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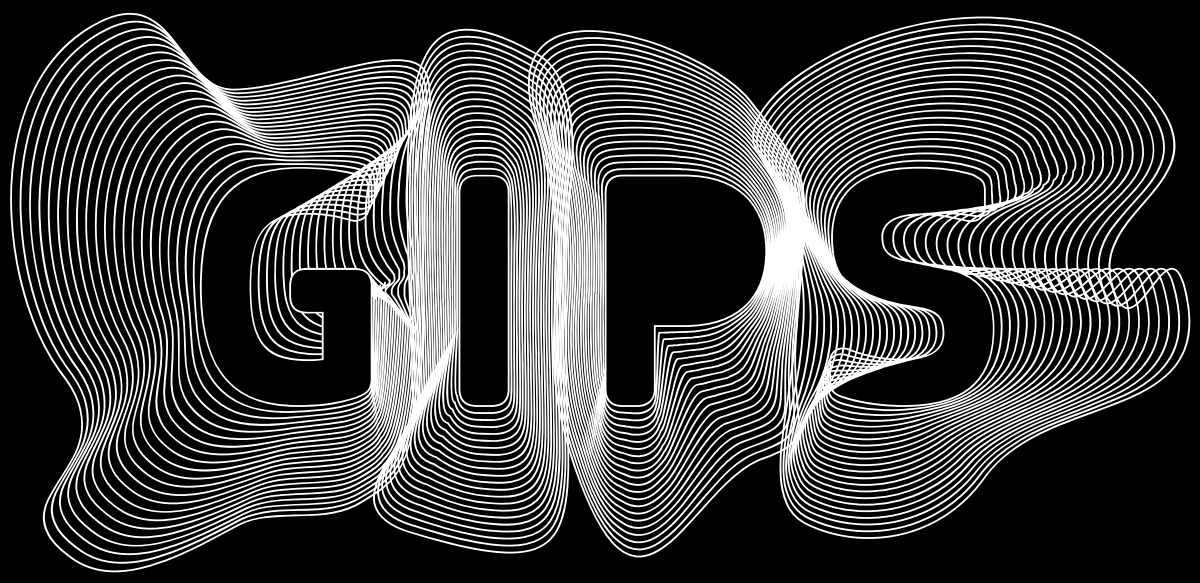
Performance measurement and reporting

A practical guide to implementing GIPS standards for asset managers



If you are thinking about becoming GIPS compliant or need to fine-tune your existing process, this document will help you understand the steps involved. It is designed to help you understand the value of compliance, what's needed to achieve it, pitfalls to avoid, and how to ensure that your performance reporting is both complete and fairly presented.

Full Disclosure and Fair Representation

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."

—Warren Buffett

This paper was written with Ashland Partners, a leading CPA firm specializing in GIPS compliance and verification.

Performance is an investment manager's calling card. It is what keeps existing clients and wins new ones. The ability to promote your firm's performance is a competitive necessity. Equally essential, however, is that clients and prospects can trust the integrity and fairness of your performance claims.

That is why the CFA Institute (the body that confers the Chartered Financial Analyst® certification) implemented the Global Investment Performance Standards or GIPS.® Based on the underlying principle of "full disclosure and fair representation," GIPS is just what the name implies—a worldwide set of standards for measuring, calculating, and presenting aggregate total return gain and loss percentages in discretionary, managed investment accounts. While compliance with the GIPS standards is voluntary, institutional investors usually require their portfolio managers to be in compliance with the Standards, and often even go a step further and require verification of compliance by an independent party with GIPS expertise.

Advantages of Compliance

There are three major advantages to complying with GIPS and getting third-party verification. One is the additional credibility the claim of compliance brings to performance numbers in sales presentations, service negotiations, advertising, media relations, and marketing literature. This added credibility can help reinforce your existing client relationships and open doors to consultants and more potential clients. A second advantage is that compliance provides a framework that helps strengthen a firm's internal control structure. Processes run smoother and portfolios are managed more cohesively as a result of established policies and procedures around the calculation and presentation of performance. The third advantage is to avoid running afoul of the SEC. Claiming compliance without actually being in compliance is considered misleading advertising by the SEC; a qualified third-party verifier can assist firms in keeping up with the requirements of the Standards and avoid a fraudulent claim of compliance.

Constructing and maintaining composites is perhaps the greatest challenge—and the one that consumes the most time and resources—in GIPS compliance. Managers need to define composites, understand their nuances, select portfolios correctly.

Of course, realizing these advantages comes with a price. Adoption of the GIPS standards means yet another set of demands on managers. Firms need to learn the Standards, implement new processes and controls, and understand the intricacies of creating portfolio composites. This initiative requires an investment of time, labor, resources, and commitment. The price of compliance, however, is far outweighed by the potential costs of noncompliance: fewer growth opportunities, damage to your firm's reputation by not keeping up with industry best practices, and ultimately, lost business.

The Evolution of Performance Reporting Standards

A Brief History

GIPS has its origins in the Financial Analysts Federation's (FAF) Performance Presentation Standards, first published in 1987. In 1990, the FAF and the Institute of Chartered Financial Analysts joined and eventually merged under the umbrella of the Association for Investment Management and Research (AIMR®). The standards developed by the FAF became the AIMR Performance Presentation Standards (AIMR-PPS) and enjoyed widespread acceptance in North America. During this same period, however, global investing was on the rise, and many countries followed different performance measurement guidelines. The globalization of financial markets called for a global standard; thus, the "global" in GIPS—Global Investment Performance Standards. AIMR initiated the development of a global standard in 1995 and, in 1999, formally adopted GIPS. AIMR's name was subsequently changed to the CFA Institute and GIPS replaced the AIMR-PPS. Subject to continual reevaluation and modification, the most recent version of the GIPS standards, the third edition of the Handbook, was released in 2012.

While the CFA Institute initiated GIPS and funded its development, GIPS is governed by an executive committee made up of Institute officials as well as representatives from investment and accounting firms and public investors around the world. The GIPS Executive Committee is responsible for maintaining the Standards, with global participation and input from volunteer committee members. As of 2015, 37 countries have adopted the GIPS standards or have had their local performance reporting standards endorsed by the GIPS Executive Committee.

Creating and Managing Composites

The key provision of GIPS is the requirement to include all of a firm's fee-paying, discretionary accounts in meaningful composites. Creating composites is the crucial first step towards GIPS compliance. Firms that are contemplating GIPS compliance will need to set up composites and have a system in place for managing them well in advance of actually claiming compliance.

Composites are aggregates of portfolios that share common investment objectives or strategies. The composite return is the asset-weighted average of the returns of all the portfolios in the composite. The goal of composites is to ensure "apples to apples" performance comparability from one firm to another and prevent cherry picking of only a manager's best performing accounts. As stated in the Standards Handbook:

Creating meaningful composites

Compliance with the GIPS standards has become a virtual requirement in North America in order to stay competitive.

"Defining and constructing composites is one of the first steps in implementing the GIPS standards. Composites are the primary vehicle for presenting performance to a prospective client. The GIPS standards require that firms include all actual, discretionary, fee-paying portfolios in at least one composite that is defined according to a particular investment mandate, objective, or strategy. In this way, firms cannot 'cherry-pick' their best performing portfolios to present to prospective clients."

While non-fee-paying discretionary accounts may also be included in composites, the Standards specifically exclude nondiscretionary portfolios in composites. A broad definition of a nondiscretionary portfolio would be any account that contains investment guidelines significantly restricting the ability to manage the assets according to an appropriate composite strategy. The returns on such portfolios are more reflective of the client's decisions rather than an investment manager's decisions. Even certain accounts that meet the legal definition of discretionary may be deemed nondiscretionary for GIPS purposes and exempted from composites if client restrictions (e.g., no "sin stocks") or liquidity requirements limit the manager's discretion.

Constructing and maintaining composites is perhaps the greatest challenge—and the one that consumes the most time and resources—in GIPS compliance. Managers need to define composites, understand their nuances, select portfolios correctly, and deal with portfolios that do not fit neatly into composites—avoiding too many overly narrow composites or too few overly broad, meaningless composites.

Composites are difficult if not impossible to piece together in retrospect, which is why they need to be well established before you start claiming GIPS-compliant performance. Moreover, composite creation is not a one-time event. Portfolios fluctuate as the values of holdings change, issues are traded, accounts are opened or closed, or client mandates change. Composites must be monitored and managed continuously. Portfolios that no longer meet the defined criteria must have a documented change to the portfolio's mandate to be removed from the composite. Before your firm can claim compliance, you will need to demonstrate a track record of effective composite management.

Other Key Provisions
In addition to composite construction, GIPS has a number of other provisions to address key investment performance issues. Chief among them:

Written Policies and Procedures for Firm-wide Compliance. The first requirement of GIPS is a written definition of the "distinct business entity" representing itself, be it an investment firm or, for example, the investment subsidiary or division of a larger financial institution. Further documentation of policies and procedures relevant to complying with the Standards is also a fundamental requirement.

Data Integrity. Firms must capture and maintain all data and information necessary to support all items included in a compliant presentation. Transaction details and valuations are essential in meeting this requirement, as well as support for all other presented statistics and even non-performance related information such as membership changes are covered under this requirement.

The price of compliance, however, is far outweighed by the potential costs of noncompliance: fewer growth opportunities, damage to your firm's reputation by not keeping up with industry best practices, and ultimately, lost business.

Uniform Calculation Methodology. The Standards mandate specific calculation methodologies to be used for both portfolios and composites to assure uniformity among compliant firms.

Disclosures. The presentation of performance results must be accompanied by mandated disclosures, some required for all firms and some specific to the firm's circumstances. A list of required and recommended disclosures can be found in the Standards in sections 4A and B.

Presentation and Reporting. In addition to disclosures, sections 5A and B of the Standards spell out other types of information that must accompany the presentation of performance results. The key reporting requirement is the five- to ten-year or since-inception annual performance history. The Standards also contain additional guidance for specific asset types, such as real estate, private equity, and wrap fee provisions in sections 6, 7, and 8, and specific presentation types, such as advertisements versus one-on-one presentations, addressed in the Appendices.

Why Comply?
Compliance with the GIPS standards has become a virtual requirement in North America in order to stay competitive. The Standards are recognized as an industry best practice. Because the SEC requires firms that claim compliance to adhere to the requirements of the Standards on a firm-wide basis, firms that choose to comply without putting forth the necessary due diligence do so at great risk.

Credibility. GIPS compliance signals that you are committed to competing on a level playing field, that your performance reporting utilizes industry best practices and that product-to-product comparisons with other firms are valid.

Improved Client Confidence. Client trust is arguably an investment firm's most valuable asset. GIPS compliance reinforces that trust.

Marketing Support. Particularly if a firm has a record of outperforming key indices or industry averages, GIPS adds credibility to their success story. The greater the performance claimed, the more advantageous it is to support that claim with GIPS compliance. More common than firms choosing not to comply with GIPS are firms that have every intention of complying, but face challenges in doing so. They may experience time and resource constraints or difficulty in interpreting the Standards correctly, especially in the areas of composites and calculations. How do you validate your firm's reporting process and procedures? Start by understanding these twelve steps to GIPS compliance and determining whether or not your firm is following them.

Twelve Steps to GIPS Compliance

An effective compliance program has completed these steps:

1. Management support. Management must make a commitment of time and resources to bring the firm into compliance.

2. Know the Standards. Assign individuals or teams to review and familiarize themselves with the Standards and to complete each subsequent step.

The verifier can advise you on areas to round out your written policies and procedures and refine your composite definitions and presentation disclosures.

3. Define the firm. The definition should accurately reflect how the entity is held out to the public and will determine the scope of firm-wide assets under management.

4. Define investment discretion. The Standards use the term "discretion" more broadly than just whether or not a manager can place trades for a client. Defining investment discretion is an important step in determining whether or not accounts must be included in a composite.

5. Identify all accounts under management within the defined firm for at least the past five years, or since firm inception if less than five years. This should include all discretionary and nondiscretionary accounts, including terminated relationships.

6. Determine if your firm has the appropriate books and records to support historical discretionary account performance.

7. Separate the list of accounts into groups based on discretionary status, investment mandate, and/or other criteria. These groups will be the foundation for your composites.

8. List and define the composites that will be constructed and establish a process for composite management.

9. Document your firm's policies and procedures for establishing and maintaining compliance with the Standards.

10. Document reasons for composite membership changes throughout each account's history and reasons for nondiscretionary status, if applicable.

11. Calculate composite performance and required annual statistics.

12. Develop fully compliant marketing materials.

Don't Just Comply—Verify

The GIPS Executive Committee strongly recommends (but does not require) that firms claiming compliance verify that their policies, procedures, and composite construction methodology adhere to the Standards. That means firms need to bring in an independent firm to check their work. In practice, most firms prefer bringing in the verification firm early on for objective guidance on the process. Working with a verifier to see potential problem areas is invaluable to large and small investment firms alike. Verification services are offered by accounting firms and firms focused primarily or exclusively on GIPS consulting and verification.

Effective verification generally follows three phases:

1. Preverification. The verifier reviews your performance policies and procedures, if any, firm brochures, and performance presentations. This provides the verifier with an understanding of your firm and establishes the framework for a gap analysis wherever existing policies do not meet GIPS requirements. The verifier can advise you on areas to round out your written policies and procedures and refine your composite definitions and presentation disclosures.

2. Verification. The verifier reviews the same documentation as in a preverification, with the expectation that any areas of noncompliance have been corrected. The verification process also tests supporting documentation on a

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If you plan to have your compliance verified, you should engage a verifier early on.

Working with GIPS experts can help keep overhead and training costs down, while providing greater assurance that you are getting the right answers and guidance in establishing and maintaining your program.

sample basis. This engagement will result in either a management letter outlining areas of noncompliance or the issuance of an opinion letter stating that your firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and that your firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards.

3. Performance Examination. A drill-down into one or more specific composite's performance track record to affirm whether the underlying valuations, calculation methodologies, and transaction records for the composite in question adhere to GIPS requirements.

Options for Implementing a GIPS Compliance Program

Implementing and maintaining GIPS compliance requires time, resources, and expertise. The question for most firms is: how much dedicated GIPS expertise can you afford to have on staff? It may make sense for the largest firms to hire or train several specialists in GIPS compliance. It's a bigger challenge for smaller firms, where portfolio managers, traders, and operations staff are already wearing multiple hats, and chief compliance officers have their hands full with everyday SEC compliance. Whether or not one or more GIPS specialists are hired or trained, the creation of a GIPS Committee that includes members from each of the firm's key departments, (e.g., compliance, operations, portfolio management, trading, performance measurement, IT and marketing) can greatly enhance the efficiency and effectiveness of the process of becoming compliant.

Regardless of internal resources, if you plan to have your compliance verified, you should engage a verifier early on, because the costs of preverification services are usually nominal if such services are provided in conjunction with a verification, and experienced verifiers are a natural resource for an informed GIPS consultant. Specialized GIPS consultants bring to the process the experience of working with other firms facing similar firm-specific challenges and solutions.

While maintaining independence is critical for any consultant also providing independent verification, such firms can provide suggestions on how to implement a GIPS compliance project. They can assess books and records and data integrity challenges and prevent ineffective fundamental decisions around composite building.

For firms further along the process, GIPS consultants can suggest necessary adjustments to ensure GIPS-compliant performance measurement and reporting practices on an ongoing basis and take on the responsibility of staying current with and communicating changing GIPS requirements and interpretations, something many firms simply do not have time for on their own. Working with GIPS experts can help keep overhead and training costs down, while providing greater assurance that you are getting the right answers and guidance in establishing and maintaining your program.

Given that data integrity is one of the key requirements of GIPS, technology has an important role to play in GIPS compliance.

The Role of Technology

By now, of course, most investment firms' "books and records" are virtually all electronic. Given that data integrity is one of the key requirements of GIPS, technology has an important role to play in GIPS compliance.

Today's most advanced portfolio management, accounting, and reporting systems offer a high level of flexibility in the ways data can be organized and managed. They allow quick access to portfolio information for verification and portfolio examination purposes. With the latest technology, they can even automate composite creation and management based on user-defined rules and criteria—making one of the main hurdles in GIPS compliance far more manageable.

Using the most up-to-date technology also helps ensure the accuracy and consistency of data used for performance measurement and reporting. Customized reporting capabilities enable firms to create and generate performance reports in accordance with GIPS. And, in the event of an SEC inquiry, the answers are readily available.

Generally, the right technology can help ease the administrative burden of compliance while bringing greater speed, efficiency, and accuracy to the process—ultimately enabling managers to sleep at night with greater confidence that their performance reporting is GIPS compliant.

Clearly, adhering to the GIPS standards is in the best interest of any investment firm that wants to compete effectively and fairly. It helps you build a framework for implementing industry best practices, while providing you with an effective marketing tool and a competitive advantage. Most significantly, it helps engender trust on the part of clients and prospects. All these advantages are further reinforced and strengthened by expert third-party verification.

The issue for most firms is not whether to comply with GIPS, but how to accomplish it successfully. Whether that means adding GIPS experts to staff or turning to outside professionals will depend largely on the firm's size, available resources, and overall business strategy. Either way, given the importance of GIPS compliance from both the regulatory and marketing perspectives, independent verification by qualified GIPS experts is an additional key consideration. There is simply no substitute for focused, in-depth knowledge of the GIPS standards and how they have been applied historically. The value of that expertise will be realized in the form of more confidence in a regulatory examination, a more efficient compliance process, and more new business won.

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Appendices

Tips and Tricks for Building and Managing Composites

Avoid having too many composites by focusing on the firm's primary mandates. If there are a lot of unique accounts left over without a composite, you can create single-account composites or expand on your firm's definition of discretion:

> Is it because the accounts have a lot of low cost basis stock that makes them unrepresentative?

> Are there limits on duration that constrain the portfolio manager's ability to implement the firm's strategy?

> Are there "sin-stock" restrictions?

> Frequent communications from clients regarding cash flow/liquidity needs?

All these and more are good examples of accounts that could be the beginning of a future firm strategy (for example, a Socially Responsible Composite or a Limited Duration Composite) or accounts that could be deemed nondiscretionary for GIPS purposes, even if they have a fully discretionary contract. What this means is that they don't have to go in a composite, because the performance reflects the client's directives as much as it does the manager's performance.

These are also good examples of the flexibility the Standards provide individual firms, because the decision is not limited to either including accounts in a composite or excluding the account because a few of the assets are restricted. A firm could also carve out nondiscretionary or restricted assets, allowing the remaining account assets to be included in a composite.

If newly created composites have high dispersion, track down the accounts in the composite that are performance outliers and determine if there is an underlying client directive contributing to the difference. Upon reviewing the accounts, a portfolio manager might realize that two or three accounts in the composite might be better off in their own composite and update the composite definition and description accordingly. For example, these accounts may be more concentrated than the other portfolios or they may have concentrations in different sectors due to their clients' age/risk tolerances.

Common Obstacles to Becoming GIPS Compliant

1. Lack of a complete commitment of the necessary resources to attain compliance from top management. This can result from underestimating how much time, labor and other resources will be needed.

2. Lack of books and records to support performance and composite membership: client contracts and investment guidelines, custodial statements, etc.

3. Survivorship bias in the composites: terminated accounts have been removed for historical periods as well.

4. Lack of historical records to support assets under management. This is particularly problematic when building composites from scratch; you need to ensure all historical, discretionary, fee-paying accounts are in at least one composite.

Putting it all together

5. Performance calculation issues:
   - Valuation on the date of all large flows beginning 1/1/10; monthly portfolio valuations required beginning 1/1/01; quarterly valuations required prior to 1/1/01
   - Trade date accounting beginning 1/1/05
   - Interest accrual on fixed income for all periods
   - Daily weighting of cash flows beginning 1/1/05
   - Unique fee issues, such as not knowing fees charged on wrap accounts or not booking all fees to the accounting system
6. Composite policies that have been inconsistently applied historically, or policies applied historically were not documented.
7. Books and records issues surrounding a portable performance track record.
8. Lack of clear understanding regarding "investment discretion" for GIPS purposes, and/or lack of conceptual direction for meaningful composites.
9. Operational challenges when creating composites that include carve-outs, wrap accounts or other account types with difficult valuation or data integration issues.

If any of these obstacles might apply at your firm, contact a GIPS verifier/consultant to discuss possible solutions.

GIPS Policy and Procedure Checklist
Key policies and procedures should address:

- Firm definition
- Definitions of each composite
- Composite maintenance policies
- Account and composite calculation policies
- Policy on defining and valuing large cash flows on a composite specific basis
- Policies and procedures used for ensuring the existence and ownership of client assets
- Policies and procedures to ensure that performance and performance-related information does not include false or misleading information
- Valuation policies, procedures, methodologies, and hierarchy, including any changes
- Policies and procedures for capturing and maintaining all data and information necessary to support all items included in compliant presentations
- Policies and procedures for determining when an interested party becomes a prospective client
- Policies and procedures on error correction including the definition of materiality
- Treatment of special issues relevant to the firm's performance: portability, carve outs, SMAs, pricing sources, etc.

Resources

- GIPS: www.gipsstandards.org
- CFA Institute: www.cfainstitute.org
- Ashland Partners: www.ashlandpartners.com

About Ashland Partners

Ashland Partners is a specialty CPA firm focused on the investment management industry. Founded in 1992, Ashland Partners is the largest and oldest verification firm with over 800 clients. In addition to GIPS consulting and verification, Ashland Partners provides strategy and model examinations, SSAE no. 16 examinations, surprise custody examinations, financial statement audits, tax services, cybersecurity services, QPAM exemption audits, and consulting. Our professionals have achieved a wide variety of credentials including CPA, CFA Charters, and the CIPM Certificate. For more information, please visit our website: www.ashlandpartners.com.

Who We Are

Advent, a business unit of SS&C, is helping over 4,300 investment firms in more than 50 countries—from established global institutions to small start-up practices—to grow their business and thrive. Delivering unparalleled precision and ahead-of-the-curve solutions for more than 30 years, we help our clients minimize risk, work together seamlessly, and shape the future of investment management. For more information visit www.advent.com.

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