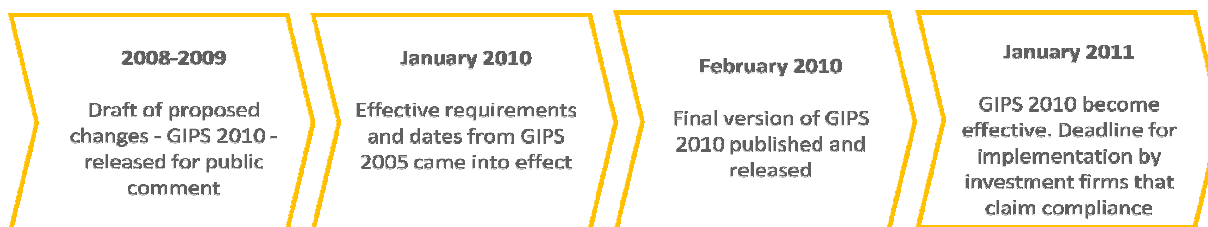


The Global Investment Performance Standards (GIPS®) get a ‘face lift’

The global standards for investment performance presentation, GIPS, were established in 1999 by CFA Institute in collaboration with volunteers from the investment management industry. To date, over 30 countries have been active in the development and promotion of the GIPS standards worldwide. The GIPS standards are based on the ethical principles of full disclosure and fair representation of investment performance and enable comparability between investment strategies and firms anywhere in the world. Compliance with the GIPS standards has become known as a “Global Passport.”¹

The GIPS standards were the first non-legislative or regulatory move to give a concrete framework for calculating and presenting historical investment performance information. As 2010 unwinds, the growing importance of the GIPS standards in the global economy is not waning. In mid-February 2010, CFA Institute released the most comprehensive edition of the GIPS standards to date and adopted further, significant changes and enhancements.

GIPS 2010 timeline



Key changes and enhancements to the GIPS standards

Before delving into the strategic considerations for investment firms, we first present a summary of the eight key changes to the GIPS standards in the 2010 edition:

1. *Fair value methodology is established:* Assets will have to be valued using a fair value methodology when no market value is available. The 2010 edition of the GIPS standards provides new valuation principles, recommends a valuation hierarchy, requires firms to disclose whether a firm’s valuation policy and hierarchy materially differs from requirements of the GIPS standards and to disclose the availability of valuation policies and procedures upon request.
2. *The importance of risk comes of age:* Firms will be required to present the (three-year annualized ex-post) standard deviation of the monthly returns of both the composite and the benchmark, and to show an additional (three-year ex-post) risk measure if the standard deviation is not a relevant or appropriate risk measure.
3. *Compliance statement with verification status disclosure:* As part of the GIPS compliance statement, disclosure of the verification status (i.e., whether a firm has been verified) and prescribed details of what verification covers, will be required.
4. *Increased understanding and consistency of GIPS verification:* The scope and purpose of verification, as well as the required verification procedures that have to be followed by verifiers, have been clarified.

¹ CFA Institute, *Global Investment Performance Standards (GIPS®)*: As adopted by the GIPS Executive Committee on 29 January 2010.

5. *More frequent external valuation of real estate:* For periods starting 1 January 2012, real estate investments must be valued by an independent external valuer or appraiser at least once a year unless client agreements stipulate otherwise (in which case an external valuation has to be performed at least once every three years).
6. *Specific requirements for real estate closed-end funds as well as new disclosure and presentation provisions for private equity fund of funds.* Important to highlight is that on the private equity side, composite construction and calculation methodology provisions were updated. All private equity primary funds will have to be included in a composite defined by vintage year and investment mandate, objective or strategy, while fund-of-funds will have to be included in a composite defined by fund-of-funds vintage year and/or investment mandate, objective or strategy. Further, firms will need to calculate annualized Since Inception Internal Rates of Return (SI-IRR) using daily cash flows (rather than monthly cash flows).
7. *New (but already known) provisions came into force on 1 January 2010.* Investment firms have to:
 - ▶ *Value portfolios* as of (calendar) month-end (or the last business day of the month) and on the date of all large cash flows (“large” defined on a composite-specific basis). The 2010 edition of the GIPS standards explicitly requires not to deviate from this policy and prohibits revaluing portfolios if cash flows do not meet the definition of ‘large’.
 - ▶ *Calculate composite returns* by asset weighting the individual portfolio returns at least monthly.
 - ▶ Not include *carve-outs* in a composite unless the carve-outs are actually managed separately with their own cash balances.
 - ▶ *Disclose error corrections* due to a correction of a material error and any changes to a compliant presentation that has been provided to prospective clients; the Error Correction Guidance Statement applies.
8. *The text and language of GIPS 2010 are simplified, clarified and made consistent throughout the provisions.*

The GIPS standards logo for use by GIPS-compliant firms



During the GIPS Executive Committee meeting in Lisbon, Portugal, on 19 March 2010, CFA Institute announced that firms claiming compliance with the GIPS standards will be allowed to sign up to use the GIPS standards logo. The logo is a visual representation indicating that a firm claims compliance with the GIPS standards. To use the logo, firms must be in compliance with the GIPS standards and may only present it in a GIPS-compliant presentation or in an advertisement that adheres to the GIPS Advertising Guidelines. Firms that wish to use the GIPS standards logo must email CFA Institute (at standards@cfainstitute.org) the following information:

- ▶ Firm name, address, phone number and website
- ▶ Name, phone number and email address of contact at the firm
- ▶ Whether the firm claims compliance with the GIPS standards
- ▶ If the firm has been verified; and if yes, by which verification firm

Once this information is received by CFA Institute, a confirmation email will be provided together with the GIPS logo. The logo can be viewed as an additional service from the CFA Institute and is not required as part of

compliance with the GIPS standards. The use of the logo is free of charge. Additional information is available at www.gipsstandards.org.

Strategic considerations for investment management firms

It is important to consider the content of the 2010 edition of the GIPS standards as a driver for some necessary adjustments and implementations in an existing operating framework. The above key changes indicate that firms will need to review their policies and procedures (including internal controls), composite construction, performance measurement, as well as composite presentations and disclosures, to name the least. Compliant presentations that include performance results for periods beginning on or after 1 January 2011 will have to be prepared in accordance with the 2010 edition of the GIPS standards. Furthermore, compliant firms must consider all respective Guidance Statements and Q&As², which will also undergo changes throughout 2010, and not just the GIPS standards themselves.

The 2010 edition of the GIPS standards creates enhanced opportunity for investment managers to compare their investment performance, strengthen their investment processes and controls, and provides more transparency to investors. Of course, there is the cost benefit analysis associated with compliance with the GIPS standards, which essentially boils down to the question of direct cost – how easily a firm will be able to gather relevant portfolio information and data, and coordinate resources to construct and maintain this information in a GIPS-compliant manner.

In the current market environment, many investment managers and senior executives understand the risks associated with supplying inaccurate or misleading investment performance data and the significance of investment performance reporting standards. However, a number of firms still fail to address the risks, and more importantly, to understand the overall, detailed processes involved in the investment performance reporting process, as well as the extent of potential reputational and operational risks as a result of inefficient and inaccurate processes and unreliable performance reporting. The dilemma here is often that investment reporting issues fail to make their way to the top of an investment firm until there is a major problem. How should firms go about building an efficient business operating model in line with the GIPS framework as well as improving the overall risk management? Firms are first advised to address investment performance reporting proactively from both a bottom-up and a top down perspective. Adopting compliance with the 2010 edition of the GIPS standards and sustaining it over the long term is feasible by creating an efficient and effective operating model with senior management buy-in, participation and oversight. Firms then have to create a consistent, firm wide investment performance reporting operating model supported by the right processes, people, and up-to-date technology.

Formal procedures are needed to serve as building blocks for an operational and internal control framework, under which various functional departments can work together on an end-to-end basis to drive data collection, data maintenance and correction, composite management, calculation of performance and assets under management, performance reporting and analysis, and record retention. Ideally, an effective compliance program for investment performance reporting should encompass the entire end-to-end process and include policies and procedures, internal controls, and information technology to support the calculation of performance figures and assets under management, composite maintenance, performance reporting and disclosure, policy and procedure updates, and record retention.

Compliance with the GIPS standards is also a process that needs key stakeholders to be involved. Frequently, minimal communication exists among marketing, legal, operations and information technology departments, as well as up and down the management chain. Therefore, firms must create clear communication channels and protocols and allocate human capital sufficiently to be able to detect problem areas and to ensure that the processes and technology in place run smoothly. In order to sustain continued compliance with the GIPS

² Further information available at the GIPS Standards Website at <http://www.gipsstandards.org/standards/index.html>.

standards, firms need effective management and oversight of the investment performance reporting infrastructure to ensure that all aspects of the performance measurement and presentation process are harmonized and standardized. This is possible when all functional groups involved in the process understand and adhere to the standards, assume responsibility for better information data management, improved internal controls and increased efficiency.³

Challenges of compliance with the GIPS standards:

- ▶ Allocating new accounts/portfolios to appropriate investment strategies and composites
- ▶ Aligning and coordinating the performance reporting and disclosure functions across disparate operational, legal, compliance, sales and marketing divisions
- ▶ Operational and IT challenges related to the maintenance and management of data, records, reports across multiple tools, systems and spreadsheet technologies, as well as the accuracy and timeliness of performance reporting
- ▶ Inadequate technologies, non-automated and fragmented processes and missing controls
- ▶ Poor governance structure and weak internal communication
- ▶ Continued senior management buy-in and support

Potential benefits of complying with the GIPS standards:⁴

- ▶ Enhanced ability to compare performance between investment firms and strategies
- ▶ Consistency in calculation and presentation of performance results, such as frequency of valuation, treatment of large cash flows and handling of accruals, thus preventing cherry picking of best-performing accounts/portfolios
- ▶ Full disclosure of important details on performance data, such as fees, composite investment strategy, dispersion of returns, etc.
- ▶ Firms recognized for adherence to industry best practice
- ▶ Strengthened internal processes and controls, improved risk management

Who benefits from compliance with the GIPS standards:

- ▶ Investors:
 - ▶ Plan sponsors, institutional investors
 - ▶ High-net-worth investors
 - ▶ Retail investors
- ▶ Investment managers:
 - ▶ Including equity, fixed income, hedge fund, private equity, and real estate investment management firms
- ▶ Intermediaries:
 - ▶ Consultants
 - ▶ Family offices
 - ▶ Regulators

GIPS 2010: An opportunity or an obligation for hedge funds and alternative investments firms?

In the eyes of some managers and executives in the hedge funds and alternative investments business, the GIPS standards are not applicable to their firms. However, this impression is now outdated. On the one side, the GIPS standards already cover alternative investment instruments, including real estate and private equity, while

³Investment performance reporting: from obligation to differentiator, Financial Services, Ernst & Young, August 2008.

⁴ GIPS Standards Today 2010, CFA Institute, March 2010.

a Guidance Statement dedicated to alternative assets is scheduled for publication in the second half of 2010. On the other side, the industry view on this debate is changing compared to some years ago. For example, a Glass Hammer/Stone House Consulting survey of buy-side industry trends in October 2009 found that two thirds of survey respondents expected compliance with the GIPS standards to come for hedge funds in the next few years.⁵ Furthermore, industry associations and working groups, including the UK Hedge Fund Standards Board and the President's Working Group on Financial Markets in the U.S., actively call on Hedge Fund managers to comply with the GIPS standards.

At this stage, those hedge funds and alternative investments firms not compliant with the GIPS standards should analyze their operational investment reporting set-up and be prepared for the developments ahead. Today, most investors expect firms to comply with the GIPS standards and rely on firms to report performance that is both accurate and verified. In this context, it is important to consider the following strategic aspects⁶ as to why compliance with the GIPS standards is increasingly important to hedge funds and alternative investments firms and their investors:

- ▶ *Transparency*: The key benefit, as always, is for clients and investors of the investment firm; the GIPS standards require key product data and disclosures to be provided to these parties in a comparable format. More importantly, the demand and pressure from the client/investor side have come to life.
- ▶ *Improved view of the firm's track record*: Many hedge fund managers manage separate accounts. Managers that comply with the GIPS standards would thus have one or more composites reflecting the track record of the separate accounts that are managed. Current and potential investors could compare performance results between the hedge fund and any separate accounts following the same strategy.
- ▶ *Reputation*: Credibility of the performance track record of the firm.
- ▶ *Due diligence*: Hedge fund managers that comply with the GIPS standards have adopted many best-practice processes and procedures that can reduce operational risk.
- ▶ *Consistency*: The GIPS standards ensure that the same standard of care is applied to the selection and review of alternative investment managers as that applied to traditional investment managers.
- ▶ *Flexibility*: The GIPS standards are accepted and recognized in most regulatory environments around the world. Further, the option of complying with the GIPS standards as a global firm as well as the marketing and selling of products across geographical boundaries (the primary benefit of global firm compliance) exists.⁷

The GIPS standards are voluntary and, while firms are not obliged to comply, the transparency these standards provide can mean the difference in a firm's ability to compete effectively for investor capital. The GIPS standards are widely recognized as an industry best practice, add credibility to performance presentations and provide client confidence in investment firms. Given today's increased emphasis on operational, market and regulatory risks, clients and investors are demanding more robust risk and governance practices from their investment managers.⁸ As investors flock more toward alternative investment options, they will increasingly require more standardization and reliability from firms' presentations when evaluating their offerings.

Hedge fund and alternative investment managers stand to benefit from complying with the GIPS standards. In particular, hedge funds, which continue to increase in number, will increasingly need to rely on sound and transparent investment reporting practices in order to gain the trust of new investors. Achieving and maintaining compliance represents an opportunity to possess a competitive advantage in the marketplace. By placing investment performance reporting at the forefront of their operating model, and maintaining the proper people, policies, processes and technology to maintain it, firms can be positioned to capture further growth in an evolving and challenging market environment. It is, therefore, highly advised that the non-compliant firms proactively analyze their current situation and adjust their operating model in the most efficient way necessary.

⁵ *The Glass Hammer / Stone House Consulting Survey of Buy-Side Industry Trends*, September / October 2009.

⁶ Some ideas and inputs from the CFA Institute, *GIPS Standards Today 2010*, March 2010.

⁷ *GIPS compliance as a global firm: the turbulent rise of the global project*, GIPS® news, Ernst & Young, September 2008.

⁸ *Asset Management Industry in Switzerland Survey – Future Trends and Developments*, Ernst & Young, February 2010.

Conclusion

Firms that achieve and maintain an efficient and effective investment performance reporting framework can differentiate themselves from competitors. Compliance with the GIPS standards is a core component of such a framework - a set of standards that can help firms either improve or establish a competitive advantage by developing stronger operational and technological infrastructure, devising streamlined processes and training people to support accurate and timely investment performance reporting. Those that adopt the right processes can go to market with a higher level of confidence that their performance data is accurate and that customers and investors rely on it.

As investment managers continue to leverage new and more complex investment products and new hedge fund strategies to increase assets under management, their ability to compete and effectively market such products has a direct correlation with the reliability and accuracy with which they report the investment performance of these, and all, vehicles to investors. Among other important criteria, investment managers will primarily differentiate themselves in the future on their quality of service - investment process, experience and qualifications, track record and reputation. Success will particularly lie with the strength of reputation and reliability of investment performance data and reporting processes.

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