



Association for Investment Management and Research  
Professional Standards & Advocacy Department  
Reference: “Gold” GIPS Standards  
P.O. Box 3668  
Charlottesville, Virginia 22903

Dear Sir or Madam:

First, I commend the IPC for recognizing the burden and confusion faced by the investment industry that currently needs to comply with multiple performance standards. Over time, the GIPS gold standard will move industry participants to a single evaluation standard and eliminate potential barriers to entry for firms trying to comply with specific local standards when they enter new markets.

My only concern with the proposed changes relates to treatment of carve outs. Specifically GIPS Gold proposes that the requirement stipulating that a carve-out return be managed separately with its own cash balance should be moved from 2005 to 2010. I believe that the use of carve outs should be eliminated now.

A classic example of carve out use involves a balanced fund. Cash is allocated to the equity and fixed segments to produce equity and fixed income portfolios which can be included in respective equity and fixed income composites. Current practice allows one to use various cash allocation methodologies to *manufacture* segment plus cash returns to produce total returns. Use of carve outs is the only case where performance software and not the source accounting valuation system provide the valuation used in the total return calculation. For the equity plus cash carve out, the impact is probably nominal but various cash allocations assumptions could materially impact the resulting performance of a fixed plus cash carve out. Basis point conscious buyers of a fixed income product cannot see the potential “performance boost” from varying cash allocation assumptions.

Another example of a carve out relates to a sector, country level exclusion for example a global equity index excluding a particular country. For example an asset manager markets a MSCI World ex Japan product. Historically, excluding Japan securities eliminates Japan country exposure but this approach may represent other underlying bets such as a bet against various industries that contribute more significantly to Japan country performance relative to securities in other MSCI countries. As long as the portfolio manager and prospect understand these potential sources of differences everything is fine. Long-term performance should reflect the resulting MSCI ex Japan portfolio construction differences, but if the portfolio is initially managed as a simple operational (exclude Japan stocks) carve out to MSCI the associated risks may not be readily apparent.

Also just as importantly, if the carve-out is not actually managed separately with its own cash balance why should firms be allowed to present it as such. IPC obviously recognizes the potential to mislead a prospect which is why “Beginning 1 January 2010, carve-out returns must not be included in single asset class composite returns unless the carve-out is actually managed separately with its own cash balance.” Why allow five more years for firms to potentially mislead prospects. Is there a burden to operationally manage carve out segments as a separate portfolios? Various trading and portfolio management system options are available to “sweep” cash proportionally. In some cases an equity manager may not want frictional cash but it is part of the implied assets that they have been entrusted to invest for a client. Some of the pro arguments supporting the use of carve outs include lowering operation fees by minimizing the number of accounts, streamlining cash management for portfolio managers and operation support. The IPC’s guidance statement (effective June 1, 2004) expresses multiple concerns regarding the use of carve outs. Still the IPC postpones this requirement due to its perceived concern that industry infrastructure, specifically the ability of portfolio management systems had not evolved to account for separate cash accounts. One could make a similar argument to delay AIMR after tax performance requirements. For some firms it could be a significant burden to run tax lot accounting. Still the IPC did not delay it after tax performance requirements. Although I empathize with the challenges of eliminating carve outs, I do not see any business drivers that will force a different environment by the year 2010.

In terms of Performance disclosures for carve outs; section 4.A.15 states, “For periods prior to 1 January 2010, when a single asset class is carved out of a multiple asset portfolio and the returns are presented as part of a single asset composite, the firm must disclose the policy used to allocate cash to the carve-out returns”. Disclosing cash allocation *policy* can be useful to assure a consistent approach but it does not detail the materiality of the impact of cash management assumptions on the carve out portfolios. I anticipate audit firms will present multiple interpretations of policy documentation. Beyond carve out percentage of overall composite; I suggest that a disclosure be added that details the history of monthly weights and returns for asset class, cash segment and total portfolios. I admit this disclosure approach is sub optimal due to the burden of providing this level of detail. Also to assure disclosures are reader friendly, I would advocate less not more disclosures. The longer the disclosure information the obvious risk is that a prospect will not read or understand the voluminous detail. Eliminate the use of carve outs and you do not need the disclosure.

Finally GIPS advertising guidelines do not require any disclosures regarding carve outs. As a minimum I would think advertising details should at least mention the use of carve outs.

I appreciate you talking my thoughts into consideration. Looking forward to the rollout of Gold GIPS and associated communications support from the CFA Institute.

Best Regards

Joseph G McDonagh CFA  
Product Manager