



May 6, 2004

Association for Investment Management and Research
Professional Standards & Advocacy Department
Reference: "Gold" GIPS Standards
PO Box 3668
Charlottesville, VA 22903

Dear AIMR:

Thank you for the opportunity to comment on the proposed changes to the GIPS standards, affectionately known as "Gold" GIPS.

In general, the concept of these standards is fantastic and should be well received by the industry. The concept of "Gold" GIPS, as a *process to evolve the presentation standards to a single standard, recognized globally* is excellent.

General Comments

1. Do you support AIMR's effort to revise and expand the GIPS standards?

Yes!

2. Do you agree with the evolution process for the GIPS standards as outlined above?

Yes!

3. Is the language of the Standards straightforward and comprehensible? If not, how can it be improved?

In general, yes. The Interpretations Subcommittee should continue its efforts to develop guidance statements to enhance the material found here.

4. What modifications, if any, should be made to this proposal?

As you will see on the following pages, I offer several comments in response to this question.

#1 Page 29; Section III Preamble – Mandatory Verification – I strongly oppose this proposed change. My reasons include:

- a. The survey our firm conducted in 2002 showed little support for mandatory verification within North America, for either GIPS or a country version:¹

Verification of compliance with local or country versions of GIPS:

- C 38.3% said “yes”
- C **53.1% said “no”**
- C 8.6% said “don’t know.”

Verification of compliance with GIPS:

- C 34.6% said “yes”
- C **53.1% said “no”**
- C 12.3% said “don’t know.”

These findings are hardly ringing endorsements for mandatory verification.

- b. The market has caused firms to become compliant. When we surveyed the industry in 1993, over 45% of the firms said they had *no plans to be verified*.² Because of market pressures, this number has fallen to 12 percent.³ The market has worked quite well to persuade firms to (a) become compliant and (b) undergo verification. We don’t need mandatory standards.
- c. Within the United States, the Securities & Exchange Commission (SEC) offers “free verifications.” Granted, they’re not technically verifications, but any investment advisor is subject to periodic reviews by the SEC. If they falsely claim compliance, they are subject to disciplinary action by this government agency – something no US firm desires.
- d. Mandatory verification contradicts one of the initial aims of the standards: to provide a *level playing field*. With this provision, firms that cannot afford or justify the expense of verification will be forced to rescind their claim of compliance. Is this what we want?
- e. Verification doesn’t technically verify compliance; it requires the verifier to insure that the firm has “complied with all composite construction requirements” and that their policies and procedures are designed to calculate and present information in accordance with the standards. But no statement that “we have examined the books and records of XYZ Firm and found them to be in compliance...” is required. Thus, we’re not verifying compliance. So why make a firm spend the money?

¹ *Performance Presentation Standards Survey – 2002 Detailed Results*, (The Spaulding Group, Inc., 2002), pages 23-24.

² *Performance Measurement Survey*, (The Spaulding Group, Inc., 1994), page 8.

³ The Spaulding Group, 2002, page 20.

- f. A number of firms that were verified have later been found to be *out of compliance* by the SEC. In many cases, the verifiers *got it wrong*. Even today, we know of firms who question the reports their verifiers issue.

While we, as a firm, have always encouraged our clients to undergo verification, we do not recommend that this become a requirement. Our clients (and most money managers) are smart enough to figure out if they should undergo verification.

#2 Paragraph 1.A.6 – Requirement to accrue for dividend interest

I oppose this requirement:

- a. The impact for many firms will be quite insignificant on their return.
- b. If there is a difference, we would expect it to result in a slightly higher return.
- c. To implement such a change may require additional costs as well as operational changes.

Since the change may require costs that a firm cannot justify for the negligible benefit in accuracy and since the change will only result in higher returns, why require someone to do this if they don't want to? Firms should be free to decide whether or not the cost is justified.

#3 A measurement of risk should become a requirement

Risk and reward are equally important. The standards have always *recommended* that a risk measure be shown.⁴ Most firms calculate at least one measure of risk. Most portfolio accounting and performance measurement systems provide risk calculations, so there should be no incremental cost associated with this. Risk measures help an investor understand the degree of risk that was taken to achieve the return. It's time that the standards mandated it.

I recommend that the disclosure of a risk measure become a requirement 1 January 2010.

5. Do you agree with the numbering and format of the proposed GIPS standards?

Yes.

6. Should AIMR consider any other methods for meeting the objectives of evolving the GIPS standards?

None that I can think of.

⁴ Even the BAI Standards recommended this (*Measuring the Investment Performance of Pension Funds*, (Bank Administration Institute, 1968), pages 11-13).

Specific Comments

1. Is the new requirement that mandates firms to provide a compliant presentation to all prospective clients too onerous a burden for firms claiming compliance with the GIPS Standards?

No - this has been a requirement of the AIMR-PPS, and I'm pleased that it's being included as part of GIPS.

2. Is the new requirement that mandates firms to provide a list and description of composites to any prospective client that makes such a request too onerous a burden for firms claiming compliance with the GIPS Standards?

No – Good addition!

3. Do you agree with the new recommendation that states the firm should not market a composite to a prospective client with assets less than the composite's minimum asset level?

No – it should be a requirement. Otherwise, a firm that markets to prospects below their minimum is invalidating the minimum that they set. This does not mean that they may not pick up a client with assets below their minimum (as a concession, perhaps) but they should not be actively marketing to prospects with assets below their minimum.

However, I have an objection to the wording of paragraph 2.A.7 “If the firm sets a minimum asset level for portfolios to be included in a composite, no portfolios below that asset level can be included in that composite.” Firms that establish minimums are supposed to have written policies on how these situations are handled. Often, firms set rules around the minimums, e.g., the minimum may be \$1 Million, but an account will be removed if they fall below \$950,000; or, if the account is below \$1 Million for more than two months. To have a blanked rule that “no portfolios below the asset level can be included” is, in my opinion, too “black and white.” Firms should be able to establish policies around their use of the minimum, providing they are consistent in their application.

4. Do you agree with the new requirement that mandates firms to be prepared to provide a compliant presentation for any composite on the firm's list of composites to a prospective client that makes such a request?

Yes – again, this has been (or should have been) an understood part of the AIMR-PPS, and this additional requirement clarifies this point.

5. Do you agree with the new requirement that requires firms to calculate composite performance by asset-weighting the member portfolio returns at least monthly (beginning 2005)?

Yes – since portfolios are to be calculated at least monthly (since 2001), it only makes sense that composites are, too.

6. Do you agree that the effective date should be moved from 2005 to 2010 for the requirement that stipulates a carve-out return be managed separately with its own cash balance?

On the one hand, I'm pleased that "Gold" GIPS has shifted the date to prohibit the allocation of cash for carve-outs from 1 January 2005 to 1 January 2010. However, I question why we need this prohibition at all. My comments are regarding carve-outs from "balanced" portfolios, where there are at most three or four asset classes (i.e., at the asset class level (equities, fixed income, cash, real estate)), not to below this (e.g., not to Japanese equities, UK bonds, Australian real estate,...).

- a. *As I understand it, the original prohibition was established because of concerns with firms carving their portfolio up into many, many pieces. I don't have a problem with such a provision at this level. However, at the asset class level, I see no problem with cash allocation.*

In the US, we typically find cash allocations done at the asset class level, splitting away the equity and/or bond portions into single asset class composites.

- b. *The ability to allocate cash has always been deemed acceptable within the AIMR-PPS. I was a participant in the ad hoc committee AIMR created in 1993 to address this, and we all agreed that separate cash buckets or sub-portfolios was ideal, but recognized that this wasn't going to be feasible for many and that the allocation of cash should be fine.*
- c. *As long as the rules are followed (that an acceptable, non-arbitrary method is used; that it's defined in advance; and that it's consistently applied), there is nothing wrong with cash allocation*
- d. *There has been no demonstration that there's a problem with cash allocation.*
- e. *Many investment firms would find it difficult to operationally deal with cash being separated.*
- f. *Not all portfolio accounting systems can support this approach well enough to get the cash right.*
- g. *Since balanced portfolios are recognized at the custodian as a single account, reconciling cash, when multiple cash buckets are used, will be a challenge for many firms (where reconciliation is difficult enough).*

I'm unaware of any justifiable reason to disallow firms from allocating cash when carving out asset class sections of a balanced portfolio.

7. Is it reasonable for the GIPS standards to require firms beginning 2010 to value portfolios on the date of any external cash flow?

I oppose this provision for several reasons:

- a. *This is equivalent to daily rates of return, and there is no proof that daily returns are more accurate. In fact, arguments have been made to the contrary.⁵*
- b. *Mandatory revaluation means additional costs, which often cannot be justified.*
- c. *While getting good prices for US equities may be easy, for many other security types (e.g., U.S. municipal bonds, emerging market debt, emerging market equities), this cannot always be said. Thus, accurate revaluation may not always be possible.*

To require revaluation would mean additional costs which many firms may not be able to justify. Also, the increased accuracy isn't guaranteed. So why mandate this? It shouldn't be.

8. Should the GIPS standards require firms to retroactively disclose the following when carve-out segments are used?
 - (a) A list of the underlying composites from which the carve-out was drawn, and
 - (b) the percentage of the composite that is composed of carve-outs.

No. This is an unnecessarily onerous provision. However, firms should be required to be prepared to disclose such information, should it be requested. Instead, there should be a requirement that the firm indicate if composite has received carved-out segments (and that specific details are available upon request), but these additional disclosures serve little purpose.

Again, thank you for this opportunity to comment.

In general, "Gold" GIPS (along with the new standards for private placements, real estate, etc.) is a vast improvement and a good step down the path of a single, universally acceptable standard.

Sincerely,

David Spaulding
President

⁵ See, for example, "Just Because We Can Doesn't Mean We Should," Dan diBartolomeo, *The Journal of Performance Measurement*, Spring 2003, page 30; "Using Performance Statistics: Have Measurers Lost the Plot?," Robert Darling and Alastair MacDougall, *The Journal of Performance Measurement*, Winter 2002/2003, page 22; and "Calculating Returns: Different Rate of Return Formulae = Different Results," David Spaulding, *The Journal of Performance Measurement*, Summer 2001, page 25.