

# GIPS: A Passport to Credibility for Fund Performance

Post-Madoff era sees investors focusing more on GIPS than ever

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**H**as the financial crisis and the associated problems with alternative investment funds created the ideal climate for GIPS (Global Investment Performance Standards)? The GIPS were created to introduce a globally accepted universal investment performance reporting standard. Ultimately, the aim was to make investors' lives easier, and ensure that it would be possible to compare funds on a fair basis.

Although we have not seen universal uptake of GIPS by hedge funds, ultimately the issue is not one of convincing fund managers of their value, says Antony Howland, a strategic adviser with BI-SAM who sits on one of the GIPS sub-committees. The issue is one of how much importance is attached to GIPS by the investor community. If large scale investors begin to insist that hedge funds report using GIPS criteria, it will be difficult for fund managers to resist it.

"We're talking here about being open and transparent with your performance track record," says Howland. "If you are a hedge fund manager, this represents a good kite mark for your business." He accepts that hedge funds have been put off by the idea of GIPS in the past, but now sees the investor community beginning to get behind them in a big way.

More and more RFPs are asking whether funds are compliant, and a recent UK local government mandate used GIPS as a key criterion when screening funds. Outside the UK, the Swiss Bankers Association is now solidly behind the standards, as are investors in Australia and New Zealand. Germany, which used to use its own standard, has now adopted GIPS under the auspices of the German Asset Management Standards Committee.

"While compliance is voluntary, investors are increasingly demanding that firms comply," says Jonathan Boersma, executive director of the GIPS standards at the CFA Institute. "Firms that do not report their investment performance according to the GIPS standards are often excluded from competitive bids."

Crisis apart, another reason why GIPS have been attracting attention this year has been the revised standards, initially published in Q1, and which will come into force in 2011. This will require fund managers to publish a statement showing how they are GIPS compliant and the course taken to achieve that. They will also have to state whether this has been independently verified.

The standards come with the blessing of the CFA Institute, the UK's National Association of Pension Funds (NAPF) and sponsoring bodies in 32 countries.

Even firms that are already compliant really only have until the end of the year to implement the additional requirements.

The new standards tackle a couple of critical areas:

### *Fair value*

Assets to be valued using a fair value methodology when no market value is available. The new standards include a recommended valuation hierarchy in an appendix.

### *Risk*

There was unanimous agreement in the GIPS Executive Committee that GIPS should address risk, and here we can see the impact of the financial crisis on thinking. Compliant firms will now have to present standard deviation of monthly returns.

### *Verification status*

Firms will now have to confirm whether their GIPS compliance has been verified. The risk component could prove hard to adopt on a universal basis, and BI-SAM's Howland says that funds will be able to use proprietary risk measures if they so choose, so long as they explain adequately how these work.

Howland also stresses that managers who claim GIPS compliance, and are not compliant in reality, could effectively be committing fraud. Regulatory agencies like the SEC in the US have an in-house GIPS team and the FSA in the UK has been observing the meetings to develop the standards. Accordingly, they are alive to what GIPS means, and can tell whether a manager really is GIPS compliant. It is critically important then that even those firms which currently have a GIPS certification make sure that, come 1st January, they remain so. "Anyone can report you for a breach," says Howland.

Apart from investor pressure, the GIPS standards also require the support of regulators. The level of support, the so-called bite behind the bark, will vary from country to country. The SEC has, however, taken a dim view of managers claiming GIPS compliance, but in reality failing to live up to the standards. An SEC review of managers in the US found a large percentage of those claiming compliance were failing to live up to the standards. Becoming GIPS compliant takes time, although it can vary depending on the size of the firm, and how many funds it manages. A large and complex business can take up to 18 months before the full due diligence package goes through, while some have been able to turn their GIPS review around in six weeks. With a strong control environment regarding portfolio records and the right resource deployment, a typical hedge fund manager could realistically target achieving GIPS compliance within a 3 to 6 month timeframe. There are half a

dozen providers in the UK, including the Big Four accountancy firms, which are equipped to help fund managers achieve GIPS compliance and offer that crucial independent verification which investors are looking for.

Another important factor to bear in mind is that significant changes in the structure of a business, or of the way a fund is being managed, will require a review. GIPS compliancy is an ongoing process. It is not about 'snapshots' like, for example the proposed UCITS IV Key Information Document (KID). The investing client has to be able to see that the standard is being adhered to consistently, not just this month.

Matt Price, a partner at Ernst & Young, which verifies the compliance of some of the leading hedge funds in Europe, says he expects take up from the hedge funds that are interested in managing institutional accounts. "Any hedge fund with assets of \$5 billion upwards and looking to manage pension fund assets is likely to benefit from becoming GIPS compliant," he says. Embedded in consultant questionnaires, GIPS has become a hygiene factor in the presentation of performance results for institutional RFPs, he argues. "Asset growth in 2010 has been very sluggish and in this market, any additional means of demonstrating the application of best practice and the presence of third party scrutiny in such a sensitive area is of clear value to the sales process. Furthermore, GIPS compliance is one of the ways hedge funds could look to send a clear message to investors that they are subjecting themselves to the same compliance frameworks as their traditional peers."

So what does it all cost? A medium-sized GIPS-compliant fund manager is likely to be spending, on average, about £100,000 a year. A smaller firm, with only one or two funds, perhaps need to spend as little as £50,000. Ultimately, many companies view it now as part of the cost of doing business.

### **Conclusion**

Smaller managers with a private client base composed of high net worth individuals are less likely to require GIPS, but bigger firms interested in some kind of institutionally-recognised standard are focusing more on GIPS than they were. Go back 10 years, and few hedge fund managers in Europe had even heard of GIPS. The standards were beginning to gain traction with long only managers in the wake of a couple of major scandals in the mid-1990s covering the way performance data was presented. It has only been since 2004-05 that hedge fund managers have begun looking more closely at GIPS, but it is obvious that institutional investors who allocate to both long only and alternative investors are taking the standards on board. **THFJ**