



Global Investment Performance Standards

Guidance Statement on the Treatment of Significant Cash Flows

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www.gipsstandards.org

GIPS® Guidance Statement on the Treatment of Significant Cash Flows (~~Revised~~)

Introduction

Dealing with large external cash flows in a portfolio is a common struggle for most ~~investment managers~~ firms. These ~~large~~ flows, of cash ~~and/or securities, investments~~ can make a significant impact on the implementation of an investment mandate, objective, or 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

~~The GIPS Provision H.3.A.3 requires standards require~~ that composites ~~must~~ include new portfolios on a timely and consistent basis after ~~the each~~ 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 Provision 3.A.4 states standards also state that terminated portfolios must be included in the historical returns performance of the appropriate composites ~~up to~~ through the last full measurement period that ~~the each~~ portfolio was under management.

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~~ mandate, objective, or 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 mandate, objective, or strategy. It is also reasonable that when external cash flows to a portfolio are significantly large, the same process applies that governs the introduction of a new portfolio into a composite.

External Cash Flow Definition

For the purposes of the GIPS standards, an external cash flow is defined as ~~“capital (cash, securities or assets investments) that enters or exits a portfolio,” (i.e., capital additions or withdrawals. A significant cash flow is defined as the level at which the firm determines that are generally client initiated).~~ a client directed external cash flow may temporarily prevent the firm from implementing the composite strategy. 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 discussion of dDiscretion section in of the Guidance Statement on Composite Definition and consider whether the portfolio should be classified as non-discretionary.

For a discussion of the distinction between external ~~cash flows~~, large ~~external~~ cash flows, and significant cash flows, please see the Guidance Statement on Calculation Methodology.

Significant Cash Flows

Firms that wish to remove portfolios from composites in cases of significant cash flows must define ~~what is meant by~~ “significant” on ~~an ex-ante composite-~~by-specific basis and must consistently follow the composite-basis-specific policy. The definition may be influenced by the characteristics of the asset class(es) within the strategy, such as market liquidity, ~~market volatility~~, and/or by the trading capabilities of the investment manager. (For instance, a significant cash flow may be considered 10% ~~percent~~ of a portfolio’s ~~market~~ value for an emerging market fixed-income composite but may be in excess of 50% ~~percent~~ 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, external 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~~internal 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).

Grace Periods for the Treatment of Significant Cash Flows

Each composite ~~should~~must have a portfolio inclusion policy for new portfolios and an exclusion policy for terminated portfolios. It is the responsibility of the firm to set reasonable guidelines for each composite regarding the inclusion ~~and~~ exclusion of portfolios in the composite. Composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. Firms are encouraged to establish a policy that includes new portfolios in composites as soon as possible, preferably at the start of the ~~next~~first full performance measurement period. Firms ~~are also encouraged to~~must establish a policy that includes terminated portfolios in the historical performance of the composite through the last full measurement period ~~the that each~~ portfolio ~~is~~was under management. Similarly, these policies should be replicated for the purpose of addressing significant cash flows in composites.

Grace period policies, as well as definitions and policies concerning significant cash flows, must be established and documented for each composite by the firm *before* they are implemented (i.e., before a significant cash flow occurs and 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 reconsider whether a portfolio should be removed from a composite 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 from a composite 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 or portfolios with significant cash flows can be amended, but the changes 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.

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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. Firms are encouraged to establish significant cash flow policies and definitions for all of their composites, but are not required to do so.

Temporary Removal of Entire Portfolios with Significant Cash Flows

If a firm ~~wishes to make use of the option to remove portfolios when Significant Cash Flows occur, then it has~~ adopted a significant cash flow policy for a specific composite, the firm must disclose ~~the following items in each composite presentation:~~ how ~~the firm it~~ defines a “significant cash flow” for that composite, and for which periods.

Firms are required to disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. With respect to significant cash flows, this information is expected to include:

- ~~• how the firm defines a “Significant Cash Flow” for that composite~~
- The Grace period for the composite,
- If the definitions, policies, or grace periods for handling significant cash flows have been redefined, ~~firms must disclose~~ the date and nature ~~description~~ of the change, and
- ~~• That additional information regarding the treatment of Significant Cash Flows is unavailable upon request, which must include:~~
 - The number of portfolios removed during a given period,
 - The number of times portfolios were removed during a given period, and
 - The amount of composite assets represented by the portfolios affected by the application of these policies.

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~~ must not be mathematically linked. The periods both before and after the break in track record must be presented, with the break in performance clearly shown.

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 higher. 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 that have adopted a significant cash flow policy must document each time a portfolio moves into or out of a composite due to a significant cash flow. Documentation must be part of the firm’s record keeping process and, at a minimum, must include:

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- The date of the significant cash flow, the date the firm removes the portfolio from the composite, and the date the firm returns the portfolio to the composite,
- Depending upon the firm's definition of significant cash flow, the amount of the significant cash flow or the amount of the significant cash flow as a percentage of the most recent portfolio ~~market~~-value, and
- If the significant cash flow is moving into or out of the portfolio.

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 changes that are made to the definitions or policies.

Temporary New Accounts

The use of temporary new accounts ~~is~~remains the most direct method for dealing with significant cash flows. ~~Under this methodology, when Significant Cash Flows occur A temporary new account is defined as an account for temporarily holding client-directed external cash flows until they are invested according to the composite strategy or disbursed. Firms can use a temporary new account to remove the effect of a significant cash flow on a portfolio. When a significant cash flow occurs in a portfolio, the firm may treat these direct the external cash flows as to a temporary new accounts- according to the composite's significant cash flow policy.~~ 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~~investments into a temporary new account for liquidation and/or distribution to the client.

Temporary new accounts ~~must not~~are not required to be included in any composite. The portfolio ~~that experiences a significant cash flow (the "main portfolio")~~ would reflect the withdrawal of ~~funds cash~~ and/or ~~securities~~investments as ~~an external cash outflow~~flow out of the ~~main portfolio~~, ~~and the p~~Performance of the main portfolio would be calculated to include this cash outflow at the date of transfer to the temporary new account. The temporary new account would receive the ~~funds cash~~ and/or ~~securities~~investments as ~~an external cash inflow~~flow from the main portfolio on that date. The ~~assets~~investments would remain in ~~this~~the temporary new account until the funds are distributed. The same principles would hold true with a significant cash ~~inflow~~ into the main portfolio. In this ~~example~~case, the ~~funds cash and/or investments received~~ would remain in the temporary new account until all ~~funds cash and/or investments in the temporary new account~~ are invested in line with the main portfolio's manager's standard policy for the investment mandate, objective, or strategy and then would be transferred in to the main portfolio on that date and treated as an external cash flow.

Firms that are currently able to use a temporary new account methodology are encouraged to continue to do so. ~~Although technology at the present time does not readily allow for the use of this method, the~~The GIPS standards recommend the use of temporary new accounts to remove the effects of significant ~~external~~ cash flows. The removal of portfolios due to significant cash flows may no longer be permitted at some point in the future. The firm's policy for the use of

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temporary new accounts must be defined and consistently applied in the same manner as the policy for the temporary exclusion of ~~an portfolio-account~~ from a composite.

Effective Date

The effective date for this Guidance Statement is 1 January 2011. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

~~This Guidance Statement was originally effective 30 June 2002 and was revised to reflect the changes to the GIPS standards effective as of 1 January 2006.~~

~~Firms must not apply these guidelines prior to the implementation date of the firm's Significant Cash Flow policy as described above and 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.~~

~~The revisions made to this guidance (effective 1 January 2006) must be applied to all presentations that include performance for periods after 31 December 2005.~~

~~Key GIPS Provisions Specifically Related to Significant Cash Flows~~

~~3.A.3 Composite must include new portfolios on a timely and consistent basis after the portfolio comes under management unless specifically mandated by the client.~~

~~3.A.4 Terminated portfolios must be included in the historical returns of the appropriate composites up to the last full measurement period that the portfolio was under management.~~

~~3.B.2 To remove the effect of a significant external cash flow, the use of a temporary new account is recommended (as opposed to adjusting the composite composition to remove portfolios with significant external cash flows).~~