4. Gross-of-fees returns are presented before investment management fees and custodial fees but after trading expenses. All clients pay an investment management flat fee of 75 basis points on the month-end account value plus a 10-basis-point performance fee whenever the composite return exceeds the benchmark return by 100 basis points.
5. Internal dispersion is the equal-weighted standard deviation of the annual gross returns of the five portfolios included in WMC's Large-Cap Equity Composite.

McGourn asks Walter why he uses standard deviation as the measure of internal dispersion and whether there are better dispersion measures. Walter responds, "Standard deviation has the advantage of comparability across investment firms. Other measures, such as the high/low range and the interquartile range, are skewed by outliers."

Finally, McGourn asks Walter about WCM's policies regarding the valuation of its investments. Walter states that WCM uses a valuation hierarchy based on items 1 through 4 as follows:

Item 1. Observable quoted market prices for similar investments in active markets.

Item 2. Quoted prices for similar investments in markets that are not active.

Item 3. Market-based inputs other than quoted prices that are not observable for the investment.

Item 4. When no quotes or other market inputs are available, we use WCM estimates based on quantitative models and assumptions.

1. Is WCM most likely correct in claiming compliance based on the verification report?

A. Yes

B. No, because of the level at which verification is claimed

C. No, because of the timeframe for which verification is claimed

Solution: B.

B is correct because a single verification report is required to be issued with respect to the whole firm. Verification cannot be carried out only on a composite and, accordingly, does not provide assurance about the investment performance of any specific composite. The Standards stress that firms must not state or imply that a particular composite has been "verified."

2. WCM's methodology for calculating performance, as disclosed in Note 1, is least likely consistent with GIPS standards for:

A. External cash flows.

B. Geometrically linked returns.

C. Frequency of return calculations.

Solution: C.

C is correct. WCM's return calculation is not GIPS compliant. GIPS requires that returns are calculated on a monthly basis for periods beginning on or after 1 January 2001.

3. Is WCM most likely compliant with GIPS required standards for composite construction as disclosed in Note 2?

A. Yes

B. No, because of how the large-cap model portfolio is treated

C. No, because of how nondiscretionary portfolios are treated

Solution: A.

A is correct because the composite consists of all actual, fee-paying portfolios, which are managed on a discretionary basis.

4. With respect to gross-of-fees returns, Note 4 is least likely compliant with GIPS required standards in its treatment of:

A. Custodial fees.

B. Performance fees.

C. Trading expenses.

Solution: A.

A is correct because custodial fees should not be considered a component of direct trading expenses.

5. With respect to relative merits of internal dispersion measures, Walter is least likely correct about:

A. High/low range.

B. Interquartile range.

C. Standard deviation.

Solution: B.

B is correct. Walter is correct about the high/low range, which is skewed by outliers. He is also correct that the standard deviation allows for comparability across investment firms. However, he is incorrect about the interquartile range. Because this measure includes only the middle 50% of portfolio returns, thus excluding extreme observations, it is not impacted by outliers.

6. Is Walter's response to McGourn's inquiry regarding WCM's valuation hierarchy most likely correct?

A. Yes.

B. No, item 4 from the valuation hierarchy should be excluded.

C. No, the valuation hierarchy should be reordered as item 2, item 1, item 3, and item 4.

Solution: A.

A is correct. The valuation hierarchy presented by Walter is GIPS compliant.

Case 6: Ng

Katherine Ng, a Global Investment Performance Standards (GIPS) specialist, has been hired as a consultant to assist Rune Managers in becoming a GIPS-compliant firm. Rune is a global asset manager with several divisions around the world that invest in both stock and bond strategies. James Arnott, a performance specialist at Rune, is responsible for the project. In their first meeting, Ng and Arnott discuss the GIPS standards and the steps Rune will need to take to become compliant.

Ng recommends starting with the definition of the firm. She tells Arnott that how the firm is defined will affect the compliance process and that the standards recommend the firm be defined as broadly as possible. Arnott replies that Rune management has been discussing the firm definition, and they want the definition to include all Rune divisions except the European division, Rune Europe. Rune Europe has its own strategies and management team that are distinct from the rest of Rune. Ng replies that the Rune Europe division should be included in the definition of the firm because the division markets itself as part of Rune Managers.

Ng then asks about Rune's policies for the inclusion of portfolios in composites. Arnott responds that Rune has the following policies for all composites:

Policy 1: All new accounts funded with cash or securities on or before the 10th day of the month are added to the composite at the beginning of the following month. Those funded after the 10th day of the month are added at the beginning of the 2nd month after funding, or at the beginning of the calendar month after the proceeds are substantially invested in the appropriate strategy.

Policy 2: All portfolios are deemed "non-discretionary" on the date the notice of termination of the management relationship is received and removed from the composite at the end of the month of notification.

The discussion then moves on to a new composite that Rune is constructing. Arnott tells Ng that the marketing department has decided to target domestic Swiss investors and would like to carve out the Swiss portion of international and global accounts for the period of 1 January 2006 through 1 January 2011 and allocate cash to each carved-out segment to create a Swiss franc (CHF) composite. Ng responds that this new composite will comply with the standards, but Rune must disclose the percentage of composite assets that are carve-outs for each annual period end, as well as the policy used to allocate cash to the carved-out segments.

Arnott interjects that the marketing department is looking forward to claiming GIPs compliance in advertisements. He is meeting with the marketing department and asks Ng what they need to be aware of regarding the Standards in advertising. Ng responds that there are several requirements in the GIPS Advertising Guidelines; specifically, the following must be disclosed in the advertisements: the firm description, composite and benchmark descriptions, and the number of accounts in the composite.

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Arnott and Ng then move on to discuss one of Rune's GIPS-compliant performance presentations, provided in Exhibit 1.

Exhibit 1

Rune Mid-Capitalization Value Equity Composite; Benchmark: Russell Midcap Value Index

Year	Composite Gross Return (%)	Composite Net Return (%)	Benchmark Return (%)	Composite 3-Year Std. Dev. (%)	Number of Portfolios	Internal Dispersion (%)	Composite % of Firm Assets
2006	11.2	10.69	12.65		15	0.09	7.1
2007	18.92	18.68	20.22		19	0.06	7.2
2008	0.07	–0.17	–1.42		22	0.46	6.8
2009	–33.75	–33.95	–38.44		23	0.25	5.5
2010	31.44	31	34.21		26	0.95	5.9
2011	22.09	21.73	24.75	22.83	25	0.21	6.9

Rune Managers claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Rune Managers has not been independently verified.

Notes:

1. Rune Managers is an investment manager registered with the US SEC. Rune Managers has divisions in Europe, Asia, and the United States that invest in various equity and bond strategies.
2. The Rune Mid-Capitalization Equity Composite includes all institutional portfolios that invest in mid-capitalization US equities, with the goal of providing long-term capital growth and steady income from dividends by investing in low price-to-earnings, undervalued securities.
3. A complete list and description of Rune Managers' composites, as well as policies for valuing portfolios and preparing compliant presentations, are available upon request.
4. The composite was created on 30 November 2005.
5. Leverage, derivatives, and short positions are not used by this strategy.
6. Performance is expressed in US dollars. The returns include the reinvestment of all income. Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Net-of-fees returns are calculated by deducting the actual fees of the accounts from the gross composite return.
7. The management fee schedule is as follows: 0.80% on the first $10 million, 0.55% on the next $40 million, 0.40% on assets greater than $50 million.
8. This presentation is not required to conform to any laws or regulations that conflict with the GIPS standards.
9. Internal dispersion is calculated using the asset-weighted standard deviation of annual gross

returns of those portfolios that were included in the composite for the entire year.

10. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns during the preceding 36-month period. The standard deviation is not presented for 2006 through 2010 because monthly composite and benchmark returns were not available, and it is not required for periods prior to 2011.

1. In their discussion of the Rune Europe division, which of the following is most likely correct?

A. Ng's analysis, because of how the division markets itself

B. Arnott's analysis, because of how the division is managed

C. Arnott's analysis, because of how the strategies are run

Solution: A.

Ng is correct. Because Rune Europe is using the Rune Managers name and marketing materials, the division is not being held out to clients or potential clients as a distinct business entity and so it should be included in the definition of the firm.

2. Which policy on the inclusion of portfolios in composites is most likely compliant with the GIPS standards?

A. Policy 1 and Policy 2

B. Policy 1

C. Policy 2

Solution: B.

The policy on account inclusion is compliant with the standards.

3. In the discussion of carve-outs, Ng is least likely correct in her statement regarding the:

A. Compliance of the composite.

B. Disclosure of the percentage of composite assets.

C. Disclosure of the cash allocation policy.

Solution: A.

For periods after 1 January 2010, carve-outs must include their own cash balance in order to be included in a composite, so a cash allocation policy for periods after 1 January 2010 would not be GIPS compliant.

4. In the discussion of the GIPS Advertising Guidelines, Ng is most likely correct in her statement regarding the disclosure of:

A. Number of accounts in the composite.

B. Composite description.

C. Firm description.

Solution: C.

The firm description must always be presented in GIPS compliant advertisements. The number of accounts in the composite need not be disclosed in advertisements, and only advertisements that include performance information must disclose the composite and benchmark descriptions.

5. Regarding the disclosures contained in the notes to Exhibit 1, the notes most likely required are:

A. 1, 5 and 6.

B. 6, 7 and 9.

C. 2, 7 and 8.

Solution: B.

The currency used to express performance, whether any fees other than trading expenses are deducted from gross-of-fees returns, whether any fees other than trading expenses and management fees are deducted from net-of-fees returns, the fee schedule, and a measure of internal dispersion are all required disclosures for compliance with the GIPS standards.

6. Regarding Exhibit 1, which item is least likely an error in the presentation?

A. Note 3

B. Composite percentage of firm assets

C. Three-year standard deviation

Solution: B.

The annualized three-year ex post standard deviation of monthly returns must be presented for both the composite and the benchmark for each annual period after 1 January 2011. Firms are required to disclose that policies for valuing portfolios, calculating returns, and preparing compliant presentations are available upon request.