

Professional Standards and Advocacy  
Association for Investment Management and Research  
Re: GIPS Guidance Statement  
PO Box 3668  
Charlottesville, VA 22903  
United States of America

31 October 2001

Dear Sir/Madam

**Proposed Guidance Statement on the Treatment of Significant Cashflows**

PricewaterhouseCoopers wishes to thank the Association for Investment Management and Research (AIMR) for this opportunity to comment on the Proposed Guidance Statement on the Treatment of Significant Cash Flows (Guidance). Our comments are provided in the attached Appendix. Please note that these comments are not meant to detract from the many favourable aspects of GIPS™. The treatment of significant cash flows is an important topic and we welcome the Guidance proposed by the Interpretations Subcommittee (Subcommittee) of the Investment Performance Council (IPC).

This is a complex issue with many questions left unanswered by the Guidance pending input received during the comment process. We would recommend that, once all comment letters have been received and reviewed, an additional draft should be submitted for public comment which reflects the conclusions to these unanswered questions as well as a discussion of the related issues associated with these questions.

If you wish to discuss these points further, please contact Kelvin Laing-Williams in London on +44 (20) 7804 1707 or Peter McNamara in New York on (646) 471 8743.

Yours faithfully

## **Appendix: PwC Comments on the Proposed Guidance Statement on the Treatment of Significant Cash Flows**

### **1 Responses to specific questions ("Comment Requested")**

#### ***Should the Standards allow the removal of portfolios due to significant cash flows at all?***

We welcome and generally support the recommendations made by the IPC, as stipulated in the Proposed Guidance Statement on the Treatment of Significant Cash Flows. It is our opinion that the use of temporary new accounts seems to be the most appropriate solution, but this option has often proved to be unworkable in practice. Hence, we agree that allowing the temporary removal of portfolios from composites is a reasonable short-term alternative until firms readily have performance systems in place that can account for temporary new accounts.

Any Guidance should not, in our opinion, lead to a situation where the removal of accounts from composites becomes a common occurrence in any firm.

#### ***Should firms only be allowed to remove portfolios from composites that are invested in less-liquid asset classes?***

We recognise the argument that the removal of portfolios should only be allowed for less-liquid asset classes. However, we do not consider that this Guidance should be restricted to less-liquid asset classes because, if this argument were followed, either the Guidance or the firms themselves would need to define what constitutes a liquid investment. This is likely to prove impractical, as the notion of what is liquid can change over time and may vary according to the investment strategy adopted, even for different strategies in respect of similar investments (e.g. an index tracker of liquid equities may find cash flows more distorting than an active strategy in the same equities).

#### ***Should there be any consideration given to asset classes that have liquid futures markets by which firms can gain immediate exposure?***

Firms should be able to consider the availability of derivative markets when determining whether to adopt a significant cash flow policy on a composite by composite basis. However, this decision should be up to the firm and should not be required by the Guidance.

## **Appendix: PwC Comments on the Proposed Guidance Statement on the Treatment of Significant Cash Flows**

*Should significant cash flows be defined according to the size of composite assets rather than the size of portfolio assets?*

The size of the cash flow relative to either the portfolio or the composite as a whole should both be allowable measures in determining its significance. Utilising composite assets could avoid the need to adjust for cash flows in portfolios when the overall impact on composite performance is not material. However, firms should consider the potential impact on composite dispersion when defining significance in terms of composite assets rather than portfolios.

*Should significant cash flows be defined according to an absolute monetary value for each asset class?*

Although a definition using absolute monetary value could be used, any such definition could become inappropriate over time as the size of the composite and individual portfolios changes (such changes making the monetary value either too small to be significant or too large to catch other cash flows that are smaller but still significant). We are therefore of the opinion that it is more appropriate to define significance in terms that are relative to the size of the composite or portfolio.

*When should this Guidance Statement become effective?*

We would suggest that the Guidance be effective no earlier than for performance periods beginning July 1, 2002. This will allow the IPC to more closely examine this important area as well as provide additional time for firms to decide if and how portfolios with significant cash flows would be excluded from composites.

## Appendix: PwC Comments on the Proposed Guidance Statement on the Treatment of Significant Cash Flows

### 2 Specific Comments on the Proposed Guidance Statement

<i>Section</i>	<i>Comment</i>
<b>Cash Flow Definition (page 2)</b>	<p>The Cash Flow Definition section defines a “cash flow” as an “external flow of cash and / or securities”. We believe that the inclusion of securities warrants greater discussion, as presently there is no detail in the Guidance as to how these should be treated and whether any aspects of a cash flow policy can differ based on whether a flow is comprised of cash and/or securities. For example, it can be difficult to define what constitutes “significant” when investments are transferred, when conceivably the liquidity of the securities transferred and their similarity to the composite strategy may be of more importance than either the monetary value or the liquidity of the composite’s investments/strategy.</p> <p>The Guidance states that “transfer of assets between asset classes within a portfolio or manager initiated flows must not be used to move portfolios out of a composite on a temporary basis.” Generally, we agree with this statement, but we also consider that there should be an exception in the case of carve outs, allowing the removal of portfolios, even if the asset allocation decision was made by the manager. For example, in a global equities strategy, a decision by the Global Equity manager to change the asset allocation from one region to another (say from Europe to the US) should not result in the removal of the portfolio from the Global Equities composite. However, if the US equities part of this composite is managed separately, carved out and included in the US Equities composite, the implementation of the asset allocation decision could distort performance of that carve out, even though the US Equities manager had no influence over that decision. Therefore, we consider that the portfolio should be able to be removed from the US Equities composite.</p>

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### Significant Cash Flows (page 2)

The Guidance should make it clear that, if a firm wishes to adopt this Guidance that they must do so for the firm as a whole. In other words, if a firm wishes to establish a significant cash flow policy with respect to a particular composite, they need to decide for each of their other composites whether they want to adopt a significant cash flow policy and if so, the specific policy as well.

The Cash Flow Definition section states that “The “cash flow” may be defined by the firm as a single flow or an aggregate of a number of flows within a stated period of time.” The Guidance should indicate and discuss allowable definitions for “stated period of time” to remove inconsistency and subjectivity as far as possible.

We believe it would be helpful if the Guidance indicated the factors that should be considered by a firm when establishing their cash flow policy. For example, firms need to consider the impact on composite history and the inability to link history if all the portfolios in the composite are temporarily removed due to significant cash flows;

We also note that the “Significant Cash Flows” section states that the measure of cash flow significance “should” be determined as either a specific monetary amount or as a percentage of portfolio assets based on the most recent valuation. We consider that the word “should” is ambiguous and that this item should be restated to say either “is required”, if that is the intention, or “recommended” if it is not mandatory. We suggest that this be a requirement in order to avoid the possibility of other definitions being adopted (notwithstanding our belief that a monetary amount is not the most appropriate measure, as mentioned above).

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### Temporary Removal of Portfolios with Significant Cash Flows (page 3)

The Guidance states that “Firms must not retroactively apply these policies to restate performance.” It should be made clear when a firm first brings its history into compliance with GIPS, whether or not it is able to implement a significant cash flow policy on an historical basis.

We believe that the statement that “It is expected that the removal of portfolios due to significant cash flows will be an infrequent occurrence in composites invested in the larger, most liquid asset classes” can be strengthened by indicating that, if a firm finds it is frequently having to remove portfolios from composites, it should review its significant cash flow policy and modify it going forward if deemed appropriate.

The proposal makes reference to the grace period of new portfolios for the purposes of bringing an excluded portfolio back into the composite. This section should also indicate the timing of when a firm can initially exclude a portfolio from the composite under its cash flow policy. We believe that the timing must be consistent with the firm’s policy for terminated accounts.

We have one specific comment on wording, namely that, in order to minimise ambiguities in the document, this section should be titled “Temporary removal of entire portfolios with significant cash flows”.

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### Documentation (page 3)

We consider that items 4 and 5 in the documentation section should be combined such that a firm is only required to document any significant cash flow in accordance with its cash flow policy. That is, if the policy defines significance according to the size of the portfolio, the required documentation should be of the amount as a percentage of the portfolio, if the policy is based on composite size, the documentation should be of the cash flow as a percentage of the composite.

Item 4 in the disclosures section states that disclosure is required if policies have been amended. This should be extended so that firms must also indicate the reason for the amendments.

The Disclosures section states that “upon request, firms must disclose to clients the number of times portfolios were removed in a given period, the number of portfolios removed and the amount of assets represented by the portfolios affected by the application of these policies to the composite.”

We consider that the above information should be made a recommended disclosure, rather than disclosed upon request. Otherwise, this requirement should be deleted from the Guidance.

We consider that the focus on clients receiving this information is misplaced. If it is recommended, this information should be disclosed to all users of the report(s), including prospects and consultants. We also believe that the phrase “given period” is too vague and would recommend that such disclosures be provided on an annual basis.

Lastly, the last requirement should be clarified to indicate that this data is required to be presented on a composite basis.

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### Temporary New Accounts (page 4)

The Guidance envisages a time when firms will be required to use temporary new accounts. We believe that this is a complex area in itself and that there is a need for more guidance and greater clarity as to how to use such accounts in practice.

The proposal states that in the temporary new account cash inflow example described in the Guidance, “the funds would remain in the temporary new account until invested in line with the manager’s standard policy for the mandate and then be transferred to the main account.” However, as the Guidance simply refers to the cash inflow example provided, it is not clear whether the firm has discretion over when a new temporary account established from a cash inflow must be closed out (ie once the account is appropriately invested) or, for example, if it may be treated consistently with the firm’s policy for new portfolios. A discussion as to any valuation considerations and/or requirements upon the transfer of the temporary new account to the existing portfolio also may be helpful.

The Guidance states that with respect to outflows “the account would reflect the withdrawal of funds and/or securities as a cash outflow of the portfolio, and the performance figures would be calculated to include this cash outflow at the date of transfer to the temporary account. Similar to inflows, there is no discussion as to any valuation considerations upon the establishment of the temporary new account. It is also not clear whether firms would have the option of accounting for the cash outflow as of the beginning of the period and not necessarily the date of withdrawal. In addition, we note that the example provided only makes reference to a cash flow taking place at the end of a month. More realistic examples with single and multiple flows taking place during the month could also be provided.

The proposal indicates that beginning January 1, 2010 the use of temporary new accounts may be required. We support the eventual prohibition of temporarily removing portfolios from composites due to large cash flows. The Guidance should indicate that the use of temporary new accounts is expected to be a recommendation starting January 1, 2010 if feasible and cost effective.



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