



Responding to (crazy) database questions

Firms deal with many issues when calculating and reporting performance, but none may be as frustrating as trying to complete consultant database questionnaires or respond to RFP questions about the firm's Global Investment Performance Standards (GIPS®) compliance and verification status. Some questionnaires are better than others, but many that we've seen or helped clients answer are rife with errors. Some questionnaires still ask firms if they claim compliance with the AIMR-PPS® Standards. Really? We probably should not be surprised by these questions, as we sometimes see money managers still claiming compliance with the AIMR-PPS standards. In this article we review some questions (in bold font) taken from actual questionnaires that are improperly worded, and discuss how we believe a firm should respond.

“Our composites have been verified (yes or no)? If yes, attach the latest verifier report.” First, a refresher. Composites aren't verified. Only a firm is verified. What does verification test? Verification tests two things: 1) whether the firm has followed the composite construction requirements of the GIPS standards on a firm-wide basis (in other words, are the right accounts in the right composites for the right time periods), and 2) whether the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not, in any way, provide assurance about the accuracy of any specific composite presentation or composite performance. Verification also does not ensure that a firm is properly claiming compliance with the GIPS standards. If a firm wishes to obtain an opinion on or assurance about a specific composite's returns, the firm may choose to have the composite examined. A performance examination (or performance audit) may be conducted either at the same time as the verification, or after the verification. A GIPS performance examination may not be conducted on a composite unless the firm has also been verified, or is being verified.

Back to the questionnaire. The first question was followed by: **“Our composites have gone through a complete audit. We have attached the latest audit.”** Looking at these two questions together, we believe the first question is asking whether the firm

has undergone a firm-wide verification and the second part is asking if the composites have been examined. If the firm has been verified the answer would be yes, the composites have been verified, and the firm would attach the verification report. If the composite that is the subject of these questions has been examined, the firm would say the composite has been audited and would attach the performance examination report.

“Are the composites shown in conformance with AIMR/CFA Standards? If yes, please select which standards apply (select one option below) (a) 2001 AIMR-PPS; (b) 1999 GIPS; (c) 2006 GIPS; or (d) GIPS and AIMR-PPS.”

This is an odd question, at best. First, for the purpose of claiming compliance with the GIPS standards, only a firm can claim compliance with the GIPS standards. However, when asked a question such as this, if the performance information is derived from a proper GIPS composite or compliant presentation, as opposed to being based on a representative account or something other than a GIPS-compliant composite, then the firm can say yes, the composites are in conformance. But in conformance with what? As of today the only option from this list is 2006 GIPS. The AIMR-PPS standards do not exist anymore; they were put to rest over five years ago. Even if a firm previously complied with the AIMR-PPS standards, it should not be doing so currently so the only possible option is 2006 GIPS. Hopefully they will add 2010 GIPS as an option soon.

“Is the Composite history GIPS Verified?” Once again, a composite is not verified, the firm is verified, and a composite may or may not be examined. Because of the confusion on the proper use of the word “verified,” the new claim of compliance in the 2010 edition of the GIPS standards includes language stating what verification tests and what it does not. But that will only help prospectively. Earlier this year a very widely used database asked a very similar question. Two of our clients followed up directly with the database and asked for clarification as to what was being asked. One client was told that the database was inquiring as to the firm's verification status, but the other client was told they were being asked whether the composite had been examined. So what is a firm to do? We recom-

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mend reviewing the database in totality, and determining where this question fits within all of the questions that are asked. If this question is in the section about the firm, we would read this question as a poorly worded question asking about the firm's verification status. If it is in the section asking about a specific composite, we would read this as asking about the composite's examination status. What a mess.

The following questions relate to an examined composite and were asked in two parts. The first question started with, "**Date Performance Examination concluded (mm/dd/yyyy)**" and the second part was "**Date Verified Performance began (mm/dd/yyyy)**". Huh? We believe the questions are really asking for which periods the composite was examined, and should be answered accordingly.

The following questions were part of the "compliance" section of a database and as such can be answered together. The questions are as follows: "**The compliance of this track record has been externally verified? (yes or no)**"; **If yes, period of verification? (space left to fill in periods); Name of Verifier? (space left to fill in name);** and "**Describe the nature of the verification, including the level of verification and other details.**" (Big comment box for your writing pleasure.) Because the questions ask about a specific track record, it is likely that the questionnaire is asking whether the composite has been examined as opposed to whether the firm has been verified. The part of the question that asks about the level of verification is a very old holdover from the AIMR-PPS standards. (We keep thinking we will never see a question asking about levels of verification, but they keep coming back.) We will explain the old concept of verification levels solely for the purpose of allowing you to understand what is behind the question, so you can answer appropriately.

Back in the old AIMR-PPS days, prior to January 1, 2003, firm-wide verification was called Level I verification, and a performance examination was called Level II verification. When a database asks about the verification level, if the firm has been verified we suggest responding that the firm has been Level I verified. If the composite has been examined, we suggest responding that the composite has been Level II verified.

But the concept of levels also flows through to questions about compliance. Another database asks the following question in rela-

tion to a specific composite: "**What level of compliance is reflected by this composite?**" Three options are provided: No GIPS compliance; GIPS; or GIPS with performance examination. This is particularly confusing, as the concepts of GIPS compliance and performance examination status are all mixed up in the potential answers. Adding to the confusion is the fact that prior to asking this question, they asked if the composite had been audited or not. We assume they are asking if the firm is compliant or not, and then if the composite has been examined.

And now promise yourself that you will never voluntarily use the word "level" with respect to compliance or verification, unless responding to (bad) questions asking about verification or compliance levels.

Recently one of our clients was completing an RFP that asked the following questions: "**Are the grossed up returns prepared in accordance with CFA Institute Standards? At what level, if any, does the firm comply? Have the numbers for the most recent year-end been formally audited?**" The first question was a bit of a challenge. We know they were referring to the GIPS standards, but the GIPS standards don't require a certain method for grossing up returns. We recommended answering yes, as no is obviously not correct. Level of compliance? As we just discussed, there is no such thing as levels of compliance. A firm either claims compliance with the GIPS standards or it doesn't. We recommended responding that the firm fully complies with the GIPS standards; what else could they say? The last question about performance being "formally" audited was easy (assuming that no one is yet conducting informal performance examinations.) This question can be answered based on a composite's performance examination status.

The December 13, 2010 edition of *Pensions and Investments* included an ad for an Active Emerging Markets Equity Investment Management search. One of the requirements to be qualified to participate in the search was that the firm must have "**three years verifiable GIPS compliant investment performance record for the period ended September 30, 2010.**" We weren't sure if the consultant was asking for a compliant presentation for the period ended September 30, 2010, a firm-wide verification for at least the three years ended September 30, 2010, or a performance examination for the composite covering at least the three year

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period ended September 30, 2010. In a situation like this, we would assume that the consultant is asking for a compliant presentation that is updated through September 30, 2010.

But it's not only consultants and databases that get these things wrong. Firms do too. Here is a sanitized disclosure from a presentation on a firm's website. Only the names have been changed to protect the innocent: "ABC Capital Management has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS). The Micro Cap Growth Equity, Small Cap Growth Equity, and Smid Cap Growth Equity composites have been verified by Accounting Firm, LLP since inception."

The verifier's report was not on the website so we could not determine whether the error was incorrectly using the term verified instead of examined, or if the firm was verified and the firm misunderstood and believes that a firm-wide verification provides assurance on composite results. (It doesn't.)

Here's another example of an improper reference to verification on a website: "XYZ Capital Group claims compliance with the Global Investment Performance Standards

(GIPS®). The results of the International Equity Composite have been verified from January 1, 2000 through December 31, 2009 by an independent verifier. A copy of the verification report is available upon request." Again, results are not verified.

To conclude, always remember:

- There are no "levels" of compliance. A firm either claims compliance with the GIPS standards or it does not.
- A firm that claims compliance with the GIPS standards may choose to be verified.
- There are no levels of verification. A firm is either verified or not verified.
- Only a firm is verified. Composites are not verified. Performance is not verified. A firm's claim of compliance is not verified.
- A composite can be examined or audited. Or said another way, a firm can have a performance examination or performance audit of a specific composite.

Good luck with those RFP responses and database questionnaires.

"Only a firm is verified. Composites are not verified. Performance is not verified. A firm's claim of compliance is not verified."

Feibel and Vincent book available

Our firm's founder, Karyn Vincent, has co-authored a book with Bruce Feibel, Managing Director of Investment Management Products at BNY Mellon, named *Complying with the Global Investment Performance Standards (GIPS®)*, as part of the Frank J. Fabozzi Series. Mr. Feibel is the author of *Investment Performance Measurement*, our firm's go to reference book for any performance calculation questions. This new book is a step-by-

step guide to complying with the GIPS standards. The book covers the mathematics for calculating performance as well as the policies and procedures for achieving and maintaining compliance. Also included are recommendations for efficiently and effectively maintaining compliance.

The Kindle and hard copy editions of the book are available at amazon.com.

New Q&As re: aggregate method issued

When calculating composite returns, returns of portfolios within the composite must be weighted by each portfolio's beginning value, or weighted using a method that reflects both beginning value and external cash flows. One method is the aggregate return method, which combines all of the portfolio-level information and calculates the composite return as if it were one portfolio; portfolio-level returns are not used in the calculation. Recently some have questioned whether the aggregate method is an accept-

able method or not. In response to these questions **two Q&As** were recently issued that confirm that the aggregate method is an accurate method for calculating composite returns. A second point is made that when calculating composite returns for a specific period, only portfolios that are included in the composite for that entire time period are included in the calculation. Assume a firm calculates both portfolio-level and composite-level returns monthly. When calculat-

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ing the composite return for the month of May, only portfolios that are managed for the entire month of May are included in the monthly composite calculation. A portfolio that begins on May 14th is not included in the May composite calculation as it does not have a full month of performance. A portfolio that terminates on May 25th would also not be included in the May composite calculation as this portfolio also does not have a full month of performance. Only portfolios that have a full month of performance may be included in the monthly performance calculation. This is true regardless of which composite return calculation method is used.

If a firm wishes to change the composite membership during a month, the firm must calculate composite returns daily. But the same concept holds true for daily composite calculations. Only portfolios managed for the full day are included in the daily composite calculation. A portfolio that funds during a day or terminates during the day is not included in that day's composite calculation.

We assume that these questions arose due to a lack of understanding for how the Advent Axys and APX systems calculate composite returns. Advent is a very widely used performance system in the U.S., which calculates composite returns using the aggregate method. Portfolios can be assigned to a composite as of a specific day, but the portfolio is

not reflected in the monthly composite calculation unless the portfolio is assigned to the composite for the full month. For example, assume portfolio 123 is assigned to the Equity Composite from 5/14/10-11/18/10. Although it looks like portfolio 123 would be included in the aggregate return calculation for the month of May, it is not. Axys/APX includes in the composite calculation only those portfolios that are assigned to the composite from 4/30/10-5/31/10. (Advent users: be careful with the first date of composite assignment. If portfolio 123 is instead assigned to the composite beginning 5/1/10, it would not be in the composite calculation for the month of May.) Portfolio 123 would also not be included in the composite calculation for the month of November given its final composite inclusion date of 11/18/10.

Composite-level returns calculated using the aggregate method can sometimes seem to not make sense relative to the portfolio-level returns. This can happen if portfolios are revalued during the month for cash flows above a specified amount, but the composite is not also revalued at the same time. To prevent this mismatch in returns from happening, firms can establish a policy whereby the composite is revalued whenever any portfolio in the composite is revalued for a large cash flow. This will ensure that composite returns are in line with portfolio-level returns.