



Introduction

Earlier this fall, Beacon sent a team to Chicago to attend the Annual GIPS Conference. We always feel that this event provides a unique opportunity for us to stay at the forefront of the Standards. We realize that many of you are also interested in these developments, and consequently, this special edition of our newsletter is devoted to the topics which were covered at the GIPS Conference. As always, the Conference provided interesting perspectives on some very important issues, and these are summarized in the following articles.

CIPM Update

Philip Lawton, the head of the CIPM program gave a quick update on the industry's newest examination. He indicated that the CIPM test is gaining momentum within the industry. Topics covered include ethics, performance measurement, attribution, performance appraisal, and the GIPS, themselves. This is a two part test which requires approximately 60 hours of preparation for each level. The committee has updated the online preparation tools to be more user-friendly. It should be noted that based on the surveys, the majority of the successful candidates used both the online tools and the excerpt readings. We at Beacon fully support the program (approximately 90% of Beacon's employees are either certificate holders or candidates) and feel that the test is a great tool to master the standards. Good luck to all taking the test soon!



Manager Searches and the Use of the GIPS Standards

This year's annual conference also had a section dedicated to the use of the GIPS in relation to manager searches conducted by investment consultants. Howard Crane, CFA, formerly a Practice Director for Watson Wyatt Investment Consulting, pointed out several interesting items that firms should consider when submitting their performance to consultant databases and RFP's.

While performance is certainly a crucial part of the manager selection, Mr. Crane pointed out that survey results indicate that only about 20% of the manager selection decision is based on past performance. Quality of the investment decisions, the firm's brand and processes, and the firm's proposed service and team approach are all important factors consultants consider in addition to performance when consultants conduct a manager search.

Mr. Crane also pointed out that voluntarily complying with the GIPS is certainly an added benefit to the firm's current clients, prospective clients, consultants, and the firm itself. However, surveys indicate that most firms choose to comply with the Standards and be verified to meet unofficial industry mandates for institutional investors and the investment consultants who represent these investors. Mr. Crane hit on another important point that many familiar with the GIPS already know: when the Standards were first introduced, claiming compliance with the GIPS was considered a competitive advantage; however, as the Standards have become generally recognized and accepted within the investment community, non-compliance has become more of a disadvantage, essentially pointing to the fact that compliance with the GIPS has become the unofficial mandate for performance reporting.



Frequently Asked Questions from the GIPS Conference

Below is a sampling of the FAQs that a panel at the conference answered:

Q. On our website, we include information in compliance with the GIPS Advertising Guidelines. Must we include a link to a fully compliant presentation and/or list and description of composites?

A. No. This was a requirement from the old AIMR-PPS, but is no longer required.

Q. Is it correct that you don't have to use the Modified Dietz method if you revalue portfolios for large cash flows?

A. No, this is not correct. After 2010, portfolios will be revalued for large cash flows, but the Modified Dietz will still be used to calculate the sub periods. This is of course assuming daily valuation is not utilized.

Q. What time period is used to calculate dispersion?

A. Your firm's favorite dispersion measure is calculated using all accounts that have been in the composite for the entire year.

Q. If a gap exists in performance for a GIPS-compliant firm, is it ok to link the two periods?

A. No, this is obviously not permitted. When a gap in performance exists, "prior performance history of the composite should be shown but not linked to the ongoing composite performance results." (p.172 in the GIPS Handbook)

Q. Can a GIPS compliant presentation show more than one benchmark?

A. Yes, though it should be disclosed that one is your primary benchmark, and one is your secondary benchmark.



Applying the GIPS to Hedge Funds and other Alternative Assets

The hedge fund industry is becoming increasingly receptive to the idea of complying with the Standards.

However, because of the general complexity involved in many hedging strategies, application of the GIPS to hedge funds can be very difficult. This is because:

1. The Standards were originally established for traditional investment strategies
 - a. Many issues unique to hedge funds, such as multiple series or share classes, are not addressed by the GIPS
 - b. Standards do not always apply neatly to hedge funds.
2. The hedge fund industry has not historically embraced the GIPS, and the hedge fund marketplace has not required compliance the way traditional investors have.

Specific Issues include:

Composite Definition

A track record can reflect variation in strategies (think share class, series, etc.) employed over time. Can define strategy:

- o Broadly – Combining all variations (share class/series)
- o Narrowly – Each variation is in its own composite.

Calculation Methodologies

Different methodologies can have vastly different returns, so it is of paramount importance to maintain consistency.

-Viable methodologies include:

- o Using NAV, calculated by a third party administrator
- o Time-Weighted Rate of Return, much the same way separate accounts are calculated
- o Internal Rate of Return – More applicable for private equity, or any time a manager controls the timing of the cash flows.



Applying the GIPS to Hedge Funds and other Alternative Assets (cont.)

Performance / Incentive Fees

-Individual investors may pay different fees depending on when they invested.
How do you deal with this?

- o Track Original Investor – Present a return for the initial series.
- o Aggregation / Weighted Average – Combine all investors; however, this could be misleading due to deviations in investor returns.

Side Pocket Investments

-This is similar to the performance fee issue, but it occurs when some investors can invest in “side pocket,” or special investments, that not everyone in the fund can invest in.

-Need to present the most representative fund return, but how?

- o Liquid Share Class – The return without impact of side pockets
- o Track Original Investor – Reflect the original investor’s participation in all side pocket investments.
- o Aggregation/Weighted Average – Pool all investors together to get total return.

No definitive guidance exists for how to deal with these side pocket and different fee structures, but it remains paramount to disclose all policies and calculations.

It was announced at the conference that the GIPS Executive Committee hopes to have a draft of guidance on Hedge Funds out before the end of the year.

Above all, when presenting performance for hedge and alternative strategies, remember the spirit of the GIPS – fair representation and full disclosure.



Update from the SEC

We've recently discussed the SEC's first "Compliance Alert" in our newsletter and touched on its impact. This topic was covered during the conference by William R. Meck of the SEC. The alert pointed out some very interesting information regarding firms that claim compliance and common errors the SEC encountered during the sweep. The speaker touched on several pertinent aspects of that sweep including how firms included in the sweep were identified, some of the interesting notes, and finally, what this means for future SEC audits.

An SEC sweep differs from a regular audit in that the SEC chooses a particular issue on which to focus instead of examining the firm as a whole. To determine the sample of firms that would be included in the sweep, the SEC looked at top firms in industry magazines which were known not to scrutinize returns submitted by firms for surveys. It then took out firms with mutual funds since these are highly scrutinized and the likelihood of the mutual funds being incorrect were slim. Finally, the SEC removed additional firms they were comfortable with, and ended up testing a sample of 31 RIA's.

After the sweep, the SEC aggregated some interesting points. An intuitive point is that the quality of the firm's Policies and Procedures document was found to be correlated to the level of the firm's compliance. Another interesting point was that the degree of the verification was not correlated to the firm's verification firm, i.e., firms with larger verification firms were not more likely to be compliant than RIA's verified by smaller firms.



New GIPS Guidance

As we all know, it is imperative that Firms comply with all applicable requirements of the GIPS® standards, including any updates, reports, guidance statements, interpretations, and clarifications published by CFA Institute (GIPS® Provision 0.A.15). It is equally important that the Standards adhered to are up-to-date and current.

Please remember that all guidance statements are issued for public comment (60-90 days). Therefore, it is vital that firms respond to requests for comments. It is just as important to say you agree as to disagree; after all, the Executive Committee can only respond to what the public proposes!

Below is a list of a new Guidance Statements (GS) that were highlighted in the GIPS® Conference.

Performance Examination GS

- This Guidance Statement includes minimum procedures that must be performed to ensure the consistency of the services being provided.
- There is no particular reporting format; much is left to the verifier's judgment.
- The Effective Date is December 31, 2006.

Record Keeping GS

- There is no "MAGIC LIST" because each firm is different. Nevertheless, one must maintain supporting records that correspond to the performance presented. Whatever you need to support your claim of compliance must be readily available and easy to access (whether in hard copy or electronically).
- This Guidance Statement is not limited to portfolio recordkeeping, but also should be applied to recordkeeping on the composite and firm level.
- If the firm experiences a catastrophic event that is beyond the control of the manager and causes the firm to lose underlying data, the firm may continue to claim compliance if the lack of records is disclosed, along with the reason for the missing records, and the fact that the firm is unable to make duplicates.
- The Effective Date is October 31, 2007.



New GIPS Guidance (cont.)

Error Correction GS

- This Guidance Statement was issued for public comment and is currently under review.
- What should a firm do if it experiences an error (since there is no current guidance in GIPS)?:
 - o Consider following the old AIMR concepts
 - Bring composite into compliance; institute steps to ensure the error won't recur; deliver corrected compliant information
 - o Rely on the Guidance Statement draft for ideas.

Verification: Mandatory or Voluntary

Verification – Mandatory or Voluntary...That is the ultimate question!

Much talk about mandatory verification has continued to linger in the atmosphere within the financial sector. Other countries have previously mandated verification or believe it should be mandated. What is keeping the US from requiring companies to undergo independent verification? Needless to say, the Standards have documented the expectation of mandating verification ever since the 1999 GIPS, but the debate on this topic appears to be coming to an end.

Some industry members may side with intellects who feel that independent verification is valuable and promotes global consistency. These optimists believe that the Standards will lose their credibility and all firms verified, or not, will appear as equal competition if verification prevails without a mandate.



Verification: Mandatory or Voluntary (cont.)

However, other industry members may feel that the industry already mandates itself, and therefore, mandatory verification is unnecessary because the market is working just fine. Indeed, they question whether there are enough qualified verifiers in the industry to service such a demand. In fact, independent verification is costly and would likely be a burden for smaller firms. Likewise, verification does not verify compliance; it tests whether the firm has complied with all composite construction requirements and that the firm's processes and procedures are designed to calculate and present performance compliant with the GIPS standards.

As it stands now, the Executive Committee of the GIPS has decided to keep verification voluntary.

What is Verification?

Although verification is becoming more common and is almost a prerequisite in the industry, there are still many questions about what verification actually is. The speaker at the conference underscored the importance of fully understanding what verification is. Verification is not required to be compliant; however, engaging a verifier will ensure that a firm has the proper outlines in place to lead to compliance. This is accomplished in two overarching steps: ensuring that a firm has complied with all composite construction requirements of the Standards on a firm-wide basis and that the processes and procedures are designed to calculate and present performance results in compliance with the standards.

Verification ensures that a GIPS compliant firm complies with the composite construction requirements of the Standards on a firm-wide basis. This is a crucial point that can get blurred given some SEC requirements. A firm that claims compliance does so as a whole firm, irrespective of which composites it markets. The standards require that all fee paying, discretionary accounts are in at least one composite.



What is Verification? (cont.)

The goal of verification is to ensure that a firm's policies are developed to do just this. The next item that verification addresses is whether or not the firm's processes and procedures are designed to calculate and present performance results in compliance with the Standards. The verification process is based on a sampling basis which takes into account many factors, including the firm's control policies.

Once a firm has received its firm wide verification, the next optional step is to receive a performance examination on specific composites. The performance exam is composite specific, and the objective is to check the specific composites more thoroughly. However, a performance exam cannot be done without having a firm wide verification first. The speaker noted the trend that the firms in the US are more prone to obtain a performance exam whereas firms abroad usually receive only a firm wide verification.

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