



New Year's Resolutions, Anyone?

It's that time of year, which prompted some interesting discussions in our office. We'll spare you the details about promises to get more exercise and eat better. We did identify a list of resolutions we hope might be adopted by those folks responsible for GIPS compliance at their firms.

Vigorously adhere to established composite inclusion and exclusion policies.

GIPS Provision 3.A.1 requires all actual, fee paying, discretionary portfolios to be included in at least one composite. Once you've identified all accounts that must go into a composite, you have to establish rules for the timing of inclusion in and exclusion from the composites. GIPS Provision 3.A.3 requires firms to include new portfolios on a timely and consistent basis after the portfolio comes under management. It is up to the firm to establish what timely means, and it can be different from composite to composite. For example, a U.S. Large Cap Equity Composite may have a shorter inclusion time than an Emerging Markets Fixed Income Composite due to liquidity issues. Our favorite inclusion policy is "after the first full month under management." With this policy a firm rarely has to debate whether a new account should be an exception to the new account inclusion policy. Closed portfolios must also be treated consistently. Often we see firms determine exclusion based on the liquidation date. However, exclusion should be based on when the firm loses discretion versus the date the account actually closes. Once the policies are established you should rarely deviate from them. When the relationship manager tries to make the case that the \$1b account that funded on December 2nd is an exception, as the market was flat on December 1st, and that one day doesn't really matter and the account really should be included in the composite in December, you know what your answer should be. And, you should diligently track down those termination letters and emails for all closed accounts. Without them you will not be able to determine when discretion actually ended.

If you do have any exceptions from your composite inclusion/exclusion policies, ensure the exception is well documented and supported.

Move no account from one composite to another unless you have client-directed guideline changes in hand.

GIPS provision 3.A.5 says that portfolios are not permitted to be switched from one composite to another without documented changes in client guidelines, or the redefinition of the composite makes it appropriate. (A composite redefinition is a change in the types of accounts included in a composite, such as a change to no longer include carve-outs in a composite beginning 1/1/08.) So, if the portfolio manager comes over and tells you to switch an account from one composite to another, you're going to reply, I'd love to, as soon as you provide me with the client directed guideline changes. The good thing is that the GIPS standards say that documentation can take the form of, but is not limited to, letters, faxes, e-mails, and/or internal memorandums documenting conversations with clients. Finally, remember that accounts must not be moved into or out of composites due to tactical asset allocation changes.

Review composites on a regular basis looking for outlier account-level returns.

It's March and you're working on February returns when you notice that the performance doesn't look right for the largest account in your Core Equity Composite. The account returns range from -0.50% to -0.25%, but this particular account has a return of 0.28%. You do further research and find that the recon department had grouped all cash flows during the month as if they posted on the last day of the month. Once you update for proper daily cash flows the return is -0.47%, which is in line with the other accounts. You look back and determine that this same mistake had happened each month for the past six months since Wanda the Wonder Reconciler took over the account. You go back and realize that this account was consistently the highest performing account in the composite. How could this have been avoided? A simple review of returns, looking for outliers, likely would have spotted the error. Now you have to go through the process of restating returns and potentially sending corrected performance to all those

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prospective clients, databases and consultants you previously sent marketing materials.

When you think of the time and cost of having to restate and resend corrected performance results, a little more time spent on the front end can save a lot of time, cost, and aggravation on the back end.

Ensure all accounts that you believe are paying commissions are in fact doing so.

This may seem like a trivial point right? We think not. If you have even one account in a composite that you thought was paying commissions and wasn't, you're not in compliance with the GIPS standards. The Standards require that all returns, both gross and net, must reflect the deduction of trading costs. We find non-commission-paying accounts included in "regular institutional" composites more often than you would think, and it typically comes as a complete surprise to everyone involved. With the proliferation of dual contract accounts, multiple distribution channels, directed brokerage arrangements, and unique fee structures, it's no wonder that such accounts creep into the mainstream composites. So how do you ensure all accounts are paying commissions? Running an account's commission report for the past year is the quickest way to prove commissions are being paid. For fixed income accounts you can still run a commission report, but would instead look for the use of multiple brokerage firms. If only one firm is used, additional work will be required. Most importantly, talk to your traders. Ask them about special trading arrangements for any accounts. Let them know the importance of keeping you informed about significant changes in trading for any existing accounts. Raised awareness of this issue should help mitigate this risk.

If net returns are calculated using actual fees, ensure all accounts have proper fees applied.

When calculating composite net returns, firms have a choice between using a model fee or actual fees. When using actual fees it's important to ensure the correct fee is applied to all accounts in the composite. This can be easier said than done. Some accounts may have their fees deducted from their account, while others may pay their fees with assets outside of the account. Or, fees may be calculated by combining related accounts and the fee may be paid out of one account on behalf of several accounts. Assuming fees impact the net return on a when-paid basis,

you should normally see four fee payments a year. A simple test can be done quarterly to compare account-level quarterly gross and net returns. If the numbers are the same, you likely missed applying a quarterly management fee.

Resolve to reconcile AUM to GIPS firm assets and composite assets at least once a year.

GIPS Provision 0.A.3 defines total firm assets as all discretionary and nondiscretionary, fee-paying and non-fee-paying assets under management within the defined firm. However, the combined assets of all the composites may not add up to total firm assets for a variety of reasons. Composites will exclude accounts that are deemed non-discretionary, and may not include accounts that fall below established minimum asset levels. Assets and accounts may be double or triple counted, so summing composite assets will overstate total assets. And accounts that are new and not yet included in a composite, and closed accounts that are in the process of liquidation, will also result in reconciling items. It is important for firms to reconcile firm assets with composite assets to make sure that all eligible accounts are included in at least one composite and all accounts, whether in a composite or not, tie to total firm assets.

Take a fresh look at compliant presentation disclosures.

Let's face it, the GIPS standards are more about presentation than anything else. The true spirit of the GIPS standards is making sure the reader of a presentation is able to gain an understanding of how a firm presents performance. While the Standards require certain disclosures, firms are encouraged to provide any additional information that would help a prospective client interpret the performance record. If you wonder whether a certain disclosure should be added or not, you probably should include it. When in doubt, disclose. You should consider whether anything has changed from the last presentation. For example, if you had a star portfolio team leave your employ, resulting in a large decrease in firm assets, you may want to disclose information about this event even though it would not be required in presentations for strategies that were not managed by that team. Most importantly, assuming you are an SEC registrant, ensure your compliance folks also review your presentations to ensure they are happy with any SEC-related disclosures. We heard from Bill Meck at the annual GIPS conference in

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Chicago, and we can confirm from first hand experience with firms that have recently been examined by the SEC, that the SEC typically views compliant presentations as advertising materials. Make sure net returns are included as well as other SEC disclosures. And don't forget those pesky Clover Capital disclosures that are so easily forgotten.

Ensure procedures are adequate to meet the requirement to make every reasonable effort to provide a compliant presentation to all prospective clients.

Before we discuss suggested procedures, we need to define what a "prospective client" is. For example, you go to meet with company ABC's pension group. Is this a prospective client? You might consider them a prospect in the general definition; however, for purposes of "prospective client" in our view the answer would be "it depends." If you know nothing about ABC's investment philosophy and asset allocation policy, then the initial meeting is more than likely going to be a fact gathering meeting to see if you have a product that they may consider using. For example, if your firm only has hedge fund mandates, and ABC has a strict policy forbidding investments in hedge funds, then ABC really isn't a prospective client.

Now consider a scenario where you're a domestic equity manager. Let's pretend that you've met with a prospective client and they currently have 40% of their assets allocated to a Large Cap Value mandate with manager XYZ, and they are unhappy with the performance the manager has produced over the last five years. It just so happens, that you also have a Large Cap Value Composite that has an excellent track record over this same time period. Now you have a prospective client. You've established their need for a specific investment mandate and you have a product that meets their need.

Providing a compliant presentation is going to depend on what type of manager you are. Are you an institutional manager or a wrap fee/SMA manager? If you're an institutional manager, then you would typically provide the appropriate compliant presentation in your pitch book. If you're a wrap fee manager, then this requirement becomes a bit more challenging. When meeting with a prospective wrap fee sponsor you would provide the appropriate style-specific wrap composite. However, you may or may not meet with a prospective wrap fee client. If

you do meet with a prospective wrap client, you will have the opportunity to provide the appropriate compliant presentation. But, in most instances the manager doesn't meet with the wrap client, as that is the responsibility of the sponsor. So how do you meet the requirement to provide a compliant presentation to a prospective client if you don't meet with them? First, you can ask the sponsor to provide the presentation. Second, if you provide a new client welcome package to new clients, you could include the presentation in this package. We acknowledge that some sponsors do not allow contact with clients, and/or strictly control the information the manager provides to them, so this may not be an option for some programs. Finally, you could post the presentations on your website. If you were to take these three steps we think you would have made every reasonable effort to provide a compliant presentation to all prospective clients (GIPS Provision 0.A.11.)

Ensure no accounts were temporarily removed from composites prior to 7/1/02 due to cash flows.

We wrote about this in our June 2007 newsletter, but just in case you missed it, here it is again. For periods prior to 7/1/02 a firm that previously claimed compliance with the AIMR-PPS standards was not allowed to temporarily remove accounts from composites based solely on cash flows. This goes back to the old AIMR-PPS days when there was some confusion on the subject. In 1996, an AIMR-PPS Q&A was issued explicitly stating that a firm could *not* temporarily move an account to non-discretionary status and remove it from a composite based solely on a large cash flow occurring. In 2002, the GIPS Guidance Statement on Significant Cash Flows was issued that allowed for the temporary removal of an account from a composite due to cash flows, but only on a *prospective* basis, and only if certain policies were followed and certain disclosures were made. So, if you removed an account from a composite prior to 7/1/02 solely based on cash flows, then you need to go back and include the account in the composite and restate performance. Note that we are not talking about a situation where a firm had a minimum account size requirement and a cash flow causes the portfolio to fall below the minimum. And, we resolve that if we do not encounter this issue in 2008 we will never, ever mention this issue again.

"Providing a compliant presentation is going to depend on what type of manager you are."

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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.

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Ensure GIPS policies and procedures address all requirements of the GIPS standards.

Imagine you're a factory trained, certified mechanic. You have this great manual that tells you how to fix just about everything. However, the editors of the manual decided to leave out a few sections on the electronics of a certain part because they didn't think the part would break and need attention. It just so happens that the part does break. You, as the mechanic, are left scratching your head, because you have no guidance on the correct course of action. A policy and procedures manual addressing the GIPS standards is just like the mechanic's manual. You may think that there is an area in the GIPS standards that won't apply to you, but you'd be surprised how often something comes up that you never thought would occur. When developing policies and procedures, please look at each section of the GIPS standards carefully and address each requirement. You should also think through as many different scenarios as possible, and how you would address each. Creating a well thought out, well documented policies and procedures manual will make your life much easier. Your internal auditors, friendly regulators, and verifiers will also thank you.

Resolve to submit a comment letter on all documents issued for public comment.

In the old AIMR-PPS world guidance was issued by CFA Institute (formerly AIMR) and a compliant firm had to follow the guidance, no questions asked. That has all changed in the new GIPS world as firms are able to participate in the GIPS guidance creation process. All proposed guidance is issued for public comment. Each and every comment letter is read and considered. The first letter in GIPS stands for global, and the global community outside the U.S. has been doing a good job of providing comments. Here in the U.S., we're falling short of our counterparts when it comes to participation, so we're hoping for two things in 2008. First, that we'll see more participation, especially from U.S. firms, and second, when you do comment, please comment on the things you agree with as well as those you don't. The comment letters tend to only address items firms don't agree with. You should also comment on proposals you agree with and why you agree with them. If you have provided comments in the past, keep up the good work. For those of you that haven't commented in the past, this is your chance to make amends. The next version of the GIPS standards are expected to go out for public comment in 2009. It is important for you to comment on the draft version as these are the Standards you are going to be living with for at least the next five years.

We wish you all a very happy and prosperous 2008!!!