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Professional Standards & Advocacy Department
Reference: The Addition of Carve-Out Treatment and Guidance to the GIPS® Standards.
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Initial remark:

GIPS facilitate only one application of carve outs: to create a single asset class track record, by taking the single asset class out of a multiple-asset portfolio.

In the asset management business, however, there is an important second application of carve outs: balanced mandates. Since the diversity of structures of balanced mandates is so enormous, it hardly occurs that the structure of a balanced portfolio of an existing client resembles the structure desired by the prospect.

Example: suppose current client A invests in global equity and in European fixed income and current client B invests in European equity and global fixed income. The asset manager, specialized in balanced investments, does not have a need to present "global equity" as a stand-alone composite. His need is to combine carve-outs global equity and global fixed income for reason that prospect C asks for such a product.

In our opinion the Guidance Statement on carve-outs should facilitate the second application of carve outs, to fill a gap in GIPS. Unfortunately it does not. The Guidance Statement only refines the application of carve-outs already present in GIPS.

Below we first give our comments on the Guidance Statement in respect of the refined first application of carve-outs. Secondly we explain more about the second use of carve-outs. We hope this gives input for an extension of the Guidance Statement.

We refer to the first application of carve-outs as "carve-outs for stand-alone composites" and we use "sub-strategies in balanced portfolios" to refer to the second use.

Question 1: Do you agree with the principles established in the Guidance Statement?

VBA-PPS answer to question 1: ("carve-outs for stand-alone composites")

With the addition of a few remarks we generally agree with the principles:

1. Generally we feel that using carve-outs for stand-alone composites is only relevant if the management style is at least to a certain degree using independent sub-portfolios, otherwise sub-portfolio returns will generally not be representative for the strategy of the composite.
2. The Guidance Statement lacks a definition of cash and an explanation plus example on how to add cash to a carve-out excluding cash. Both elements should also have to be added to the

GIPS Handbook. We also feel that both the Guidance Statement and the Handbook should be extended with a certain number of possibilities for carve-outs (examples).

Question 2: Are there other cash allocation methods that should be allowed prior to 1 January 2005?

VBA-PPS answer to question 2: ("carve-outs for stand-alone composites")

We suggest making the addition of cash returns a recommendation, but certainly not a requirement. This holds equally for the inclusion of cash in every sub-portfolio after January 1, 2005. Also, the Guidance Statement is not entirely clear as to whether the addition of cash returns is a requirement or a recommendation (in the Standards themselves it is clear that it is supposed to be a requirement).

Both suggested methods for allocating cash as described in the Guidance Statement have their problems, e.g. the first one could be very cumbersome. How does that work in practice? A message beginning every month to the verifier, stating the cash percentage for the beginning of the second month? Are there then situations why this percentage could be changed during or after the first month? Also this first method is open to multiple interpretations. In the Dutch PPS Committee three different interpretations were discussed, which could all be possible given the description of method 1. In some interpretations method 1 will also lead to the possibility to influence performance in a balanced portfolio. For example in a simple balanced portfolio with 80% bonds and 20% equities and one cash-account, the obvious rule would be 80% cash bonds and 20% cash equities. If the performance of the equities portfolio is negative compared with the benchmark and also compared with bonds (a common result in recent years), the performance of the equity portfolio could be influenced by selling bonds, adding extra cash to the cash-account. This option to influence performance is also an additional argument to handle balanced portfolios differently when dealing with carve-outs.

With respect to the second alternative, adding up to the strategic asset allocation, we foresee problems. Specifically in the case of off-benchmark asset classes in the portfolio, this approach would generally result in too high cash allocations. Also even in the case of no off-benchmark asset classes, one should consider that in a balanced mandate all classes are 'balanced' against each other, not only against cash as in a stand-alone situation. This generally results in relatively low cash weights, also bearing in mind the assignment to be fully invested.

As a much simpler, more objective and in our opinion more justifiable approach, we suggest to allocate the cash portion proportional with the weights of the non-cash asset classes at the beginning of the month. In this calculation we should bear in mind that both in the determination of the amount of cash and in the determination of the weight of an asset class, we should consider treating derivatives in a notional way.

An important related question is how to determine the return achieved on cash. It is surprising to see that both the Standards and the Guidance Statement do not spend a single word on this question. If this is meant to indicate that the 'true' TWR of the cash portion is to be used, then we feel obliged to strongly protest against this suggestion. Not only because the true cash return

will be influenced by events in non cash asset classes and/or by general portfolio events (costs), but also because of the fact that cash is often held at a very low level, implying that returns (as an outcome of calculations) are often extremely high in absolute terms (>100% or <-100%). This effect is even enlarged by the common use of currency forwards (or alternative derivatives) when hedging the currency returns of certain (or all) asset classes. Even with relatively low weights these extremely high (absolute) returns have an unrealistic high influence on the sub-class returns.

The Dutch PPS Commission therefore suggests using a predefined short-term rate as the return for the allocated cash. We realize that in this way we create a return series for the carve-out, which is to a certain degree 'simulated'; however we prefer that strongly compared to using the real cash returns.

Question 3: Do you agree with the principle relating to the treatment of fees?

VBA-PPS answer to question 3: ("carve-outs for stand-alone composites")

We agree with this principle.

Question 4: Do you agree that if a firm creates a carve-out, "then all similar portfolio segments managed to that strategy should also be carved out and included in the composite"?

VBA-PPS answer to question 4: ("carve-outs for stand-alone composites")

Yes, both in the case of carve-outs for stand-alone strategies as for carve-outs for balanced, we strongly support this concept. Or, in other words, there should be no opportunity left for cherry picking.

Question 5: There are three proposed methods for properly accounting for the cash position for periods after 1 January 2005. Are these methods understandable and complete? Are there any other appropriate methods?

VBA-PPS answer to question 5: ("carve-outs for stand-alone composites")

In order to properly use carve-out returns for inclusion in composites, the Standards require that after January 1, 2005, each sub-portfolio must have its own cash. We feel that this element should not be required, but only recommended.

Question 6: Do you agree with the proposal that this guidance should only be applied on a forward-looking basis (i.e. not retro-actively)?

VBA-PPS answer to question 6: ("carve-outs for stand-alone composites")

Yes, we think that the guidance should not have to be applied retroactively. We would like to remark that for the year 2002 adding cash returns to equity returns would clearly improve the composite returns. Therefore the timing of changing the policy should be considered carefully,

i.e. there could be a strong commercial side-argument for starting the cash-adding policy immediately.

Question 7: Do you agree with the proposed Effective Date?

VBA-PPS answer to question 7: ("carve-outs for stand-alone composites")

We agree with the proposed Effective Date. However, it is our impression that this Effective Date has a very limited meaning. Basically everything that is in the Guidance Statement is also described in the Standards. Maybe the interpretation is that the only 'new element' is that the methods to allocate cash to sub-portfolios, respectively to have cash in sub-portfolios, are now limited to those methods as described in the Guidance Statement.

Additional remark: The Standards require, as mentioned also in the Guidance Statement, firms to disclose a list of the underlying composites of which the carve-outs are members and the percentage of the composite that is composed of carve-outs. We think that such a requirement is only relevant if the composite represents a stand-alone strategy. Even then we feel that this requirement is too strong; in our opinion only disclosing the fact that composite B is a sub-composite of composite A (plus disclosing the percentage it represents), is material information. Disclosing the composites of all sub-portfolios in a certain composite would result in very lengthy lists, because very often sub-portfolios are subs of higher order subs, etc. We consider it not meaningful to require the disclosure of all this information.

A strict application of the requirement of the Standards would almost result in a matrix of all (hundreds of) composites, showing what percentage of the assets under management of the first composite are also included in the second composite. In our opinion this would be 'over-information' and not relevant.

Sub-strategies in balanced portfolios

The Dutch PPS Commission is of the opinion that the Standards and the Guidance should make a distinction between two ways of using carve-outs: (a) for stand-alone composites and (b) for sub-strategies in balanced portfolios.

Requirements and recommendations regarding carve-outs can depend on the type of application. Most importantly, for carve-outs representing sub-strategies within balanced portfolios, it should not be required nor recommended to add cash.

Balanced portfolios.

Introduction.

Both the Guidance Statement and the Standards themselves have one implicit view on the use of carve-outs, namely that the carve-out is to represent a stand-alone strategy (which then may eventually be included in a composite representing that strategy, i.e. in a stand-alone composite). Clearly this is an important form of using a carve-out, probably relevant in all parts in the world and in all possible market circumstances.

However, it is not the only possible use of carve-outs and in some parts of the investment world probably not even the most important. In our country, the Netherlands, and in many Continental European countries, the use of balanced mandates is very popular. These balanced portfolios usually include both an equity- and a fixed income element, but often also other asset classes like real estate, hedge funds, private equity and other specific classes. Normally, probably always, the balanced portfolio also includes a liquidities class, while liquidities sometimes are separated in a liquidities class as a strategic investment class and in a cash class, where cash include basically only transaction cash. Also liquidities may be included in many different forms, e.g. in a synthetic form by using derivatives.

Mostly the balanced portfolio will not include one equity sub-portfolio, but many different ones, e.g. a Pacific-sub, a North American-sub, a European-sub, a UK-sub and sometimes also a separate sub for the home country. To a lesser degree the same remark is also relevant for the Fixed Income part of the balanced portfolio. On the equity part the sub-class distinctions may also be made on industries/sectors, sometimes even on combinations of regions and industries. Likewise it is not uncommon to separate Credits from Governments on the fixed income side of the portfolio, also sometimes with regional distinctions.

In such structures it is not uncommon to have in between 4 to 8 (or even more) sub-classes in the balanced portfolio, while complicated tree-diagrams can be drawn representing the level on which risk- or currency-management are executed. An obvious intermediate level is the Equity Total sub-portfolio, which may 'only' be an administrative sub-level, or it may be the level on which the risk management of the equity part is executed.

Obviously many different portfolio structures are imaginable in such situations and practice also shows that it is almost non-existing that two balanced portfolios have the same structure, even when managed by the same asset management firm.

Two questions are important in the context of using carve-outs from such balanced portfolios. The first one is to which degree the management of the separate sub-classes are interrelated and the second one is on which level(s) cash portfolio(s) is (are) held in the portfolio.

With respect to the interrelation-question two extreme approaches are possible. Either the entire portfolio is managed as one big, holistic portfolio where the decisions for one class may (strongly) influence the decisions for other classes. A simple example may be that the composition of the Credit Fixed Income sub-class will/may influence the risk profile of the several Equity sub-classes. In such situations it is very probable that one manager or one team of managers is managing the entire portfolio. One of the implications of a completely holistic approach is that taking carve-outs for a stand-alone composite is very often not meaningful because the carve-out will generally not be representative for the stand-alone strategy.

On the other extreme there is also the possibility that the balanced portfolio is managed in the form of totally independently managed sub-portfolios, with an asset allocation manager responsible for assigning the assets to each sub-class. In this approach it is very likely that each sub-portfolio is managed by a different manager. In this situation very often the assignment for each of the independent sub-managers is to be fully invested at all times, the reason being that the exposure to that class is decided at asset allocation level, i.e. by another manager. So compared to a manager of a stand-alone portfolio, this balanced sub-class manager very often lacks the possibility 'to go partly in cash' if he has negative expectations for his asset class. Obviously there are a very large number of approaches, which are in between these two extremes; an obvious example being that the equity sub-classes do influence each other, while there is no influence between the equity- and the fixed income sub-portfolios. However, in practice we mostly see a choice for one of the two extreme approaches. A surprisingly low number of asset management organizations prefer an approach, which is in between the two extremes.

As far as the cash question is concerned, we hardly ever see another choice than one of two extremes: either there is just one cash-portfolio (which is also a separate asset class) or every sub-class has its own cash. In the fully holistically managed balanced portfolio the common choice is to have cash only at one level (the portfolio), while in the case of independently managed sub-portfolios both extremes are used: either still one cash portfolio - implying that almost every transaction is also a cash flow - or cash included in every sub-portfolio. However, as mentioned earlier, in this last case the situation is still merely administrative because of the common assignment to be fully invested at all times for those independent managers.

An important remark here is that attaching cash to each sub-class puts higher requirements on the portfolio management system and on the administrative organization, generally implying higher costs. Therefore smaller asset management organizations tend to choose the option of only one cash portfolio, even when the sub-classes are managed totally independent from each other.

Carve-outs.

The purpose of this long introduction on balanced portfolios is to show that another use of carve-outs is extremely important too: namely in the process of defining the structure of a future balanced mandate - with discussions between the potential asset manager, the potential client and possibly a consultant - the choice which sub-asset classes are to be included in the balanced portfolio is of the utmost importance.

Mostly the decision to either manage the entire balanced portfolio as a holistic portfolio or to manage it wholly or partly as independent sub-portfolios is made at the level of the asset management organization. However the decision which asset classes to include in the balanced portfolio is mainly made by the potential client, very often in close cooperation with a consultant and in many cases the decision is at least supported by an asset liability study. In this decision the asset management organization only plays a minor, advising, role.

The outcome of this decision by the client/consultant, however, may - and in many cases will - be strongly influenced by the track records of the asset management organization on each of the several potential sub-classes, i.e. by the carve-out returns of the sub-classes. This is specifically the case in the more relevant case that the management style is to wholly or partly use independently managed sub-portfolios. Therefore it makes very much sense to create composites specifically made up of carve-outs only. And if the management organization has decided not to use cash for each sub-portfolio, those carve-outs should specifically **not** contain cash - and also cash should not be added to it - because that is the way these sub-portfolios are managed, making the carve-out returns excluding cash the relevant returns for the potential client.

Even in the case of the management organization including cash in each sub-class, thereby abiding to all requirements on carve-outs in the Standards, one has to remember that the influence of this cash is generally very small compared to a stand-alone portfolio because of the implicit assignment of balanced portfolio sub-class managers to be fully invested at all times.

The Dutch PPS Commission is therefore of the opinion that in the treatment of carve-outs in the Standards and in this Guidance Statement a distinction should be made whether the composite is meant to represent a stand-alone strategy (where including cash could be considered as a relevant element), or whether it is to represent a composite for balanced sub-portfolios (where including cash is either more or less meaningless and assigning cash can even be **misleading**). This thought was also reflected in the 'old' VBA-PPS 1998 Standards, which were strongly based on the AIMR 1997 Standards. In these old local Dutch Standards the use of carve-out-returns was required to be disclosed, as well as the disclosure of the treatment of the cash within these carve-outs (either with or without cash). There was no requirement - or even a recommendation - to add cash to those carve-outs. We still feel that this is the appropriate way to treat cash at carve-outs: disclosure of the nature of these carve-out returns, but no adaptation of these actually achieved returns in the case without cash.

Additions to answers to the questions on the Guidance Statement regarding sub-strategies in balanced portfolios

Question 1: Do you agree with the principles established in the Guidance Statement?

VBA-PPS answer to question 1: ("sub-strategies in balanced portfolios")

For balanced sub-classes we strongly disagree with the Standards and the Guidance Statement (see the above).

The pre-requirement, that the management style is using independently managed sub-portfolios, is not relevant for carve-outs intended for composites defined for the purpose of sub-strategies in balanced portfolios. Also the requirement to add cash in the pre 2005-period and the requirement of cash inclusion in the sub-portfolios in the post 2004-period definitively have to be removed.

Question 2: Are there other cash allocation methods that should be allowed prior to 1 January 2005?

VBA-PPS answer to question 2: ("sub-strategies in balanced portfolios")

As explained earlier we only agree with the concept of adding cash to the carve-out return in the case of stand-alone strategies/composites.

Question 3: Do you agree with the principle relating to the treatment of fees?

VBA-PPS answer to question 3: ("sub-strategies in balanced portfolios")

We agree with this principle. However, in the case of carve-outs used for presenting information on balanced sub-classes, there is no need to provide net returns, because net returns are then relevant only for the entire balanced portfolio.

Question 4: Do you agree that if a firm creates a carve-out, “then all similar portfolio segments managed to that strategy should also be carved out and included in the composite”?

VBA-PPS answer to question 4: ("sub-strategies in balanced portfolios")

No addition to the answer.

Question 5: There are three proposed methods for properly accounting for the cash position for periods after 1 January 2005. Are these methods understandable and complete? Are there any other appropriate methods?

VBA-PPS answer to question 5: ("sub-strategies in balanced portfolios")

In the opinion of the Dutch PPS Committee the inclusion of cash in sub-portfolios cannot be a requirement, nor should it be a recommendation.

Question 6: Do you agree with the proposal that this guidance should only be applied on a forward-looking basis (i.e. not retro-actively)?

VBA-PPS answer to question 6: ("sub-strategies in balanced portfolios")
No addition to the answer.

Question 7: Do you agree with the proposed Effective Date?

VBA-PPS answer to question 7: ("sub-strategies in balanced portfolios")
No addition to the answer.