

COMMENT FROM THE FRENCH GROUP OF EXPERTS TO THE PROPOSED GUIDANCE STATEMENT ON THE USE OF LEVERAGE AND DERIVATIVES

The French Group of Experts thanks the Investment Performance Council and its Leverage & Derivatives Subcommittee for the newly proposed guidance. We find it much clearer and appreciate the numerous examples.

We would like to comment on the links (and avoid confusion) between three different concepts which are respectively : derivatives, leveraging and/or hedging, and risk measures.

1. Derivatives and leverage do not always go together :

- Derivatives may be employed just as a substitute of direct investment in primary assets. In this case, they do not create any leverage nor hedging effect, they do not alter the return/risk profile. Subsequently, firms may decide there is no reason for treating these portfolios differently from traditional ones regarding the composite construction.
- On the other hand, if we consider the beta measure as an appropriate indicator of leverage or hedging effects (which it is), some commentator will notice that portfolios may have betas as low as 0.8 or as high as 1.5 without using any derivative. They just overweight defensives or technology stocks. Subsequently, firms should probably to treat these portfolios differently from other equity portfolios regarding the composite construction.

2. Regarding the appropriate risk measures, a distinction should be made between at least three type of situations :

- In traditional situations, when the market exposure is 1 and the beta is 1, volatility and tracking error seem to be adequate absolute and relative risk measures.
- In leveraged or hedged situations, typically when the beta is 0.8 or 1.5 as proposed supra, the use of tracking error is not appropriate. The first thing any manager tracking an index will do is to have the beta near 1. If the beta significantly differs from 1, its an evidence that the manager is not “tracking” the index. In these situations, the use of the “tracking” error risk measure is not only nonsense, but misleading.

- In situations where the manager significantly alters the risk profile, twisting it in an asymmetric profile, volatility and tracking error, which are symmetric measures, are not sufficient to capture the risk profile. Other risk measures like skewness or VaR, CvaR may highlight the asymmetry and/or the downside risk.
3. **The purpose of our comment is not just academic. We would like the IPC members to state that :**
- Derivatives should not be a synonym of greater hazard ; they may be just an alternative to direct investment.
 - The tracking error is not the alpha and omega for measuring risk. The tracking error is an excellent risk measure when the investment objective is to track an index ; it may be an appropriate measure of the degree of freedom left to an active manager in traditional situations ; but it is an inadequate concept for leveraged or hedged strategies as well as for alternative investment styles.
 - Expanding in new fields such as institutional reporting or risk control goes far beyond the purpose of the GIPS standards, which should focus on its original subject, i.e. presenting past performance to prospective clients.

Having that in mind, we agree with the principles established in the Guidance Statement, relative to the creation of a leverage policy, to the composite construction principles and to risk measure disclosure and reporting principles. We are convinced that GIPS should avoid being prescriptive otherwise than requiring firms to document *ex ante* policies on these matters. These *ex ante* policies may be firm wide policies, or defined on a composite level. We approve the choice to leave it to the firm to decide which risk measures are appropriate to which investment strategy.

We agree with guiding principles provided to firms, but we consider these principles should not be addressed to “firms employing leverage and/or derivatives”, but to “firms employing leverage, hedging or other techniques altering the risk/return profile”.

Regarding the proposed effective date, we agree it to be the same date as the effective date of the next edition of the GIPS Standards.

We remain at your disposal for any additional information/discussion which might prove useful to you.

Yours faithfully,

on the 31 December, 2004

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