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Professional Standards and Advocacy
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GIPS Guidance Statement on Calculation Methodology

We offer the following comments on the GIPS Guidance Statement on Calculation Methodology, which is proposed to be Effective 1 April 2003.

Firstly, we do agree that it is reasonable to expect firms to be able to value portfolios at the time of any external cashflow beginning 1 January 2010. Indeed, all of our clients are currently valuing daily.

Secondly, we do agree with the proposed Effective Date for the Guidance Statement (1 April 2003).

Thirdly, there is one enhancement we believe is necessary. On page 7, when describing the Daily Valuation Method, the draft Guidance Note provides the following formula:

$$R_n = \frac{(EMV - BMV)}{BMV}$$

This formula assumes that the cash flow is not available for investment until the next day. This is commonly called an "end of day cashflow assumption". An alternative assumption is the "start of day cashflow assumption", in which the cashflow is added to the denominator in the calculation. Between these two extremes, there are alternatives where part of the cashflow is added to the denominator. One can capture all of these possibilities by using the following formula:

$$R_n = \frac{(EMV - BMV)}{BMV + CF \times W} \quad \text{Where } 0 \le W \le 1$$

There are many different firms that have chosen different cashflow assumptions for various different reasons. We believe that it would be unnecessarily prescriptive for the standards to force every fund manager to use the end of day cashflow assumption. The usual requirement for consistent application should apply, to protect against

situations where a fund manager unethically used different methods on different days in order to maximize their reported returns.

As it is currently drafted, the Guidance Note states:

> "This method assumes that the cash flow is not available for investment until the beginning of the next day. Accordingly, when the portfolio is revalued on the date of a cash flow, the cash flow is not reflected in the Ending Market Value, but is added to the Ending Market Value to determine the Beginning Market Value for the next day."

We believe this statement is confusing, since the correct way to calculate the numerator in the return calculation is unaffected by the cashflow assumption that one chooses. The numerator should always be net of the cashflow, since it has to capture the change in fund value that was *not* due to external cashflow.

Accordingly, we believe it would be clearer if the formula changed to:

$$R_n = \frac{\left(EMV_n - EMV_{n-1} - CF_n\right)}{EMV_{n-1} + CF_n \times W} \quad \text{Where } 0 \le W \le 1$$

This formula avoids the concept of a Beginning Market Value, and makes it clear that the numerator is net of cashflow. The Ending Market Value in this formula has the ordinary meaning of the term. We believe this formula is less likely to generate confusion, since it does not rely on a subtle distinction between Beginning Market Values and Ending Market Values. Instead, the formula makes the treatment of cashflow completely explicit.

Yours Faithfully,
Investment Performance Objects Pty Ltd

Damien Laker
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