



ATTEST **BVS**

Hello and welcome to the February edition of Attest BVS. During these somber times we pause to think of the turbulent environment we all are dealing with which is only exacerbated by the continuing news of fraud in the marketplace. Thus, in this edition, we take some time to consider the recent news of the Madoff scandal and examine this within the scope of the GIPS. In addition, we also have a quick tidbit (and a slightly more dry piece) on calculation methodologies which may prove to be helpful for those using the Aggregate method to calculate composite returns. As always, please let us know if you have any questions or comments.

INSIDE THIS ISSUE

GIPS in the Madoff Era	1	Beacon Comes to NY Metro!	3
The Aggregate Method	3	Congratulations!	3

GIPS in the Madoff Era

In mid-December, Bernard Madoff was arrested and charged with possibly the largest financial fraud ever, purportedly losing as much as \$50 billion of his clients' investments in a massive Ponzi scheme.

In the wake of this discovery there has been significant media attention and public outcry over how so many investors, who invested so much, could have been deceived in such an egregious manner. Of course the answers to this question will take many months to surface as more is learned each day about how Mr. Madoff orchestrated this scheme. However, the initial response in the marketplace is already noticeable.

An immediate reaction is the increased due diligence which investors will be performing before

they place their assets. It is abundantly clear that many of Mr. Madoff's investors did not perform sufficient research, and as a result, it is no surprise to see increased investor scrutiny of money managers. Managers now face an even more important task of ensuring transparency in their operations and full disclosure of all processes and procedures used in the investment strategies they employ.

A natural consequence of this demand for increased transparency and disclosure will be a move in the asset management industry to further (CONTINUED)



embrace GIPS compliance. The GIPS are a voluntary set of best practices used by investment managers to calculate and present their investment performance. The overriding fundamentals of the GIPS are full disclosure and fair representation, and as more and



more firms choose to comply, we will see a more credible and honest environment in the investment industry. Compliance with the GIPS is not necessarily an easy undertaking for many firms to achieve, as it requires a commitment from not only the performance measurement group, but also from a firm's compliance and marketing departments as well. Compliance is, of course, abiding by each of the GIPS requirements, but it is also more than that. The claim of compliance becomes a mindset, a true indication of a firm that wants to be as open and honest with its prospective clients as possible. Firms that choose not to claim compliance are likely to do so because they either have something to hide (as Mr. Madoff did) or because they do not want to make the effort to commit to industry best practices (likely the more prevailing reason why a firm chooses not to comply). For whichever reason compliance is not claimed, the prospective investor should be rightfully hesitant to invest.

In an effort to be as open as possible, there is a second step after compliance which we expect more

firms to take. This is the third-party verification of a firm's claim of compliance. Claiming compliance is certainly a major step in the right direction for firms that want to increase their transparency. However, the independent examination of this claim from a third-party verifier is what really signals to the marketplace that a firm is actually adhering to all of the requirements of the GIPS. Allowing an independent party to come into a firm and examine its underlying records and methodologies also is a strong indication that a firm has nothing to hide.

A firm's choice of service providers is equally as important as the firm's desire for independent verification. Though Mr. Madoff did not choose to embrace the GIPS or verification, he has been routinely lambasted for his poor choice of service providers. Specifically criticized was his choice of auditor and custodian, who were either unqualified, or directly affiliated with his firm. In selecting any service provider, it is important that a firm select an established, independent, and reputable partner. The provider that a firm chooses is a reflection of the firm itself. As Mr. Madoff has received such widespread criticism for his poor choice of providers, we anticipate more questions from prospective clients about the quality of firms' third party providers. If a firm is confident in the abilities of its third-party partners, then this increased attention should be a welcome opportunity to explain how the third-party benefits the firm.

As prospective investors require more transparency and diligence from investment firms, it is natural that they will want to see firms not only comply with the GIPS, but also take the extra step to have a third-party attest to the firm's claim of compliance. Though neither of these two initiatives is required by any regulatory body, it is abundantly clear that the market forces are dictating that firms move toward compliance and independent verification if they want to compete for assets. ◀



The Aggregate Method

As verifiers, we see certain questions with quite a bit of regularity. One such question we inevitably encounter during volatile times (the current time being a prime example) relates to a firm's use of the Aggregate method in composite return calculations.

With the use of this method, it is very possible that the returns of the composite and the underlying accounts are disparate. As you may know, for firms calculating composite returns monthly, the Aggregate method sums the underlying accounts and treats them all as one large account. The monthly return for the composite is then calculated using the Modified Dietz. The tricky part here is that most firms have an established threshold whereby accounts (both individual portfolios and the composite itself) are revalued.* The problem arises when the threshold is reached at the account level but not the composite level. At this point, the accounts experiencing the cash flows get revalued while the composite does not. Enough such events will cause quite a difference between the composite and the account returns. So, the next time you wonder why the returns for all the accounts in the composite do not line up with the composite return; consider lowering your composite revaluation threshold.

*The need for revaluation is an inherent issue with the weighting methodology in the Modified Dietz formula, and the GIPS will mandate the revaluation at large cash flows in 2010 for accounts' returns. ◀

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. ◀

Congratulations!

Warm congratulations go out to Christie Dillard for passing the Principles level of the CIPM exam. Congrats Christie!

We at Beacon are strong supporters of the CIPM program. The designation involves a demanding pair of tests which is excellent preparation for the everyday challenges we face as verifiers. ◀