



Excluding accounts with cash flows from composites, again

Over the past few years, we have written several articles about how a GIPS-compliant firm may handle accounts that experience a large cash flow. Since July 1, 2002, a firm has had the option of adopting a policy whereby accounts that experience large cash flows may temporarily be excluded from a composite. The Guidance Statement on the Treatment of Significant Cash Flows includes the following key facts:

- “Significant” can be defined on a composite specific basis;
- Significant cash flow policies must be determined before they are implemented;
- Once implemented, the policy must be applied consistently and properly disclosed; and
- The policy may not be applied retroactively.

However, for a firm that previously claimed compliance with the AIMR-PPS standards, the prior AIMR-PPS guidance on this topic must also be considered.

There has been much discussion and confusion on this topic over the past few years. We have consistently advised firms that had previously claimed compliance with the AIMR-PPS standards and adopted such a policy for periods prior to 7/1/2002 to go back and re-include such accounts in composites and restate returns. Why? Until 1996 there was no official guidance stating a firm could not adopt a policy of temporarily removing such accounts from composites, but there was much discussion at conferences that this was not in accordance with the spirit of the Standards. However, in 1996 a Q&A was published explicitly stating that a firm could not temporarily move an account to non-discretionary status and remove it from a composite basely solely on a large cash flow occurring. That was the rule until the GIPS Guidance Statement on Significant Cash Flows was issued in 2002, which said that a firm could adopt such a policy, but only on a prospective basis and only if certain policies were followed and certain disclosures were made.

To finally put an end to this discussion, the North American Investment Performance Council issued a Q&A addressing this topic. Because of the importance of this topic and the continuing controversy, we are including the entire Q&A.

Question: Our firm created composites in 1995. As part of our composite construction policy, portfolios with an external cash flow during the current performance measurement period of 15% or greater (calculated as of the previous performance measurement period's portfolio ending market value) would be removed from the composite. The composite construction policy also stated that portfolios which were removed from a composite due to a cash flow would be placed back in the composite at the beginning of the performance measurement period following a 45-day investment period. We have claimed compliance with the AIMR-PPS standards since 1996. Does this policy comply with the AIMR-PPS standards?

Answer: No, for part of the time cited, implementing the above policy was prohibited by the AIMR-PPS standards. It should be noted that this answer does not address the situation where a firm has a minimum account size policy for a composite and, due to a cash flow, a portfolio falls below the minimum.

In January 1996, the AIMR-PPS Implementation Committee issued a question and answer in the January – February 1996 edition of the AIMR Standards Reporter clarifying its position that removing portfolios due to large cash flows was not permitted.

In 2001, the AIMR-PPS standards became a Country Version of the GIPS standards, meaning that the AIMR-PPS standards automatically incorporated future developments to the GIPS standards. The Guidance Statement on the Treatment of Significant Cash Flows, adopted 13 March 2002 and effective 30 June 2002, allowed portfolios with significant cash flows to be excluded from composites, provided specified criteria were met. The Guidance Statement is available at the www.cfainstitute.org website.

Consequently, for the period from January 1996 to June 2002 removing portfolios from composites due to large cash flows was not permitted under the AIMR-PPS standards

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(i.e., firms could not use cash flows as a criterion to define portfolios as temporarily non-discretionary). However, a firm has always been permitted to show, as supplemental information, a performance track record excluding portfolios with large cash flows.

Firms currently coming into compliance with the GIPS standards should rely on the Guidance Statement on the Treatment of Significant Cash Flows and not on previously-issued AIMR-PPS standards guidance when claiming compliance with the GIPS standards.

The Q&A is available in the AIMR-PPS Q&A database in the cash flow category at www.cfainstitute.org/centre/ips/index.html

“Consequently, for the period from January 1996 to June 2002 removing portfolios from composites due to large cash flows was not permitted under the AIMR-PPS standards...”

If you are reading this and realize you previously claimed AIMR-PPS compliance and did temporarily exclude from composites accounts with cash flows during the 1996-2002 period, what should you do? We think you should re-include accounts that were temporarily removed and recalculate composites. Next, cross your fingers and hope that returns do not materially change. If they do, see the article on page 4 on Error Correction. You should also get on the phone with your verifier and seek their advice.

Finally, if you are thinking, hey, this sounds like a great idea, let's adopt a significant cash flow policy on a prospective basis, we'd suggest thinking long and hard about doing so. Adopting a significant cash flow policy sounds like such a great idea on paper, but it can be difficult to implement, and even more challenging to apply consistently.

Will verification be mandatory in 2010?

The most recent semi-annual meeting of the GIPS Executive Committee was held in March in Cape Town, South Africa. During the session of the meeting that was open to the public, one topic was heavily debated: whether or not verification should be mandatory as of 2010. We strongly believe that verification should not be mandatory, for the following reasons.

1. The GIPS standards are ethical standards, designed to promote self-regulation. We don't see how requiring a firm to be verified fits in with the spirit of self-regulation.
2. Verification means different things to different people. We do not think there is a good understanding of what a verification is, and what it is not. A verification is simply a test of a firm's policies and procedures; it provides no assurance as to the results of a specific composite. We are concerned that people who are pushing for mandatory verification believe that a verification provides more comfort than it does. How often do you

hear someone (incorrectly) ask if performance results have been verified?

3. The cost of verification could prevent smaller firms from attaining compliance. We would hate to see a claim of GIPS compliance be something only large firms could afford.
4. Considering only the US, if thousands of firms suddenly needed to be verified, the supply of qualified verifiers would never be able to meet the demand.
5. There are numerous countries that have recently adopted or are considering adopting the GIPS standards. Particularly in those locations where GIPS compliance is a new concept, the likelihood that there would be qualified verifiers available locally seems pretty remote. Should firms in such countries be forced to fly in verification experts from other countries?

We believe each country should let market forces drive the need for verification. Stay tuned; we'll keep you informed as the debate continues.

New GIPS standards website

Until recently all GIPS standards guidance was maintained on CFA Institute's website. Now, the GIPS standards have their very own website, at www.gipsstandards.org. If you want to find old AIMR-PPS guidance,

that information is still maintained on CFA Institute's website, under CFA Centre, and then click on investment performance standards, at www.cfainstitute.org.

Do you know if your accounts pay commissions?

Provision 2.A.5 of the GIPS standards states, "All returns must be calculated after the deduction of actual trading expenses incurred during the period. Estimated trading expenses are not permitted." What this means is that for the purpose of complying with the GIPS standards, both gross and net returns must be reduced by actual trading expenses that are incurred in the purchase or sale of securities. The logic here is that trading expenses must be paid in order to implement an investment strategy.

If the actual trading expenses cannot be identified, as in the case of a bundled or wrap fee, then both the gross and net returns must be reduced by the entire bundled fee or the portion of the bundled fee that includes the direct trading costs (Provision 2.A.7). In the real world, it is nearly impossible to identify the portion of a bundled fee that includes trading expenses. Most firms we have seen will report a "Pure" gross return and a net return. The Pure gross return is not "GIPS compliant," and may only be presented as supplemental information as it does not reflect the deduction of trading expenses. The net return must reflect the deduction of the entire bundled fee.

Institutional accounts pay commissions on trades, so no special adjustments to calculated returns are needed.

But, what about accounts that look sort of like wrap accounts and sort of like institutional accounts? This type of account, commonly referred to as a "fee-in-lieu of commission" or "dual contract" account, is a bit tricky. These clients pay a management fee directly to you (the firm) just like all your other non-wrap accounts, and sign a contract directly with you. The client also pays a fee to a broker and has a contract with the broker too. This fee includes the broker's fee as well as commissions. You can see the issue: just like a wrap account, the gross return for this type of account does not reflect the deduction of transaction costs.

So what's a firm to do?

Before figuring out how to handle these accounts, you first need to make sure you have identified all of them. Here are some things you can do to identify these accounts:

- Identify any accounts with 100% directed brokerage arrangements. Look at their contracts and see if the contract specifies whether broker fees include commissions.
- Talk to your traders. Ask them if they are aware of any accounts that do not pay trading expenses.
- Run a commission report on your trading or performance system for all non-wrap accounts.

Once all of these accounts have been identified, you must determine how to treat the accounts for composite assignment purposes. If you wish to include these accounts in composites with institutional accounts and show "regular" gross returns, you must reduce the gross (and net, if shown) returns by the fees paid to the broker. You might also consider applying actual commission charges, as incurred by other accounts in the same composite, to all portfolio transactions of fee-in-lieu accounts. We would argue that these are not estimated trading expenses, but instead represent actual trading costs.

If you don't want to go through the effort of doing these special calculations, you can include these accounts in a bundled fee composite whereby the pure gross returns are only shown as supplemental information.

Finally, we recommend implementing a policy to ensure that all new non-wrap accounts are reviewed to ensure that they pay trading expenses. This extra step will avoid the painstaking process of having to restate performance of your institutional composites when you later determine that fee-in-lieu accounts are hiding in your institutional composites.

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Save the date

The next annual GIPS conference, sponsored by CFA Institute, will be held on September 27th and 28th, at the Intercontinental Hotel in Chicago. This conference is the must attend event for many of us in the performance world. The day before the conference, on September 26th, a GIPS introduction workshop will also be held. This workshop is targeted to performance folks who are new to the GIPS standards, or wish to

have a thorough refresher on complying with the GIPS standards.

Registration information should be posted on the GIPS standards website in the next few months. As always, we recommend registering early as this conference and the workshop typically sell out.

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

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Error correction guidance, or lack thereof

In the old days, a firm that claimed compliance with the AIMR-PPS standards and experienced an error had broad guidance for how the correction of the error should be handled. A Q&A in the AIMR-PPS database asked, "If a firm discovers an error in the calculation and/or presentation of performance results that were presented to their clients as being in compliance with the AIMR Performance Presentation Standards, what must the firm do to remain in compliance with the Standards?" The answer stated, "The firm has an obligation to promptly: (i) bring the composite calculation and performance presentation in compliance with the AIMR-PPS standards including, if applicable, recalculating the performance of the portfolio(s) in which the error occurred; (ii) deliver AIMR-PPS compliant performance with the disclosure that the composite performance has been corrected to clients and others that the firm reasonably believes relied upon the non-compliant performance, including consultants and verifiers; and (iii) institute steps to ensure that errors will not recur. A firm should also consider the legal and regulatory requirements that it is required to follow when correcting inaccurate investment performance

delivered to its clients." In the GIPS world, no comparable guidance exists. To address this issue, a draft GIPS guidance statement on error correction was issued for public comment, but it's been a long time since the comment period closed and no guidance has been issued. What's a firm to do when an error occurs?

Until the GIPS guidance is issued, we recommend continuing to follow the old AIMR-PPS guidance, with two additional considerations. First, materiality should be considered. A two basis point change on an annual return of 15% might be viewed as immaterial and the firm could determine that it is not necessary to deliver a corrected presentation to prospective clients. The firm should also document its rationale for determining whether the error is material or not. Second, regardless of whether an error is large enough to require a firm to redistribute the corrected compliant presentation, we recommend including a disclosure about the change in the compliant presentation. We recommend including this disclosure for at least one year.

And, in all cases, make sure you get input from your verifier.