-outs

Currently a firm may “carve-out” a portion of a portfolio and include it in a composite. For example, assume a firm manages the equity portion of balanced accounts in the same manner as “equity only” accounts. The equity portion of balanced accounts may be included in the appropriate equity composite as long as cash is included. If the equity portion does not include its own cash balance, currently a firm may allocate cash to the equity segment. Cash may be allocated based on relative beginning of period market values (if the equity segment represents 40% of the total account then 40% of the cash is allocated) or the strategic asset allocation (if the target asset allocation to equity is 60%, then 60% of the cash is allocated).

As of January 1, 2010, cash allocation to carve-out segments is prohibited. Instead, a carve-out segment must have its own cash. **The Guidance Statement on the Treatment of Carve-Outs** describes three possible methods for accounting for the cash associated with carve-outs, as follows: (1) create separate portfolios where cash and securities for a carve-out segment are actually segregated into a separate portfolio at the custodian; (2) create multiple cash accounts with each segment’s cash accounted for separately (e.g., equity cash account, fixed-income cash account); or (3) divide the portfolio into sub-portfolios with each sub-portfolio accounted for as if it were a separate portfolio.

As we noted in our **October 2008 newsletter**, “fully invested” carve-out segments, such as “equity only with no cash,” must not be included in composites. If your firm has not determined how it is going to handle carve-outs going forward, now is the time to start the discussion to make sure you have a plan in place before January 1, 2010.

Month-end Valuation

Effective January 1, 2010, firms will be required to value portfolios as of calendar month-end or the last business day of the month. This would only impact firms that do not price daily. We do not expect this to have much impact on U.S. firms as most already adhere to this future requirement. However, this may impact some non-U.S. firms, especially those located in Asia where non-month end pricing is more common.

Large Cash Flow Revaluation

Firms have been required to value portfolios at least monthly since January 1, 2001. If monthly return calculations are used, as of January 1, 2005 external cash flows must be day-weighted. (Prior to January 1, 2005 cash flows could be assumed to happen mid-month.) Effective January 1, 2010 firms must also value portfolios on the date of all large external cash flows and calculate intra-month returns. Intra-month returns are then linked to calculate monthly returns.

So what is a large external cash flow? External cash flows are flows of cash or securities that come in or go out of a portfolio and are client driven. The definition of “large” is left to each firm to decide and can be different from composite to composite. When determining the level of “large” for a composite, we recommend considering what level of cash flow would materially affect the precision of an account’s return calculation. This consideration should be weighed against the additional cost of obtaining intra-month prices. Firms that manage equity securities should not have a significant issue with intra-month pricing as most equity prices are readily available. However, firms managing less liquid securities will have a more difficult decision to make. Also, some thought will need to be given as to the exact calculation of “large.” Will you use an absolute dollar amount, or a percentage based

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on the prior month-end market value of either an account or the composite in total? Regardless of the method selected, it should be well documented and must be applied consistently. You also should establish procedures to ensure all portfolios that have large cash flows are identified and properly revalued. You want to avoid a situation whereby a large external cash flow was missed when it occurred and you now have to try and strike an intra-month revaluation several months later. If you currently receive month-end pricing only, you may want to check your contract with your pricing vendor to see if the contract needs to be modified.

To anticipate your question, what is a typical level for defining a large cash flow, we can tell you that we often see either a 5% or 10% level based on beginning of period account values. (We've yet to see anyone use an absolute dollar amount.) These amounts happen to be the default level in two widely used performance systems.

While it is a common assumption that most firms calculate performance daily, or at least revalue for large cash flows, we found this is not the case. According to the [VPS 2008 Survey of Compliance with the GIPS Standards](#), 23% of equity managers and 28% of fixed income managers still calculate account-level returns monthly. The impact on these firms could be significant.

If your firm still prices monthly, do you need to transition to what is effectively a daily pricing environment? The good news is no, you do not. You might consider the following options:

- Establish a high threshold for the definition of "large." For example, if the established level was 50% of an account's beginning market value, the likelihood of a cash flow meeting this requirement would probably be small. This option might be best for those composites/strategies where securities are illiquid and/or expensive to price; or
- Adopt a "significant cash flow" policy for all composites whereby an account that experiences a cash flow above a pre-determined "significant" amount is temporarily removed from the composite. If the account is not in a composite you do not need to revalue the account and could stick with your monthly modified Dietz calculation; or
- Establish a "temporary new account." Cash or securities associated with the cash flow would be transacted outside

the account. For example, assume one of your clients contributes an additional \$5m cash to their existing \$12m account. The \$5m of cash would be contributed to a temporary new account for this client. You would buy securities in the temporary new account. When the transactions are complete you would do an in-kind contribution to the existing account. Similarly, if your client wished to withdraw \$5m from their existing \$12m account, you would transfer to the temporary new account those securities that will be sold to fund the withdrawal. The sale of those securities would take place in the temporary new account. Note that these temporary new accounts do not go into composites!

Whichever method you choose, the devil will be in the details. Each of these methods sound easy, but they can get very tricky. Make sure your decisions are well documented and as detailed as possible. Also be ready to modify and enhance your policies as unanticipated events occur.

Composite Calculation Frequency

Until the current version of the GIPS standards, the Standards were silent with respect to how often composites must be calculated. For periods beginning on or after January 1, 2006, composites must be calculated at least quarterly (quarterly account returns are weighted by beginning of quarter market values.) As of January 1, 2010 composites must be calculated at least monthly. We believe this will be a non-event for most firms as monthly composite calculation is the norm. Please note that this requirement speaks to the frequency of the weighting of individual account returns within a composite, and not the periods for which composite returns are reported.

Error Correction Policies

There is one additional requirement that comes into effect as of January 1, 2010 but is outside the current version of the GIPS standards themselves. A GIPS-compliant firm must create error correction policies no later than January 1, 2010, and then must apply the established procedures to any error that is identified on or after that date. When the [Error Correction Guidance Statement](#) was issued last summer, we wrote extensively about it in our [July 2008 newsletter](#). Do not postpone establishing these policies until year end as we anticipate most firms will have to put considerable time and thought into crafting them.

"A GIPS-compliant firm must have error correction policies in place no later than January 1, 2010, and then must apply the established procedures to any error that is identified on or after that date."

SEC No-Action Letter Issued to TCW

On November 7, 2008 the SEC issued a **no-action letter to the TCW Group**, significantly changing what the Commission defines as acceptable use of past performance recommendations in marketing materials.

In addition to composite performance, TCW proposed showing no fewer than five holdings that contributed most positively to a representative account's performance and an equal number of holdings that contributed most negatively to the representative account's performance. In creating and distributing this information ("Charts"), TCW stated they would use a mechanical and objective calculation ("Calculation") to select the presented holdings. Conditions of the letter are as follows:

- The Calculation will take into account consistently the weighting of every holding in the representative account that contributed to the account's performance during the measurement period, and the Charts will reflect consistently the results of the Calculation;
- Each Chart's presentation of information and number of holdings will be consistent from measurement period to measurement period;
- The Charts will show no fewer than ten holdings, including an equal number of

positive and negative holdings;

- The Charts will disclose how to obtain: (i) the Calculation's methodology; and (ii) a list showing every holding's contribution to the overall account's performance during the measurement period;
- Each Chart will include all information necessary to ensure that the Chart is not misleading, including presenting the best- and worst-performing holdings on the same page with equal prominence, and with appropriate disclosure as discussed above, in close proximity to the performance information; and
- TCW will maintain, and make available to the staff upon request, records that evidence: (1) the criteria used to select the specific securities listed in each Chart (i.e., the Calculation); (2) a list showing the contribution of each holding in the representative account to the overall account's performance during the measurement period; and (3) all supporting data necessary to demonstrate the calculation of the Chart's contribution analysis and to demonstrate the appropriateness of the holdings included in each Chart.

Note that there is no discussion on how the representative account should be selected.

"The Charts will disclose how to obtain: (i) the Calculation's methodology; and (ii) a list showing every holding's contribution to the overall account's performance during the measurement period."

Preparing for the SEC Document Request List

If you are anything like us, we are addicted to news about the (purported) Madoff Ponzi scheme. We couldn't help but wonder what might have happened if the SEC had done a routine exam of what should have been a registered investment advisor. We took a fresh look at the most recently issued **SEC standard request list** and noted a lot of similarities to some of the information we ask for during a verification, but some items go way beyond what we would request. Here is a subset of the information that relates to performance and that you must be able to provide to the SEC during a routine exam. Be warned; some of the items may make your heart pound:

- In Excel, a list of all advisory clients, including those that are wrap clients, as well as the account number, type of account, account's custodian and location; if the account is discretionary, the investment strategy and the performance composite in which the account is

included, if any; and details of each client's directed brokerage arrangement;

- Names of all advisory clients lost, including the reason, termination date, and asset value at termination;
- Names of all fair valued and illiquid securities held by clients, and a description of any fair value process employed including any testing and results and all fair value reports prepared or reviewed by a valuation committee;
- Supporting documentation for the most recent advisory fee calculation, including performance fees and the manner in which the fees were calculated;
- All pitch books, one-on-one presentations, pamphlets, brochures, and any other promotional and/or marketing materials furnished to existing and/or prospective clients for each investment strategy and/or mandate;

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Performance is all we do.



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Vincent Performance Services LLC provides consulting and verification services to firms that comply, or wish to comply, with the Global Investment Performance Standards (GIPS®). Our clients range in size from less than \$1 billion of assets under management to over \$500 billion and are located throughout the U.S.

Additional information about our services and expertise can be found at www.vincentperformance.com

To unsubscribe or change recipient information, please send an email to

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- All advertisements used to inform or solicit clients. If information on services and investments is available on the Internet, such as websites and blogs, make **all versions** available as either printouts or electronic archives (emphasis added. Yikes);
- All performance return composites including: description and investment objective, inception date, inclusion criteria (e.g. account minimum), and whether or not it is used in marketing;
- All accounts included in each composite as of [date]. Also, the staff may request the following records for each client account in an advertised performance composite: internal calculations

indicating beginning and ending asset values, all capital additions and withdrawals (including the dates) and the quarterly performance return, and all custodial statements;

- All accounts not included in a composite;
- All terminated composites;
- All RFPs completed; and
- Documentation that the adviser is complying with the GIPS standards, if applicable.

While we doubt that anyone running a Ponzi scheme would be able to produce these documents, or any of the other documents included on the standard request list, you need to be able to do so, and in a timely manner.

Revised GIPS Standards Draft Coming Soon

When the GIPS standards were originally issued, it was decided that they would be updated every five years. While it seems like just yesterday that we got the current version of the GIPS standards, it is almost time to review the next draft. In the near future the draft of the next version will be issued for public comment and will be available on the [GIPS standards website](#). While some changes have been publicly announced, they are not a done deal,

as everything is subject to change based on the public comments. We cannot begin to stress how important it is for all firms to read the draft and provide a comment letter. Every single comment is read and considered. And, if you don't want your comments to be made public, you have that option.

We promise that this is not the last time we will plead for participation from U.S. managers over the next few months!