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INVESTMENT PERFORMANCE COUNCIL (IPC)

Guidance Statement on the Treatment of Significant Cash Flows

Dealing with large external cash flows in a portfolio is a common struggle for most investment managers. These large flows, of cash and/or securities, can make a significant impact on investment strategy implementation 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

GIPS Section II.3.A.3 requires that composites include new portfolios on a timely and consistent basis after the portfolio comes under management - unless specifically mandated by the client (e.g., a client mandates a schedule of initial cash flows over several time periods and can prolong the length of time needed to implement the strategy). 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 management 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 strategy. It is also reasonable that when cash flows to a portfolio are significantly large, the same process that governs the introduction of a new portfolio into a composite should apply.

Cash Flow Definition

For the purposes of this guidance statement, a "cash flow" is an external flow of cash and/or securities *(capital additions or withdrawals)* that is client initiated. 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 Discretion section of the Guidance Statement on Composite Definition and consider whether the portfolio should be classified as non-discretionary.

Significant Cash Flows

Firms that wish to remove portfolios in cases of Significant Cash Flows must define what is meant by "significant" on a composite-by-composite basis. The definition may be influenced by the characteristics of the asset class(es) within the strategy, such as asset market liquidity, market volatility, and/or by the trading capabilities of the investment manager. (For instance, a

Significant Cash Flow may be considered 10% of a portfolio's market value for an Emerging Market Fixed-Income composite but may be in excess of 50% of a portfolio's market 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, 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 composite 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).

Temporary Removal of Entire Portfolios with Significant Cash Flows
Provided the provisions below are met, firms are permitted to temporarily remove portfolios from composites if the firm believes that Significant Cash Flows can disrupt the implementation of the investment style and strategy for a portfolio. Firms must establish criteria (i.e., policy and definition) on a composite-by-composite basis. Firms are encouraged to establish Significant Cash Flow policies and definitions for all of its composites, but are not required to do so.

The temporary removal of a portfolio from the composite is similar to the grace period permitted for a new portfolio while the intended strategy is implemented. Firms must remove portfolios as of the beginning of the period in which the Significant Cash Flow occurs. In this respect, the portfolio is treated similarly to a terminated portfolio. Portfolios that are temporarily removed from composites due to Significant Cash Flows must be returned to their respective composite according to the firm's policy defining the grace period for new portfolios. The firm is required to define this grace period, and may do so on a firm wide or composite-by-composite basis.

Grace period policies, as well as definitions and policies concerning Significant Cash Flows, must be established and documented for each composite by the firm <u>before</u> they are implemented (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 remove portfolios 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 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 or cash flow-impacted portfolios can be amended, but the amendments 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.

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. Firms that have composites with only a few portfolios should strongly consider either defining the measure of significance at a very high level or possibly determining that a Significant Cash Flows policy is not appropriate for that composite. 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 two periods cannot be linked.

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 high. 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 must document each time a portfolio moves into or out of a composite. Documentation should be part of the firm's record keeping process and, at a minimum, must include:

1. the date,
2. the amount of the cash flow,
3. if the cash flow is moving into or out of the portfolio, and
4. the amount of the cash flow as a percentage of the most recent portfolio market value.

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 amendments that are made to the definitions or policies.

Disclosures
If a firm wishes to make use of the option to remove portfolios when Significant Cash Flows occur, then it must disclose the following items in each composite presentation:

1. how the firm defines a "Significant Cash Flow" for that composite,
2. the grace period for the composite,
3. if the definitions, policies, or grace periods for handling Significant Cash Flows have been amended, and
4. that additional information regarding the treatment of Significant Cash Flows is available upon request.

Upon request, firms must disclose to clients the number of times portfolios were removed during a given period, the number of portfolios removed, and the amount of assets represented by the portfolios affected by the application of these policies to the composite.

Temporary New Accounts
The use of Temporary New Accounts remains the most direct method for dealing with Significant Cash Flows. Under this methodology, when Significant Cash Flows occur in a portfolio, the firm may treat these cash flows as temporary "new" accounts. 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 securities into a Temporary New Account for liquidation and/or distribution to the client. In most cases Temporary New Accounts would not be included in any composite. The account would reflect the withdrawal of funds and/or securities as a cash outflow of the account, and the performance figures would be calculated to include this cash outflow at the date of transfer to the temporary account. The Temporary New Account would receive the funds and/or securities as a cash inflow. The assets would remain in this account until the funds are distributed. The same principles would hold true with a cash inflow. In this example, the funds would remain in the temporary account until invested in line with the manager's standard policy for the mandate and then be transferred to the main account.

Firms that are currently able to use a Temporary New Account methodology are encouraged to continue to do so. However, technology at the present time does not readily allow for the use of this method. It is anticipated that the Investment Performance Council (IPC) will adopt a requirement to use Temporary New Accounts to handle significant cash flows beginning January 1, 2010, provided that the technology and programming required exists and is not cost prohibitive. At that time, it is expected that the removal of portfolios due to significant cash flows will no longer be allowed. 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 an account from a composite.

Effective Date

These changes are effective 30 June 2002. Firms must not apply these guidelines prior to the implementation date of the firm's policy and these guidelines must not be used to retroactively restate performance. Firms currently coming into compliance must not apply this guidance to composite performance for periods prior to 30 June 2002.