

Emilio Maffi's response to the Investment Performance Council (IPC) of the Association for Investment Management and Research (AIMR) invitation to comment on proposed Guidance Statement addressing the treatment of Carve-Outs when calculating investment performance in accordance to Global Investment Performance Standards (GIPS).

⊙ **Foreword**

I work for a Big Four Firm that is leader in its country in verification activity on Management Firms who claim compliance with GIPS; we attested compliance with GIPS of six Management Firms on a total number of nine compliant Firms in Italy (based on our acquaintances).

I'm pleased to comment on proposals from the IPC Subcommittee to add provisions to address the impact of carve-outs on investment performance and I have set out my response to the specific questions below.

⊙ **Do you agree with the principles established in the Guidance Statement?**

I agree with the principles, especially for the provisions that have been set as recommendations for periods prior to 1st January 2005.

Nonetheless, I think that the Guidance Statement should better clarify that when a carve-out isn't accounted separately from other portions of the portfolio (permitted for periods prior to 1st January 2005) it's necessary to consider any operation set out by portfolio manager and any event (such as bond coupons and dividends) that may impact carve-out valuation at the end of the performance measurement period; practically, carve-outs have to be created as if they were stand-alone portfolios and therefore all operations set out during the performance measurement period have to be considered as external cash flows.

⊙ **Are there other cash allocation methods that should be allowed prior to 1st January 2005?**

I think that the methods pointed out in the Guidance Statement are consistent and have been set according to the spirit of GIPS.

Nonetheless, I think that the second proposed method for periods prior to 1st January 2005 (*Strategic Asset Allocation*) would be easier to utilize, but it could be misleading for the fair representation of carve-out's performance when effective portfolio asset allocation substantially differs from its target strategic asset allocation, e.g. if in the proposed example (target strategic asset allocation 40% in equities and 60% in bonds) we register an effective portfolio asset allocation of 60% in equities, 30% in bonds and 10% in cash, to which carve-out must Firm allocate the portfolio portion of cash? (i.e. all the 10% to bond carve-out or 4% to equity carve-out and 6% to bond carve-out according to target strategic asset allocation or, assumedly, 30% cash to bond carve-out and 20% short of cash to equity carve-out as a leverage effect?)

Moreover, as reported formerly I think that the Guidance Statement understocks the impact of portfolio manager's activity, i.e. the first proposed method for periods prior to 1st January 2005 (*Beginning of Period Allocation*) is sound when the carve-out's portion inside the portfolio doesn't consistently

change during the performance measurement period; on the contrary, if the effective portfolio asset allocation changes during the performance measurement period, cash allocation set utilizing the proposed method could differ at the end of the period from portfolio's manager intent (e.g. if effective asset allocation at the beginning of the period is 60% in equities, 30% in bonds and 10% in cash, and during the period the manager sells half of equity carve-out to buy bonds, at the end of the period I would allocate a 6.67% portion of cash to equity carve-out and a 3.33% to bond carve-out when the effective asset allocation, assuming prices for all assets during the period being the same as at the beginning, is on the opposite 30% in equities, 60% in bonds and 10% in cash).

Besides, I think that this Guidance Statement should better specify how to implement the proposed methods; in fact, these allocation methods have to be linked to Firm's performance calculation policies, i.e. if the Firm calculates returns using a simplified method (i.e. portfolios are valued monthly and external cash flows are adjusted when calculating monthly returns - permitted until 1st January 2010), this method should be used also for allocating the portion of external cash flows that hasn't been invested by portfolio manager.

Finally, I think that the first proposed method (*Beginning of Period Allocation*) is better than the second one, and furthermore I think that the "Period" should coincide with the period of strategic asset allocation review set out by portfolio manager (i.e. the periodicity in changing carve-outs' weight inside managed portfolio).

⊙ **Do you agree with the principle relating to the treatment of fees?**

I agree with the principle, provided that fees allocation method is the same applied in allocating cash to carve-outs; consequently, I think that the Guidance Statement should require that the same method chosen for cash allocation be applied to allocate fees as well.

⊙ **Do you agree that if a firm creates a carve-out, "then all similar portfolio segments managed to that strategy should also be carved-out and included in the composite"?**

I think that this principle soundly reflects GIPS requirement that "Firm composites must be defined according to similar investment objectives and/or strategies" (GIPS 3.A.2).

⊙ **There are three proposed methods for properly accounting for the cash position for periods after 1st January 2005. Are these methods understandable and complete? Are there any other appropriate methods?**

I think that the methods pointed out in the Guidance Statement are sound and fully respond to the spirit of GIPS.

Moreover, accounting each segment of portfolio separately (or as if it were so) would solve the possible problems that a Firm could meet when applying the proposed methods for periods prior to 1st January 2005; a fortiori, I think that the Guidance Statement should better specify that Firms are permitted to use these methods for the stated period, but they are invited to begin accounting carve-outs separately as soon as possible.

⊙ **Do you agree with the proposal that this guidance should only be applied on a forward-looking basis (i.e., not retroactively)?**

I agree with the principle that cash allocation methods have to be established on an ex-ante basis by the Firm, but I think that when a Firm claims compliance for the first time, the cash allocation method can be applied also to previous management periods, provided that it's possible to clearly identify carve-outs for those periods.

⊙ **Do you agree with the proposed Effective Date? If not, when should the guidance become effective?**

I agree with the proposed Effective Date, but I think that the Guidance Statement should better specify that its provisions have to be applied also to periods prior to 1st January 2003, i.e. Firms presenting carve-outs' returns should recalculate them for a measurement period of at least five years (or since Firm's inception); if not, I think that Firm has to start applying carve-outs methodology since it is possible, but it would have to present carve-outs' returns only as a disclosure of "classic" composites' returns (i.e. "official" presentation should continue to be the one set out combining whole portfolios to create composites), waiting to have a track record of at least five years to rearrange composites' definition.

⊙ **Additional comment**

According to the reasons reported before, I think that when a Firm decides to create composite with carve-out portions of managed portfolios, the only methodology to utilize for returns calculation have to be the one that would likely be compulsory for periods beginning 1st January 2010 (GIPS 2.A.2), i.e. portfolio valuation at the time of any external cash flow; this provision would solve the majority of the issues I formerly exposed.

I'm glad to have taken part in the discussion about this Guidance Statement on GIP Standards and I hope that my comments will be taken in consideration.

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