

Association for Investment Management and Research
Professional Standards & Advocacy Department
Reference: GIPS® Standards Guidance Statement on Calculation Methodology.
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Herewith we send you the reaction from the VBA-PPS committee, the Dutch PPS committee sponsored by the VBA, regarding 'Guidance Statement on Calculation Methodology'.

For questions and/or remarks, please contact the following persons:

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Initial remark:

The VBA-PPS committee feels that this guidance statement is too general and does not add much guidance to performance calculation which is not already known by practitioners (including e.g. the implicit assumption of a MWR that the return is equally distributed over the period you measure whereas TWR does explicitly not have that assumption). Furthermore we do miss some cross reference with the other guidance statements/provisions like significant cash-flows (e.g. the 10% requirement) and the guidance statements regarding fees (e.g. gross and net). In this document we will also give a short reaction on the comments which already have been submitted by others. In particular we would like to refer to:

- Emilio Maffi (Ernst & Young Italy);
- Damien Laker (IPO Australia);
- Gunnar Winther (NFF Norway);
- Bruno Solnik (Finance and Economics Department HEC Paris).

Comment Requested

1. Do you agree with the principles established in the Guidance Statement?
2. Are all areas of rate of return and asset-weighted composite calculation sufficiently covered in this Guidance Statement?
3. Are there other areas of calculation methodology that should be addressed in this Guidance Statement?
4. Is it reasonable to expect that firms will be able to value portfolios at the time of any external cash flow beginning 1 January 2010 (excluding real estate, venture capital, and private equity)?
5. Do you agree with the proposed Effective Date? If not, when should the guidance become effective?

VBA-PPS answer on question 1:

We agree with the principles as long as in practice systems are not capable to revalue portfolios on a daily basis. Both Emilio Maffi and Bruno Solnik emphasize in their remarks that we all should be aware, and that the Guidance Statement should also confirm, that methods like Dietz, modified Dietz and IRR are actually Money Weighted Rate of Return methods. And as well known large cash flows, specifically in combination with high volatility, these MWR's can be fundamentally different from the desired Time Weighted Rates of Return. And that effect will indeed not be corrected for in another time period, as explained by professor Solnik.

This potential disadvantage of large cash flows could be dealt with by the removal of the portfolio from the composite for the relevant time period. In this respect the issue of calculation methodology is tied to the issue of significant cash flows. In this last issue the removal of the portfolio in case of large cash flows can be defined as a firm's policy element, specifically based on the liquidity of the markets that are relevant for the composite strategy. The current problem of the MWR-influence of large cash flows shows that for firms calculating their periodic returns using a MWR-methodology, the need to define such a removal policy in case of large cash flows, is more relevant than it is for firms using true TWR's.

Another idea is to only allow the inclusion in composites of those portfolios for which the cash flows in the return period are defined as small, e.g. portfolios with cash flows less or equal to 10% of the starting value of the portfolio in the return period. Alternatively the Standards could require all cash flows larger than a norm (again e.g. 10%) to be treated as Temporary New Accounts. Both previous ideas are probably impractical, the first one because of the severity (too many portfolios removed from composites) and the second one as too demanding on the technology.

A third idea that could be considered is to restrict the concept of removal from the composite, or alternatively to require revaluation at the moment of large cash flows, to those cases only where it potentially influences the ultimate composite return in a material way. This could be done in the way that was (still is till the end of 2002) an element of the Dutch local Standards, by conditionally requiring the revaluation of the portfolio in case of a large (> 10%) cash flow if the weight of the portfolio is larger than a predefined level (for the Dutch Standards: > 25%). We are aware that a concept like this implies arbitrary choices (e.g. the 25%) and that the problem of the influence on the dispersion is not solved. Furthermore it avoids the circular argument of recommendation 2B2. The main point of this idea is that a reasonable midway is found to avoid potential influences of MWR-methods, while not placing too high a burden on technology.

Further, although we agree with the comment made by Damien Laker, we believe that 'end of day cash flow assumption' versus the 'weighted cash flow during a day'-enhancement does not improve performance figures that much (in terms of materiality) that guidance on this topic is needed (but of course can be helpful to avoid misinterpretation). We are aware of, for example, performance system providers who have the assumption that cash flows are 'mid-day' so that one does not divide the numerator by zero for e.g. currency hedges.

VBA-PPS answer on question 2:

We do not agree. We do miss the integration with and therefore the area of the other guidance statements regarding e.g. fees (gross and net performance figures) and significant cash flows. We also agree with the comments made by Gunnar Winther (especially regarding the master portfolio idea for composite revaluations on each time an external cash flow occurs; this is also relevant for the performance calculation of benchmarks consisting of several indices or sub-benchmarks in relation to the rebalancing frequency; see our comment later on). We also do miss some clarification on the performance calculation methodology for composites regarding beginning of period weighting and average invested capital weights.

VBA-PPS answer on question 3:

Yes, we believe that there are other areas of calculation methodologies that should be addressed. Examples are in this respect: calculation of the performance of *benchmarks* (currency hedged or not, rebalancing frequency, total return calculations including dividends net and/or gross of withholding taxes), how to deal with out-performance fees (as they have impact on e.g. the Net Asset Value of mutual funds). Furthermore we agree with the comments made by Gunnar Winther and Emilio Maffi. In this respect we would like to point out that if a ‘transformation formula’ is added that a distinction should be made between ‘net’ or ‘gross’ management (and other) fees (i.e. is the percentage fee expressed in Euro or dollar before or after the fee is deducted?).

VBA-PPS answer on question 4:

In concept we do agree. Additional comment: first we would like to rephrase the question by including the general term ‘illiquid instruments’ like credit default swaps, inflation linked bonds, private equity, real estate, venture capital et cetera. Perhaps GIPS should require firms to have validated fair values of the illiquid instruments in addition to the firm wide verification. We also would like to state that in our opinion GIPS (or the guidance statement) should stress that the requirement as of 2010 does NOT imply that daily valuations are required; only the possibility to do so and the policy/process that a valuation will be done for the day an external cash flow occurs.

Furthermore we agree with the comments made by Bruno Solnik and Emilio Maffi.

VBA-PPS answer on question 5:

We agree. Furthermore we agree with the comment made by Emilio Maffi.

General remarks:

- We miss the clarification on the ‘*n*’ on page 5, 6 and 7. We believe the ‘*n*’ does not have the same meaning on all pages in the guidance statement.
- On page 8 it seems that in the paragraph ‘geometric linking’ the words ‘composite’ and ‘portfolio’ are not right/consistently being used.

- How are the performance figures being calculated? See the additional comment of Emilio Maffi as well.
- The second equation on page 6 may have more than one solution for the R (being the IRR).

If you have any remarks given our comments please don't hesitate to contact us,

Regards,

Utrecht, 31 October 2002

Drs. Paul W.P. de Beus

Secretary VBA PPS committee, The Netherlands