



ATTEST **BVS**

We hope that 2008 is off to a great start for you and your associates. This month’s focus article sheds light on issues in the GIPS world related to Large and Significant Cash Flows. We believe the distinction between Large and Significant Cash Flows is often overlooked or misunderstood. In addition, we will introduce you to new employees and share some joy in congratulating our employees who have passed the CIPM.

INSIDE THIS ISSUE

Large Versus Significant Cash Flow 1	March 2008 Conference. 4
Employee Spotlight 4	BVS Congratulates. 4

Large Cash Flow Versus Significant Cash Flow

An increasingly common problem that we encounter is the confusion between the terms Large Cash Flow and Significant Cash Flow. Firms often mistakenly reference the wrong term when confronted with handling cash flows of a sizeable nature.

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 Significant Cash Flow is not to be confused with a Large Cash Flow, which necessitates the portfolio be revalued. Large Cash Flows are generally large enough in size that the portfolio experiencing the flow needs to be revalued in order to prevent a distorted/skewed return; however, they are not quite so sizeable that they disrupt the effective implementation of the 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 have the opposite understanding of these terms, and this often translates into incorrectly written procedures in the Policies and Procedures document.



The way to effectively deal with a Large Cash Flow is fairly simple. A firm needs to set a minimum threshold, that when crossed, will trigger a revaluation of the account. The two sub-periods are then geometrically linked to arrive at a total period return. This threshold may be defined either in an absolute



dollar value or as a percentage of the account. Currently, the Standards do not require a policy regarding Large Cash Flows; however, in 2010, the GIPS will require all firms to define a Large Cash Flow, and to revalue an account each time this type of flow is experienced.

A more challenging set of procedures concerns the proper treatment of Significant Cash Flows. By definition, these types of flows hinder the successful and complete implementation of an investment strategy, and thus compromise the strategy's performance. Before contemplating the various options of dealing with Significant Cash Flows, it is important that the firm first define what constitutes a Significant Cash Flow. The determination of significance will vary from composite to composite, depending on the strategy employed. In fact, the definition of significance is dependent upon the characteristics of the assets in the portfolio, such as market volatility, liquidity, etc. As with Large Cash Flows, a Significant Cash Flow threshold may be defined either in an absolute dollar value or as a percentage of the account.

There are two generally accepted ways to deal with Significant Cash Flows. The first is to temporarily remove the portfolio experiencing the cash flow from the composite. The temporary removal and subsequent inclusion of the portfolio

back into the composite should follow the inclusion and exclusion policies which govern new and closed accounts. That is, if a new account is included at the beginning of the next full performance period, the

Large Cash Flows are generally large enough in size that the portfolio experiencing the flow needs to be revalued in order to prevent a distorted/skewed return; however, they are not quite so sizeable that they disrupt the effective implementation of the strategy.

re-inclusion of a temporarily removed account should be at the beginning of the next full performance period.

Additionally, there are several items which must be disclosed in each composite presentation if a firm chooses to temporarily remove accounts. These are:

1. The definition of Significant Cash Flow for that composite.
2. The grace period (inclusion/ exclusion policy) for the composite.



3. If definitions, policies, or grace periods for handling Significant Cash Flows have been changed, it is necessary to disclose the date and nature of the change.
4. That Additional Information concerning Significant Cash Flow treatment is available upon request. This information must include:
 - a. Number of portfolios removed during a given period.
 - b. Number of times portfolios were removed during a given period.
 - c. Amount of composite assets in portfolios which were affected by these policies.

In addition to the required disclosures, there are several record keeping regulations to which a firm utilizing temporary account removals must adhere. A firm must document:

1. Date of cash flow, Date portfolio was removed from composite, and Date the portfolio was returned to the composite.
2. The amount of cash flow, or percentage of the portfolio's market value, depending upon the Significant Cash Flow definition.
3. If the cash flow is entering or exiting the portfolio.

It is important to remember that if all accounts are removed from a composite during a given period, a break in performance will be created. To ensure that this does not happen, especially for composites with a very small number of accounts, the measure of significance should be set at a relatively high level.

The second method for dealing with Significant Cash Flows involves the use of Temporary New Accounts. This means that a Significant Cash Flow in a portfolio is treated as a "new" account. Put into practice, a Significant Cash Flow entering into a portfolio will first be put into a Temporary New Account, where it will remain until all assets are invested in line with the investment strategy. At this point, the assets will be transferred into the portfolio. The same concept applies to a Significant Cash Flow exiting a portfolio. The assets will be withdrawn from the portfolio and placed in a Temporary New

Account, where the liquidation and distribution can take place. The portfolio's performance will consider the outflow of assets into the Temporary New Account a cash outflow on the date of transfer. The GIPS do not require Temporary New Accounts to be included in a composite. Furthermore, the GIPS consider the use of Temporary New Accounts to be "the most direct method for dealing with Significant Cash Flows." As such, they strongly endorse their use, as opposed to the temporary removal of the entire portfolio from the composite.



To underscore the overriding point of this article, it is important for firms to understand the distinction between these two types of flows. Firms then have a choice whether or not to institute Large or Significant Cash Flow policies. As mentioned above, this choice for Large Cash Flows disappears in 2010 when firms will be required to institute a policy that addresses the revaluation of portfolios due to Large Cash Flows. At this point, it appears that there will be no such requirement regarding Significant Cash Flows. Above all, firms need to define and consistently apply their policies regarding both Large and Significant Cash Flows.



Employee Spotlight: Christie Dillard



Christie Dillard is a verification associate serving our client base with the initial and on-going verification of GIPS compliance.

Prior to joining ACA, Christie spent six years in retail commercial banking. During her career in banking, Christie served as a commercial credit analyst, a private client relationship manager, and a branch manager.

Christie graduated from The University of the South in Sewanee, Tennessee with a B.A. in Economics. She will be taking the CIPM exam in the coming months.

March 2008 Conference

Learn to survive the dangerous compliance waters at ACA's Compliance Conference.

We are excited to let you know about ACA's upcoming SEC conference. The conference will be held March 11 - 13, 2008 in Scottsdale, Arizona. It will cover a wide array of topics pertaining to SEC compliance, including some of the more challenging issues facing the industry today. To learn more, please visit www.acacompliancegroup.com/conference/.

Topics will Include:

- ▶ Trading
- ▶ The Compliance Program
- ▶ Code of Ethics
- ▶ Performance/GIPS



Congratulations!

Hearty congratulations to Alicia Hyde and Coley McKinstry for passing the Expert level exam of the CIPM program (Certificate in Investment Performance Measurement). We also congratulate Shamyia Sermons and Deborah Knowles for passing the Principles level exam.