



ACA
 COMPLIANCE GROUP
 BEACON VERIFICATION SERVICES

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ATTEST **BVS**

Hello everyone and welcome to the June edition of the Beacon Newsletter. With 2010 just around the corner, an increasingly common discussion point that we are having with many of our firms concerns the upcoming requirement to revalue portfolios at all Large Cash Flows. The primary article in this issue addresses this requirement as well as highlights the distinction between Large and Significant Cash Flows, as this is a frequent source of misunderstanding. We also highlight a common question related to benchmarks in compliant presentations.

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External Cash Flows Requirement

As we get closer to 1/1/2010, we wanted to revisit an increasingly common discussion that we are having with many of our clients. This discussion concerns a GIPS compliant firm's requirement to revalue portfolios when the portfolios experience a Large External Cash Flow. Many firms currently have this ability (as they obtain pricing daily and have the ability within the system to calculate the sub period returns), but there are still many firms who will need to address this requirement within the next seven months. Furthermore, we thought this discussion would be a great opportunity to reiterate the distinction between Large and Significant Cash Flows as this is always a frequent source of confusion for many firms.

The first topic covers the Large External Cash Flow requirement. Starting 1/1/2010, firms must revalue portfolios on the date of all Large External Cash Flows. The Standards dictate that "Large Cash Flows must be defined by each firm for each composite to determine when the portfolios in that composite are to be revalued for performance calculations." Although the Standards do not provide guidance on what constitutes a 'Large Cash Flow' the intent of the requirement is to remove the probable distor-

tions that can be caused if a portfolio is not revalued at such flows.

The GIPS require firms to define a Large External Cash Flow by either an absolute dollar amount of the cash or asset flow into or out of the portfolio, or in terms of the percent of the portfolio value that the flow represents. It is far more common for firms to define a flow based on a percent of portfolio value. Furthermore, firms have the ability (CONTINUED)



to define a Large Cash Flow as either a single flow or an aggregate of multiple flows occurring over a specified time period. The driving force behind this requirement is that a portfolio return which is revalued will yield a more accurate return than a return using weighted cash flows. Though the operational requirements (the implicit ability to value portfolios daily) might be challenging for some firms, the GIPS feel that the benefit of the increased calculation accuracy is important enough to warrant the change.



As noted, this requirement will not impact firms that revalue portfolios daily since their revaluation frequency already satisfies the requirement. For firms that do not revalue daily, but have the ability to value accounts daily, handling Large Cash Flows can be fairly simple. A firm needs to set a minimum threshold, that when crossed, will trigger a revaluation of the account. A time weighted rate of return is calculated for each sub-period and the sub-periods are then geometrically linked to arrive at a total period return. This might be a more challenging obstacle for firms that do not have an easy way to value portfolios intra-month. Remember that technological barriers are not a permissible reason to disregard any required Standard. As such, we highly recommend that firms address any potential impediments. In addition, it is critical that wrap managers who rely on sponsor calculated performance ensure that account returns are revalued according to their composites' Large Cash Flow Policies.

Since all firms *must* revalue all portfolios at all 'Large External Cash Flows,' we highly encourage all firms to check their system capabilities to ensure that they have the ability to adhere to this upcoming requirement.

The next topic addresses the Significant Cash Flow Policy. This, unlike the Large External Cash Flow policy, does not become a requirement in 2010. Given the similarity in terminology, the two policies are often confused with each other. The GIPS define a Significant Cash Flow as an external cash flow (a client-initiated flow of cash, securities, or assets) that disrupts the implementation of the investment strategy. A considerable factor in the perpetual misunderstanding of these flows is the reverse use of the terms in some performance measurement systems. Within these systems Large Cash Flows are labeled 'Significant Cash Flows.' As a consequence, many of our clients misinterpret these two terms. The Standards explicitly outline two methods of handling these types of flows. Firms can either remove the entire account from the composite for a predetermined period, or they can establish temporary new accounts. Either way, the handling of "Significant Cash Flows" is materially different than the handling of the "Large Cash Flows." The Guidance Statement on Significant Cash Flows lists out some of these differences.

Since all firms must revalue all portfolios at all 'Large External Cash Flows,' we highly encourage all firms to check their system capabilities to ensure that they have the ability to adhere to this upcoming requirement. Currently, firms have the discretion of whether or not to institute a Significant Cash flow policy. Above all, as with everything concerning the Standards, firms need to define and consistently apply their policies. ◀



GIPS Q&A

A compliant firm is required to comply with all aspects of the Standards, including Q&A's. As such, we've decided to highlight some of the Q&A's that address the more common questions we field. For a full list of the Q&A's, please visit the GIPS website at gipsstandards.org.

Benchmarks

Q. If the firm changes the benchmark for a composite, should the benchmark be changed historically for the composite?

A. When making this decision, the firm should consider that the GIPS standards are an ethical set of guidelines for presenting composite performance. The firm must keep in mind the spirit of fair representation and full disclosure of the Standards when considering this retroactive change. Changes to the benchmark primarily intended to make historical performance look better by lowering the benchmark

return, violate the spirit of the Standards. Because benchmarks are continually evolving, if the firm deems the new benchmark is a more representative test of the effective implementation of an investment strategy, the firm may consider changing the benchmark retroactively. In most cases, however, it may be most appropriate to change/the benchmark starting in the current period. The firm must disclose the date the benchmark is changed and the reason it has been retroactively applied. In addition, firms are encouraged to continue to present the old benchmark.

Date Added: March 2001 ◀

Upcoming Webcast

Proposed Changes to the GIPS® in 2010

On this important webcast, we will discuss the proposed changes to the GIPS® and how they could affect your firm. With the public comment period ending July 1, 2009, you will want to make sure you comment on any substantive changes that will affect your firm. This webcast will review the most important proposed changes, give background as to why the changes have been proposed as well as the likelihood they will be adopted. There are several changes that firms must adopt in order to remain compliant with the GIPS® after the next edition is solidified by the end of this year. Questions and comments related to your firm specifically are encouraged during this educational webcast.

Please join us at 1:00 PM EST on Thursday, June 4th as Jeff Tarumianz, CFA, CIPM; Managing Director of ACA Beacon Verification Services discusses how your firm can plan for the upcoming changes in order to remain in compliance with the GIPS®. ◀

Beacon Comes to NY Metro!

As Beacon continues to grow, we are very excited to announce the upcoming opening of Beacon's first satellite office in NY Metro! This expansion will allow us to better serve our increasingly large client base in the Northeast. Stay tuned for more details. ◀