

The Security Analysts Association of Japan

November 13, 2002

Association for Investment Management and Research
Professional Standards and Advocacy Department
P.O. Box 3668
Charlottesville, Virginia 22903

Dear Sir/Madam,

Re: Proposed GIPS Guidance Statement on Calculation Methodology

The Security Analysts Association of Japan (SAAJ) is the sponsor of the SAAJ Investment Performance Standards (SAAJ-IPS[®]), the Japanese Version of GIPS, endorsed by IPC as a Country Version of GIPS (CVG) on June 25, 2002.

Following are our comments on the proposed GIPS Guidance Statement on Calculation Methodology based on full discussion and thorough review by the SAAJ-IPS Committee consisting of professionals from a wide range of the investment industry such as asset managers, pension funds, consultants, verifiers, etc.

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

- **Yes**, we **basically support** the principles established in the Guidance Statement.
- **However**, we think it necessary to supplement or modify the Guidance Statement from the following points of view (see item 2 below for more details):
 - As portfolios must be valued at least monthly for periods beginning January 1, 2001 (Standard 1.A.3), the period for calculation is at least a month if firms do not use actual valuations at the time of external cash flows.
 - The definition and explanation of “Modified Dietz Method” and “IRR” (Internal Rate of Return) in relation to “TWRR” are misleading in some aspects.

2. *Are all areas of rate of return and asset-weighted composite calculation sufficiently covered in this Guidance Statement?*

- **Composite performance**
The Guidance Statement discusses the calculation methodology for portfolio performance as well as that for asset weighted composite performance. However, there is no explanation about the method for calculating composite annual rate of

return based on the required provision (Standard 1.A.3.) that portfolios must be valued at least monthly. Since composite annual rate of return is a most important disclosure item in performance presentation, we **propose** that **the following guidance** should be given (for instance, immediately after “Geometric Linking” <p8>) in the Guidance Statement:

Composite Performance

As portfolios must be valued at least monthly for periods beginning January 1, 2001 (Standard 1.A.3.), composite performance must be calculated at least on a monthly basis after January 1, 2001, using beginning-of-period weightings or another method that reflects both beginning market value and cash flows. Composite annual rate of return must be calculated by geometrically linking these periodic (at least monthly) asset-weighted returns.

If all of a composite’s portfolios were removed during one or more periods due to some reasons (such as portfolio termination, removal of portfolios with significant cash flows and those which fall below the minimum asset level, etc.), there would be a break in the composite performance record. In this case, it should be noted that if portfolios are added to the composite after the break the two periods cannot be linked.

• **Modified Dietz Method and IRR and their relation with TWRR**

The definitions of the Modified Dietz Method and Internal Rate of Return (IRR) and explanations of their relation with TWRR are misleading to users of the Guidance Statement (as Mr. Bruno Solnik has already pointed out), and therefore should be more accurately explained as follows:

- It is mathematically clear that the Modified Dietz Method is an approximation of Money Weighted Rate of Return (MWRR), i.e., Internal Rate of Return (IRR).
 - * The formula and explanation of “Modified IRR” in the Guidance Statement is true MWRR and usually called just “MWRR” or “IRR” (we do not call it “Modified” IRR). Also, we recognize that “MWRR” is exactly the same as “IRR”.
- If a period is short (a month or shorter) and cash flows that occur during the period not significant, then the difference between the periodic (at least monthly) return calculated using the Modified Dietz Method or IRR and the return for the same period using TWRR based on actual valuations at the time of external cash flows is negligible.

If any cash flow that occurs in a portfolio within a composite during the period is so significant that it may distort the periodic return calculated using the Modified Dietz Method or IRR, firms should revalue the portfolio on the date of the cash flow (or after investment) and geometrically link sub-period returns (Standard 2.B.2.). Or, firms are allowed to remove the portfolio from the composite following the firm’s policy on the treatment of

significant cash flows in accordance with the IPC's Guidance Statement on the Treatment of Significant Cash Flows.

- The method of geometrically linking periodic returns (calculated using the Modified Dietz Method or IRR) is that for TWRR, and an annual rate of return calculated by geometrically linking periodic returns is TWRR regardless of calculation methods for each periodic return.
- **Assumption of the timing of cash flows**
The assumption of the timing of cash flows during the day should be consistently given in each calculation method (Modified Dietz Method, IRR, TWRR using actual valuations at the time of external cash flows, and asset weighted composite return using beginning market value plus cash flow-weighted) as follows:

There are some assumptions regarding the timing of cash flows during the day: e.g. at the beginning of the day (i.e. firms assume that the cash flow is available for investment on the day) and at the end of the day (i.e. firms assume that the cash flow is not available until the beginning of the next day). Firms should establish a policy regarding the assumption of the timing of cash flows and consistently apply it in the treatment of cash flows in performance calculation.

3. Are there other areas of calculation methodology that should be addressed in this Guidance Statement?

- **Composite dispersion**
The calculation and presentation of composite dispersion as a risk measure is required (Standard 5.A.1.(d)). Various questions occur on this score in relation to the calculation methodology for composite annual rate of return. Accordingly, the subject (composite dispersion as a required disclosure item) should be addressed in this Guidance Statement, or in other Guidance Statement that more comprehensively covers risk measures.

4. Is it reasonable to expect that firms will be able to value portfolios at the time of any external cash flow beginning 1 January 2010 (excluding real estate, venture capital, and private equity)?

- It is **expected** that in Japan firms will be able to be prepared for portfolio valuations at the time of any external cash flow in *systems* by January 1, 2010.
- **However**, whether performance calculation based on such valuations is best practice or not depends on if *accurate* data with respect to market value, dividends, and corporate action (for not only developed markets but also emerging ones) is available on a timely basis (i.e. not only for the beginning or end of the period but also at any time during the period). The issue is not for investment management firms but rather for custodians and information vendors.

Accordingly, it should be carefully considered if such a database is available for investment management firms beginning January 1, 2002.

The same issue should be considered with respect to the accrual accounting for dividends requirement beginning January 1, 2005.

- The cost for designing systems and compiling a database is also an important point to be considered. In addition, whether such a daily valuation method is appropriate to be applied to any investment style/skill should be discussed.

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

- We **agree** with the proposed effective date of April 1, 2003.
- We also agree with the treatment that the Guidance Statement should not be retroactively applied since retroactive application might result in allowing firms to recalculate historic performance record, which is not appropriate.

6. *Comments on other issues*

- **Performance calculation for leverage/derivatives**

It should be noted in the Guidance Statement that with respect to performance calculation for leverage/derivatives, firms will be required to comply with new related provisions to be added to the current GIPS standards in the future as well as related guidance to be given regarding the new provisions.

- **Different valuation methods**

It is stated that firms are permitted to include portfolios with different calculation methodologies in the same composite (provided the methodologies are permitted according to the dates stated above) (p4). Similarly, using different valuation methods (trade date or settlement date, different valuation sources, etc.) in the same composite should be permitted if it does not materially affect composite performance, and such guidance should be incorporated in the Guidance Statement.

- **Explanation of IRR**

As we cannot exactly understand why it is also possible to have multiple answers if there are both positive and negative cash flows (last paragraph, page 6), more explanation should be given.