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INVESTMENT PERFORMANCE COUNCIL (IPC)

Guidance Statement on the Treatment of Carve-Outs

Preface

The Investment Performance Council (IPC) has stated its intentions to transform the current Global Investment Performance Standards (GIPS®) into “gold” standards which will represent global best practices for historical performance calculation and presentation. The IPC has agreed to follow an evolutionary approach for development of the GIPS standards, which includes a strategy of not introducing significant changes to GIPS standards before 2005. This strategy is designed to maintain a sensible balance between improving the GIPS standards while avoiding undue disruption to firms that are, or are in the process of, claiming compliance. Currently, the “gold” GIPS Standards (which do incorporate all provisions relating to carve-outs) are out for a period of public comment. During the second half of 2004, the IPC will be analyzing all public comments and potentially altering “gold” GIPS based on the feedback from the industry.

With regards to Carve-outs, the current GIPS Provision 3.A.7 reads as follows:

“Carve-out returns excluding cash cannot be used to create a stand-alone composite. When a single asset class is carved out of a multiple-asset portfolio and the returns are presented as part of a single-asset composite, cash must be allocated to the carve-out returns and the allocation method must be disclosed. Beginning 1 January 2005, carve-out returns must not be included in single asset-class composite returns unless the carve-outs are actually managed separately with their own cash allocations.”

As a result of the IPC’s analysis of current GIPS requirements, the 1 January 2005 effective date for carve outs was deemed impractical due to the fact that most portfolio management systems and technology had not evolved to account for separate cash accounts. In order to maintain a practical approach to evolving the Standards, the IPC agreed to move this effective date into the future. Firms are not expected to implement GIPS Provision 3.A.7 (the carve out provision) in 2005 as currently stated in the GIPS Standards. Although this provision is now currently proposed (in the “gold” GIPS draft) to become a requirement on or before 2010, firms are **strongly** encouraged to adopt the infrastructure necessary to implement this provision **as soon as possible**.

Because moving the date to 1 January 2010 is only proposed and is not expected to be finalized until 2006 with the release of the final “gold” GIPS standards, the following Guidance Statement will reflect both what the current GIPS standards require and what is proposed under the “gold”

GIPS revisions. This Guidance Statement takes effect on 1 June 2004. After 1 June 2004, firms must follow this guidance, regardless of what effective date is chosen for GIPS provision 3.A.7.

The “gold” GIPS proposal is currently available for public comment through 1 August 2004 on the AIMR Website at www.aimr.org/standards.

Introduction

A carve-out is a sub-set of a portfolio’s assets used to create a track record for a narrower mandate from a portfolio managed to a broader mandate. For example, the Asian securities from a Euro-Pacific portfolio or the equity portion of a balanced portfolio could be considered a carve-out. Carve-outs are generally based on asset class, geographic region, or industry sector.

Inherent Problems

Carve-outs have several problems associated with them. Because they represent only a portion of a broader, more diversified strategy, carve-out returns are only a valid track record if they are representative of what would have been achieved in a portfolio dedicated to the carved-out strategy. The use of carve-outs gives the impression that the firm has experience managing portfolios dedicated to a particular strategy, when this may not be the case. For example, a carve-out of the U.K. equities in a global equity portfolio that holds only two U.K. equities is not representative of a diversified U.K.-only portfolio.

A second problem occurs if cash is not accounted for separately and, therefore, must be allocated to the carved-out segment. If the carve-out is not accounted for separately, then the calculation of the return is potentially less accurate. The Standards require that returns from cash held in the portfolio must be included in the total return. Unless the carved-out portion is accounted for as a separate portfolio there will be no cash associated with the returns. For periods prior to 1 January 2005 (proposed to change to 1 January 2010), cash must be allocated to the returns using a consistent, objective methodology.

The GIPS standards currently state after 1 January 2005 (proposed to change to 1 January 2010), if the firm intends to carve-out an asset class, sector, industry, size range (e.g., large cap) or style type (e.g., value), each carved-out segment must have either its own cash balance or be accounted for separately, with its own associated cash position.

The rationale behind the inclusion of cash at all times in total returns is based on the principle of fair representation - a composite that does not include any cash would not be representative to the typical prospective client who hires the firm on a fully discretionary basis where cash allocation and management would be implicit. It would be misleading to present returns without cash, since this does not fairly represent how a separate portfolio would be managed.

Guiding Principles

Firms must remember the fundamental principles of the Standards, fair representation and full disclosure, and must avoid presenting misleading information. Any carve-out used as a track record must be representative of an actual segregated portfolio managed to that strategy. This means the carved-out segment should be discretionary and structured materially the same as a portfolio dedicated to that strategy and have a risk profile that is substantially similar. For

example, the equity segment of a balanced portfolio may be structured differently than a separately managed equity portfolio because additional risks taken in the equity segment may be offset by lower risk taken in the fixed income segment. The firm must determine if the carved-out segment is representative of a separately managed portfolio dedicated to the same strategy.

Firms must establish a policy for the creation, use, and calculation of carve-outs and apply consistently.

The calculation methodology used to calculate the return achieved on cash should be determined by the firm, documented, and applied consistently

The GIPS standards state “Beginning 1 January 2005, carve-out returns must not be included in single asset class composite returns unless the carve-outs are actually managed separately with their own cash allocations.” Accordingly, it is necessary to clarify what is permissible prior to 1 January 2005 (which is proposed to change to 1 January 2010) and after the provision becomes effective (currently 1 January 2005 but proposed 1 January 2010).

The following guiding principles must be met when a firm considers creating a carve-out:

Prior to 1 January 2005 (Proposed to Change to 2010)

- The carve-out should be managed separately (i.e., the segment should be managed as if it were a separate portfolio, rather than a segment of a larger portfolio).
- The carve-out must be representative of a stand-alone portfolio managed to the same strategy.
- If a firm creates a carve-out of a particular strategy, then all similar portfolio segments managed to that strategy must also be carved-out and included in the composite (e.g., if the equity segment of a balanced portfolio is carved-out and included in an equity composite, then all similar equity segments of the firm’s portfolios must be carved-out and included in the equity composite, provided the conditions outlined in this Guidance Statement are met).
- If a firm chooses to carve-out a portion of a portfolio, they are not compelled to carve-out other parts of the portfolio.
- When presenting net of fee performance of composites containing carve-outs, fees must be deducted from the carved-out returns. The fees should be representative of the fees charged for a separately managed portfolio for the asset class carved-out considering the fee schedule for the composite containing the carve-outs.
- The carve-out should have its cash accounted for separately. If the segment does not have its own cash, cash must be allocated to the segment on a consistent basis. Acceptable allocation methods include:
 1. *Beginning of Period Allocation.* Identify the cash allocation percentage for each portfolio segment at the beginning of the period. For example, at the beginning of January, identify the percentage of residual cash that will be allocated to the carve-outs at month end.
 2. *Strategic Asset Allocation.* Base the allocation directly upon the target strategic asset allocation. For example, if the portfolio is targeted to have 40% in equities and 60% in bonds, then the allocation will relate to the *actual* amounts invested.

If the portfolio had a target allocation of 40%, but at the beginning of the period only held 35% in equities, then the cash return would constitute the difference (5%).

Firms must determine which method to use, document it, and apply consistently

After 1 January 2005 (Proposed to Change to 1 January 2010)

- The carve-out must be managed separately (i.e., the segment must be managed as if it were a separate portfolio, rather than a segment of a larger portfolio).
- The carve-out must be representative of a stand-alone portfolio managed to the same strategy.
- If a firm creates a carve-out of a particular strategy, then all similar portfolio segments managed to that strategy must also be carved-out and included in the composite (e.g., if the equity segment of a balanced portfolio is carved-out and included in an equity composite, then all similar equity segments of the firm's portfolios must be carved-out and included in the equity composite, provided the conditions above are met).
- If a firm chooses to carve-out a portion of a portfolio, they are not compelled to carve-out other parts of the portfolio.
- When presenting net-of-fees performance of composites containing carve-outs, fees must be deducted from the carved-out returns. The fees should be representative of the fees charged for a separately managed portfolio for the asset class carved-out considering the fee schedule for the composite containing the carve-outs.
- The carve-out must have its own cash. Possible methods for properly accounting for the cash positions include:
 1. Sub-portfolios: each segment of a portfolio is accounted for as if it were a separate portfolio.
 2. Separate portfolios: cash and securities are actually segregated into a separate portfolio at the custodian.
 3. Multiple cash accounts: each segment's cash is accounted for separately (e.g., equity cash account, fixed-income cash account, etc.).

Performance Record for Discontinued Carve-outs

When a firm, which has created carve-outs using cash allocation methods for periods prior to 1 January 2005 (proposed to change to 1 January 2010), does not choose to apply any method for accounting for the cash position to the carve-outs and thus discontinues the carve-outs for periods after 1 January 2005 (proposed to change to 1 January 2010), then the firm must meet all of the following conditions:

- The past performance record of the carve-outs using cash allocation methods must be left unchanged within the same composites in which the carve-outs were included,
- The firm must disclose the inclusion of carve-outs using cash allocation methods and the period of inclusion in the composite presentation, and
- If the firm has a composite consisting of only carve-outs using cash allocation methods and does not apply any method for accounting for the cash position to any of the carve-outs in the composite for periods after 1 January 2005 (proposed to change

to 1 January 2010), the composite is discontinued but must continue to be listed on the firm's list of composites for five years after discontinuation.

Acceptable Uses

Effective 1 January 2005 (proposed to change to 1 January 2010), carve-outs must be managed separately with their own cash (i.e., allocation of cash will no longer be allowed as of 1 January 2005 (proposed to change to 1 January 2010)). This change will not be retroactive, so the history of existing carve-outs must not change.

Carve-out track records that are representative of the composite strategy may be used like any other portfolio provided that the carve-out is accounted for separately with its own cash.

Firms are not permitted to combine different carve-outs or composites to create a new, simulated strategy composite for purposes of compliance with the GIPS standards. For example, a firm may not combine an equity carve-out and a fixed income carve-out to create a simulated balanced composite. Although comprised of actual returns, this type of composite is hypothetical because it does not reflect real asset allocation decisions and therefore is viewed as model or simulated results under the GIPS standards. This information can be presented as supplemental information only but must not be linked to actual returns.

Disclosures

According to Standard 4.A.15, when a single asset class is carved-out of a multiple-asset portfolio and the returns are presented as part of a single-asset composite, firms must disclose the cash allocation method that was used (for periods prior to 1 January 2005 (proposed to change to 1 January 2010)). Any change in the cash allocation method should also be disclosed

In addition, Standard 5.A.6 requires firms to disclose (a) a list of the underlying composites from which the carve-out was drawn and (b) the percentage of each composite the carve-out represents. Due to the ambiguity of Standard 5.A.6.(b) different disclosure practices have been established. In the "gold" GIPS standards the corresponding provision is proposed to be amended to "the percentage of the composite that is composed of carve-outs" in order to provide more clarity. After the effective date of the "gold" GIPS standards this percentage will have to be given for the current period; firms should disclose that this information is available for all periods upon request (Note: the number of periods to be disclosed is subject to changes in the "gold" GIPS standards).

For net of fee returns the fee applied to the carved out portion must be disclosed

Effective Date

This Guidance Statement is effective 1 June 2004. Firms currently coming into compliance should apply this guidance to all periods. Firms are encouraged, but not required to apply this guidance prior to the Effective Date.

Application:

1. *Firm A manages U.K. equities as part of its global equity strategy and has a separate, U.K. only strategy. Firm A carves out the U.K. equity performance from global equity portfolios*

and combines it with its U.K. equity portfolios to create a U.K. Equity composite. The carve-outs represent 25% of the U.K. Equity Composite. Before including the carve-out in the U.K. Equity composite, the firm allocates cash to the U.K. equity segment on a pro rata basis, depending on the level of U.K. equities as a percentage of the total equity exposure. What disclosure is necessary?

(Under the proposed “gold” GIPS standards the answer to this question will be as follows)

The U.K. equity composite returns (which includes both the carve-out segment as well as portfolios that are invested solely in U.K. equity) may be presented as a part of a GIPS-compliant presentation provided the segment meets the carve-out requirements (e.g., it is representative of the strategy), cash is included with the carve-out (either accounted for separately or, for periods prior to 1 January 2005 (which is proposed to change to 1 January 2010), allocated), and the method used to allocate the cash to the carve-out is disclosed.

Sample Disclosure: “Firm A’s U.K. Equity composite includes all dedicated U.K. equity portfolios as well as the U.K. equity segment of portfolios that are managed to the firm’s Global Equity strategy. Cash was allocated to the carve-out segment returns on a pro rata basis depending on the proportion of U.K. assets to total assets in each portfolio. In the current period 25% of the assets contained in the U.K. Equity Composite are carved-out of portfolios managed according to the firm’s global equity style and contained in the Global Equity Composite. The percentage of the composite that is composed of carve outs for other periods is available on request”

- 2. Firm B manages balanced portfolios and would like to carve-out the equities to create an equity composite. Firm B charges 0.75% for its fixed income strategy, 1.50% for its equity strategy, and 1.00% for its balanced strategy. How should the investment management fee be allocated to the equity carve-out?*

Firms must allocate fees to each segment that are appropriate to the asset class. In this case, the firm should use the 1.50% that it charges for equity management.