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CFA Institute
CFA Centre for Financial Market Integrity
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Thank you for the opportunity to comment on this Guidance Statement.

It is no doubt appropriate to consider the issue of whether GIPS should give more specific guidance in regard to leverage and derivatives. However, I suggest that great care is required in this area, because implementing any new guidance is potentially complex and expensive for investment managers and their clients.

Should Leveraged Portfolios Be Treated Differently?

The Guidance Statement seems to be based on the premise that portfolios fall into two distinct categories:

1. Those that use "traditional strategies"[1]; and
2. "Materially"[2] leveraged portfolios. For these portfolios, prospective clients need "additional information"[3] about risk.

Since everything in the Guidance Statement seems to be based on this premise, it is worth considering whether this premise is a sound foundation.

As I see it, treating "traditional" and "materially leveraged" portfolios as distinct categories is potentially misleading and counterproductive, because there are many shades of grey along the continuum between completely traditional portfolios and highly leveraged portfolios. Maybe the stipulation that portfolios should be *materially* leveraged is an attempt to avoid polarizing the shades of grey into all-black or all-white. However, the guidance statement definitely seems to create two distinct categories of portfolios. The criterion of materiality merely moves the dividing line between black and white from one point to another, rather than recognizing that there is in fact a continuum.

Instead of basing the Guidance Statement on the notion that there are two distinct categories of portfolios, one could instead base it on the idea that all portfolios are (at least potentially) risky, and that there is a continuum of disclosures that may be appropriate for different portfolios, depending on where they sit along the continuum of risk.

[1] Guidance Statement, p. 3.
[2] *Ibid*. p. 3.
[3] *Ibid*. p. 3.

Consider two examples.

Firstly, the Guidance Statement would classify a portfolio holding 150% equities (short 50% cash) as materially leveraged. This portfolio would need to make additional risk disclosures. So far so good. However, a "traditional" portfolio holding 100% equities would not need to make additional risk disclosures. An investor who used margin borrowing to increase their investment in the "traditional" portfolio from $100 to $150 would be in the same economic position as the person holding the materially leveraged portfolio. Therefore, both of these investors need the same sort of risk information. By drawing a sharp distinction between "traditional" and "materially leveraged" portfolios, the Guidance Statement seems to downplay the need for risk disclosures on "traditional" portfolios, as much as it encourages the need for risk disclosures on "materially leveraged" portfolios. Some may object that the investor who uses margin borrowing is choosing to magnify the risk of their investment. Exactly so. However, *they are magnifying a risk that already exists* (i.e. the risk of the "traditional" portfolio). The only way for them to understand the consequences of this is for them to understand the risk that already exists in the "traditional" portfolio before they leverage it.

Secondly, consider a portfolio that is 150% long individual stocks, and 80% short index futures. On a net basis, this portfolio is positioned very conservatively, with a net 70% exposure to equities, and a net 30% exposure to cash. Hence, on a net basis, one could say that this portfolio is not materially leveraged. Indeed, one could say that its net position is not leveraged at all. The Guidance Statement states that "In general, a portfolio is considered to be leveraged if certain instruments or strategies are implemented to **materially** alter the return impact that a unit move in certain underlying securities markets will have on the portfolio to an extent otherwise unachievable without the use of such instruments or strategies."[4] In this case, the return impact is not materially different from a portfolio holding 70% equities. And this return would not be "unachievable without the use of such instruments or strategies". Hence, the Guidance Statement would not consider this portfolio to be "materially leveraged". Consequently, the portfolio manager would not need to make additional risk disclosures in regard to this portfolio. However, it would seem to me that, if the portfolio manager was using derivatives so aggressively, information about the use of derivatives in this portfolio would indeed be of the highest relevance to an investor.

Both of these anomalous cases arise from treating leveraged portfolios as a completely distinct category from unleveraged portfolios. I suggest that it would be more useful to change the basic approach of the Guidance Statement in two ways:

1. all portfolios would fall within the ambit of the Guidance Statement; and
2. the level of extra disclosure about risk should be reasonably proportional to the riskiness of the portfolio.

In other words, it seems perfectly reasonable to recommend extra disclosures for portfolios that fall further toward the risky end of the spectrum. But as it stands, the Guidance Statement seems to suggest that the spectrum contains only two colors.

One could possibly object that it is an undue compliance burden for all portfolios to fall within the ambit of the Guidance Statement. However, if the Guidance Statement acknowledged that there is a spectrum of risk, the compliance burden would be very light for most portfolios. Indeed, I suggest that much of the compliance burden created by the Guidance Note (as it is

[4] *Ibid*., p. 3.

currently drafted) will be in making the "all or nothing" decision as to whether a portfolio is "materially leveraged" or "traditional".

Creation of a Leverage Policy

The first principle discussed in the Guidance Statement is creation of a leverage policy.

In practical terms, there seem to be two requirements for a leverage policy:

1. "[D]iscuss in detail the types of leveraged strategies implemented across the firm".
2. "[D]iscuss what constitutes materiality for each strategy/composite".

The second of these requirements specifically reinforces the notion that there is a specific point that divides "traditional" and "materially leveraged" portfolios. As I argued above, it may indeed be counterproductive to conceptualize risk as something that falls into two separate categories, rather than being a continuous spectrum. Of course, firms will need to have regard to different degrees of risk in their composite construction. But this is dealt with under the heading of composite construction.

The first of these requirements will undoubtedly create extra paperwork. But the Guidance Statement doesn't specify the rationale for doing this paperwork. Can there be very many firms who don't use futures, options, foreign exchange instruments, and other derivative instruments? What will be the benefit of each firm writing and maintaining a document that discusses "in detail" the types of leveraged strategy that they use?

The industry may like to consider whether the creation of leverage policies is really an activity that will provide a clear benefit having regard to the cost involved.

Composite Construction

The next section of the Guidance Statement contains three paragraphs dealing with composite construction. Paragraphs 2 and 3 confirm the position taken by the existing Guidance Statement on Composite Definition. This is entirely sound.

The first paragraph is useful, because it emphasizes the fact that no special return calculation is required for a portfolio that uses leverage or derivatives. This issue could otherwise be a source of confusion.

The first paragraph also refers to Appendix A, which provides examples of return calculations. On the whole, this Appendix seems to be sound. However, there is a clarification that I suggest.

Appendix A states that "A cash flow is defined as an external flow of cash and/or securities (*capital additions or withdrawals*) that is client initiated."[5] It is potentially very confusing to include the words "that is client initiated" in this definition. Specifically, it does not matter who initiates the cash flow: if cash or securities move into or out of the fund, this needs to be taken into account in the return calculation. To give a specific example, consider a taxable portfolio that has recently experienced strong gains. As a result of these gains, the portfolio has accrued a significant tax liability. The portfolio makes a tax payment of $10. As a result, the portfolio value falls from $100 to $90. The return should be 0%, regardless of who initiated the payment. Maybe one could argue that a tax payment should be initiated (or at least authorized) by the

[5] *Ibid*., p. 7.

client. But this is beside the point. It is easy to conceive of circumstances where a tax payment may be initiated entirely by the government. Who initiates the payment is irrelevant to performance calculations.

There are other kinds of external cash flow (for example, payments of investment management fees or custodial fees) that also conceivably might not be "client initiated".

I suggest that the words "that is client initiated" be deleted from the Guidance Note.

Risk Measure Disclosure and Reporting

This section makes extra recommendations about how firms might do a better job of disclosing their risks. A substantial part of these recommendations falls into Appendix B ("Calculating Exposure"), which runs from pp. 10 to 18. I suggest that this section is vastly more complicated than it needs to be.

For example, at the top of p. 13 (Example 1), there is a horrendously complicated equation for calculating the percentage exposure of a portfolio. In the example, the portfolio comprises $90 of stocks, $10 cash, and a stock futures position whose notional value is $60. Instead of the calculation shown in the Guidance Note, the calculation could simply be:

$$\begin{aligned} \text{Percentage exposure to stocks} &= \frac{\text{Dollar Exposure to Stocks}}{\text{Total Market Value}} \\ &= \frac{\$90 + \$60}{\$90 + \$0 + \$10} \\ &= 150\% \end{aligned} \qquad [1]$$

Instead, the calculation shown in the Guidance Note entails a baffling amount of complexity, yet it produces exactly the same answer. The same kind of excessive complexity appears throughout the Guidance Note. In my opinion, the complexity in the Guidance Note produces no extra benefit, but it will create a much higher cost in terms of compliance costs and also in terms of being difficult to understand.

In brief, my suggestions about this Appendix are as follows:

- A good starting point for considering percentage exposures is that the total percentage exposure in a portfolio is (axiomatically) 100%. For example, in Example 1, the portfolio's exposure to stocks is 150%, and its exposure to cash is -50%. However, in its discussion of exposure, the Guidance Note consistently overlooks the axiom that total exposure is always 100%. Instead, it focuses only on the exposure to non-cash items, without ever clearly stating this point. I suggest that this is very confusing. It is meaningless to simply state that the portfolio "has an exposure of 150%". Rather, the portfolio has an exposure of 150% to stocks, and an exposure of -50% to cash.

- The definition of exposure in Appendix B ("the expected unit move in the portfolio divided by the move in the market") is rather theoretical, and the General Formal for calculating it[6] is also very complicated. This formula is not very applicable, because it includes

[6] *Ibid*., p. 10.

unobservable quantities (for example, it uses $\frac{\Delta V}{V}$ and $\frac{\Delta I}{I}$, but neither ΔV nor ΔI). is observable). I suggest that instead, percentage exposure could be defined in terms of exposed market values (*i.e*. dollar exposures) and unexposed market values (i.e. dollar market values). If we symbolize exposed market value as EMV and unexposed market value as MV, we can calculate the percentage exposure of an asset simply as EMV/MV, as shown in Equation 1. If there are several holdings in an asset class, one can simply sum the exposed and unexposed market values. In practical terms, this approach will mostly produce the same answer as the method outlined in the Guidance Note, but the path to the answer is much simpler. The Guidance Note combines the traditional notion of exposure with concepts from Modern Portfolio Theory (*e.g.* correlations), Capital Asset Pricing Model (*e.g.* Beta), option valuation (*e.g*. Delta) and bond valuation (*e.g*. Duration). There is of course nothing wrong with any of these ideas, but I suggest that combining them all together in a single calculation adds lots of complexity for no significant benefit.

- The Guidance Note introduces a special case where it uses the notion of Duration for bonds. On the other hand, it introduces the notion of beta for equities, then effectively dispenses with it by recommending that a value of 1 should always be used for beta. This seems to be inconsistent. It is also overly complicated. When reporting exposure, I suggest that firms can simply ignore the notions of beta and Duration. As a separate issue, firms may wish to report on beta for equities, or Duration for bonds. However, there is no need to mix these concepts in with exposure reporting.

- The Guidance Note consistently adopts an approach where exposure information for each asset class is added together (rather than being reported separately). Normally, I would expect exposures to be reported separately. For example, I understand what it means if you tell me that a portfolio's exposures are 70% stocks, 40% bonds, and 10% short cash. However, if you just tell me that the portfolio's exposure is altogether 110%, this seems like a completely meaningless number. A common metaphor for mistakenly combining separate categories is "mixing up the apples with the oranges". I suggest that the Guidance Note does exactly that. This seems to have the combined effect of increasing complexity while decreasing useful information.

As a practical measure of the approach advocated by the Guidance Note, I suggest that firms should consider its Example 5 (pp. 14-16). There is a lot of complexity in this calculation. It doesn't seem clear to me whether the calculation produces any particularly useful information. Will it really help investors to understand what is happening with their money if they receive a calculation of this sort?

A Suggested Example of How to Report Exposure

By way of making a positive contribution, I want to provide an example[7] of exposure reporting which is much simpler than the exposure reporting described in the Guidance Note. It is also more informative. The following table shows the position of a portfolio that invests long and short in global equities. It provides the "long only" exposure, and next exposure, for each geographical sector.

[7] This example is adapted slightly from the Platinum Asset Management International Fund monthly update for November 2004. See www.platinum.com.au. I provide this only as an example of clear exposure reporting. I have no association with Platinum Asset Management (other than being a client).

Table 1: Exposure Report for Portfolio Containing Long and Short Equities

	Long %	Net Exposure %
Africa	0.7%	0.7%
Asia	13.2%	13.2%
Australia	2.4%	2.4%
Europe-Euro	22.6%	22.6%
Europe-Other	7.0%	6.9%
Japan	27.4%	27.4%
North America	14.9%	(12.6%)
	88.2%	60.6%
Cash and Accruals	11.8%	39.4%
Total	100.0%	100.0%

Long: 153 stocks. Short: 23 stocks and 4 indices.

Some specific ways in which I suggest this report is more informative – yet easier to prepare – than the exposure reporting contemplated by the Guidance Note are:

- It provides separate information for each sector.
- It includes cash and non-cash sectors, using arithmetic which adds up to 100% when the cash is included.
- It shows the "long only" exposure, as well as the next exposure. This makes it clearer where derivatives are being used to hedge away the market risk of investments in individual stocks.

Other Elements of Leverage and Derivatives not Mentioned

The Guidance Statement doesn't seem to say much about currency exposures and currency hedging. However, currency positions are often a significant source of risk in portfolios, and they are frequently implemented using derivatives.

I suggest that, for multi-currency portfolios, information about currency exposures is part of the basic information that investors will require.

Table 2 provides an example of how currency information can optionally be added to the information shown in Table 1.

Table 2: Exposure Report With Currency Information

	Long %	Net Exposure %	Currency Exposure %
Africa	0.7%	0.7%	0.7%
Asia	13.2%	13.2%	13.8%
Australia	2.4%	2.4%	25.8%
Europe-Euro	22.6%	22.6%	20.1%
Europe-Other	7.0%	6.9%	6.5%
Japan	27.4%	27.4%	28.9%
North America	14.9%	(12.6%)	4.2%
	88.2%	60.6%	
Cash and Accruals	11.8%	39.4%	
Total	100.0%	100.0%	100.0%
Long: 153 stocks. Short: 23 stocks and 4 indices.			

This succinct table discloses the net currency exposures of the portfolio. But also, by comparison with the sector exposure information, it also discloses the active currency bets that the manager has implemented using currency hedging.

Summary

I have suggested several ways in which the Guidance Note could, in my view, be simplified. A relevant principle is *Primum non nocere*: Firstly, do no harm. What I mean by this is that it, if one is to err, one should err on the side of being under-prescriptive rather than prescribing procedures that will be complex, especially if there is no clear benefit. In my view, the approach adopted by the Guidance Note is definitely too complex.

In a nutshell, my suggestions are as follows:

1. Do not treat leveraged and unleveraged portfolios as completely separate categories.
2. I have doubts about the need for creating a leverage policy.
3. I suggest a change of wording in Appendix A, as detailed above.
4. The treatment of exposures in this Guidance Note (especially Appendix B) is way too complicated, for no practical benefit. I think that combining the exposures of different asset classes into a single number will confuse investors, rather than helping them.
5. When reporting exposures, it will be informative to report the gross and net exposures for whatever asset classes or sectors the investment manager considers salient.
6. For multicurrency portfolios, it will be helpful to report on currency exposures.

I hope that these suggestions are of some help.

Yours Faithfully

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