

# Global Investment Performance Standards

## GUIDANCE STATEMENT ON THE TREATMENT OF SIGNIFICANT CASH FLOWS

Adoption Date: 9/28/2010

Effective Date: 1/1/2011

Retroactive Application: Not Required



CFA Institute

[www.gipsstandards.org](http://www.gipsstandards.org)

© 2014 CFA Institute

# GIPS GUIDANCE STATEMENT ON THE TREATMENT OF SIGNIFICANT CASH FLOWS

## **Introduction**

Dealing with large external cash flows in a portfolio is a common struggle for most firms. These flows of cash or investments can make a significant impact on the implementation of an investment mandate, objective, or strategy and, thus, on a portfolio's and composite's performance. Accordingly, this Guidance Statement clarifies the issues related to the treatment of significant cash flows under the Global Investment Performance Standards (GIPS®).

## **Background**

The GIPS standards require that composites include new portfolios on a timely and consistent basis after each portfolio comes under management. The GIPS standards also state that terminated portfolios must be included in the historical performance of the appropriate composites through the last full measurement period that each portfolio was under management.

The GIPS standards were developed with the understanding that new portfolios may require a period of time (a "grace period") for a firm to fully implement the intended investment mandate, objective, or strategy. During the grace period, the portfolio is not required to be included in a composite. The necessary length of this grace period may vary from composite to composite, depending on a number of factors that impact the implementation of an investment mandate, objective, or strategy. It is also reasonable that when external cash flows to a portfolio are significantly large, the same process applies that governs the introduction of a new portfolio into a composite.

## **External Cash Flow Definition**

For the purposes of the GIPS standards, an external cash flow is defined as capital (cash or investments) that enters or exits a portfolio. A significant cash flow is defined as the level at which the firm determines that a client directed external cash flow may temporarily prevent the firm from implementing the composite strategy. Transfers of assets between asset classes within a portfolio or manager initiated flows must not be used to move portfolios out of composites on a temporary basis.

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. In cases of multiple cash flows over an extended period of time, firms should refer to the discussion of discretion in the Guidance Statement on Composite Definition and consider whether the portfolio should be classified as non-discretionary.

For a discussion of the distinction between external cash flows, large cash flows, and significant cash flows, please see the Guidance Statement on Calculation Methodology.

### **Significant Cash Flows**

Firms that wish to remove portfolios from composites in cases of significant cash flows must define “significant” on an ex-ante composite-specific basis and must consistently follow the composite-specific policy. The definition may be influenced by the characteristics of the asset class(es) within the strategy, such as market liquidity and/or by the trading capabilities of the investment manager. (For instance, a significant cash flow may be considered 10 percent of a portfolio’s value for an emerging market fixed-income composite but may be in excess of 50 percent of a portfolio’s value for a more liquid composite, such as European equities.) In theory, the determination of significance should primarily be based on the liquidity of the asset class and the investment strategy employed. Because of the dynamic nature of global markets and the inherent subjectivity involved, it is impractical to establish absolute levels of significance for each asset class. Theoretically, external cash flows that are relatively small on a composite level but relatively large on a portfolio level, can potentially distort the portfolio’s performance and skew the measure of internal dispersion. The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of portfolio assets (based on the most recent valuation).

### **Grace Periods for the Treatment of Significant Cash Flows**

Each composite must have a portfolio inclusion policy for new portfolios and an exclusion policy for terminated portfolios. It is the responsibility of the firm to set reasonable guidelines for each composite regarding the inclusion and exclusion of portfolios in the composite. Composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. Firms are encouraged to establish a policy that includes new portfolios in composites as soon as possible, preferably at the start of the first full performance measurement period. Firms must establish a policy that includes terminated portfolios in the historical performance of the composite through the last full measurement period that each portfolio was under management. Similarly, these policies should be replicated for the purpose of addressing significant cash flows in composites.

Grace period policies, as well as definitions and policies concerning significant cash flows, must be established and documented for each composite by the firm *before* they are implemented (i.e., before a significant cash flow occurs and preferably at the time each composite is created) and firms must not retroactively apply these policies to restate performance. Once implemented, the firm must consistently apply these policies (i.e., if a cash flow in a portfolio occurs that meets the definition of significant for that composite, the portfolio must be removed according to the guidelines). Firms must not reconsider whether a portfolio should be removed from a composite on an ex-post basis (after the fact) when it can be determined whether the cash flow has helped or hurt performance. It should be noted that the removal of a portfolio from a composite due to a significant cash flow will not affect the specific portfolio’s performance history. The definitions and policies for significant cash flows and grace periods for new portfolios or portfolios with significant cash flows can be amended, but the changes must not be applied retroactively. It is expected that the removal of portfolios due to significant cash flows will be an infrequent occurrence, particularly in composites that are invested in the larger, most liquid asset classes.

Firms are recommended to periodically review their policies regarding significant cash flows, especially if firms find that they are frequently removing portfolios due to significant cash flows. Firms are encouraged to establish significant cash flow policies and definitions for all of their composites, but are not required to do so.

### **Temporary Removal of Entire Portfolios with Significant Cash Flows**

If a firm has adopted a significant cash flow policy for a specific composite, the firm must disclose how it defines a “significant cash flow” for that composite and for which periods.

Firms are required to disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. With respect to significant cash flows, this information is expected to include:

- The grace period for the composite,
- If the definitions, policies, or grace periods for handling significant cash flows have been redefined the date and description of the change,
- The number of portfolios removed during a given period,
- The number of times portfolios were removed during a given period, and
- The amount of composite assets represented by the portfolios affected by the application of these policies.

It is important to note that if all of a composite’s portfolios were removed during one or more periods due to significant cash flows, there would be a break in the composite performance record. If a composite loses all of its member portfolios (whether that is due to significant cash flows, portfolio termination, or some other reason), the performance record stops. If portfolios are later added to that composite, the periods must not be mathematically linked. The periods both before and after the break in track record must be presented, with the break in performance clearly shown.

It is also important to note that removing a portfolio due to a significant cash flow removes the portfolio when transaction costs are expected to be higher. The intent of this Guidance Statement is not to allow firms to “hide” transaction costs, but rather to remove the potentially more disruptive effects that occur as a result of a significant cash flow.

### **Documentation**

Firms that have adopted a significant cash flow policy must document each time a portfolio moves into or out of a composite due to a significant cash flow. Documentation must be part of the firm’s record keeping process and, at a minimum, must include:

- The date of the significant cash flow, the date the firm removes the portfolio from the composite, and the date the firm returns the portfolio to the composite,
- Depending upon the firm’s definition of significant cash flow, the amount of the significant cash flow or the amount of the significant cash flow as a percentage of the most recent portfolio value, and
- If the significant cash flow is moving into or out of the portfolio.

Documentation will allow third-parties to easily determine whether firms have followed their grace period policy and definition of significant cash flow.

Firms must document their definitions and policies regarding significant cash flows, including the definition of the grace period and measure of significance. Firms must also document any changes that are made to the definitions or policies.

### **Temporary New Accounts**

The use of temporary new accounts is the most direct method for dealing with significant cash flows. A temporary new account is defined as an account for temporarily holding client-directed external cash flows until they are invested according to the composite strategy or disbursed. Firms can use a temporary new account to remove the effect of a significant cash flow on a portfolio. When a significant cash flow occurs in a portfolio, the firm may direct the external cash flow to a temporary new account according to the composite's significant cash flow policy. For example, if a significant cash flow is withdrawn from a portfolio at the end of the month, the firm would move the necessary cash and/or investments into a temporary new account for liquidation and/or distribution to the client.

Temporary new accounts must not be included in any composite. The portfolio that experiences a significant cash flow (the "main portfolio") would reflect the withdrawal of cash and/or investments as an external cash flow out of the main portfolio. Performance of the main portfolio would be calculated to include this cash outflow at the date of transfer to the temporary new account. The temporary new account would receive the cash and/or investments as an external cash flow from the main portfolio on that date. The investments would remain in the temporary new account until the funds are distributed. The same principles would hold true with a significant cash flow into the main portfolio. In this case, the cash and/or investments received would remain in the temporary new account until all cash and/or investments are invested in line with the main portfolio's investment mandate, objective, or strategy and then would be transferred into the main portfolio on that date and treated as an external cash flow.

Firms that are currently able to use a temporary new account methodology are encouraged to continue to do so. The GIPS standards recommend the use of temporary new accounts to remove the effects of significant cash flows. The removal of portfolios due to significant cash flows may no longer be permitted at some point in the future. The firm's policy for the use of temporary new accounts must be defined and consistently applied in the same manner as the policy for the temporary exclusion of a portfolio from a composite.

### **Effective Date**

The effective date for this Guidance Statement is 1 January 2011. Prior versions of this Guidance Statement are available on the GIPS standards website ([www.gipsstandards.org](http://www.gipsstandards.org)).