

GUEST COMMENTARY

# Wake-up call on GIPS

**As private equity becomes more mainstream, investors are calling for self-regulated standards for performance presentation. On your next investor questionnaire, how will you answer the question, "Are you GIPS compliant?"**

By Carol Kennedy

Back in 1995, when the Association for Investment Management and Research (AIMR), the predecessor to the CFA Institute, first commissioned a project to evaluate the possibility of a global performance standard, private equity was a relatively small industry and was put in the "too difficult" box. The valuation processes that would enable it to be "marked to market" seemed to be veiled by a lack of transparency, disclosure and differing practices across the world because of the differing evolution and stages of development of the industry.

Ten years on, dramatic progress has been made. Private equity is now a \$600 billion industry (based on estimated fund closings globally between 1998 and 2005) and is increasingly considered mainstream in institutional investment portfolios. There has been a significant shift and global convergence towards using "fair value" as a basis of valuation, consistent with US GAAP and international financial reporting principles. The industry has embraced this with the recent publication of "International" Valuation Guidelines in Europe which have already been endorsed by 21 national associations in addition to the three founding associations AFIC, BVCA and EVCA (the French, British and European industry associations, respectively).

In the US, meanwhile, guidelines have been developed by the Private Equity Industry Guidelines Group (PEIGG), a grouping that included investors and advisors as well as managers. While these guidelines have not been formally endorsed by the National Venture Capital Association, they have been published in its 2005 yearbook so that they are readily accessible to their members for reference and use.

Both of these sets of Valuation Guidelines have been endorsed by the Institutional Limited Partners Association (ILPA), a grouping of

141 institutional investors with some \$300 billion allocated to private equity.

It is against this background of increasing commonality of approach to valuation that GIPS (Global Investment Performance Standards) for private equity provides a standardized format for fundraising purposes and for firms to calculate and report their performance.

**"By choosing to comply with GIPS, fund managers assure prospective investors that the historical 'track record' they are reporting is both complete and fairly presented."**

### GIPS NIPS AT PRIVATE EQUITY

The GIPS initiative has achieved remarkable success and engagement across the world as a truly global performance standard:

- 27 countries (and growing) in North America, Europe, Africa and Asia Pacific have already adopted GIPS
- A recent survey by Pricewaterhouse Coopers showed that 90 percent of asset managers, in their sample, were either compliant or working on being GIPS compliant
- GIPS is now the recognised performance standard across the world

Alongside material enhancements for mainstream asset classes, new provisions for pri-

ivate equity (as well as real estate) come into force effective January 1, 2006.

The GIPS standards, which are based on ethical principles of fair representation and full disclosure, seek to provide prospective investors with the critical pieces of information needed to evaluate the firm's historic performance. With private equity, because of the difficulty in determining an objective interim valuation of investments, the ultimate return on investments is impossible to determine until they are fully liquidated. Additional reporting requirements to those in mainstream asset classes are therefore necessary in the GIPS standards.

Importantly, while GIPS for private equity recognize "fair value" as a basis of valuation conforming with US GAAP and IAS, they also recognize that full convergence of existing valuation guidelines has yet to be achieved across the world. Thus, the standards set out high-level "Valuation Principles" which are at the core of the valuation methodology generally accepted as global best practice. These include a valuation hierarchy of fair value methodologies to assist firms in determining a prudent value for an investment.

In common with other asset classes, private equity is required to present performance information on a standardized basis: input data, calculation methodology, composite construction, disclosure and presentation are all addressed in the "mainstream" Standards. In addition, the private equity provisions call for performance to be presented as since-inception IRRs (both gross and net) and calls for specific ratios:

- Total value to paid-in capital (investment multiple) reflecting the value of investments relative to their cost base;



Carol Kennedy

- The cumulative distribution to paid-in capital (realization multiple) reflecting how much of the return has been actually given back to the investor;
- Paid-in capital to committed capital reflecting the proportion of total commitments that have been drawn down;
- Residual value to paid-in capital to measure how much of the return is unrealised.

Also, where a benchmark is used, it must reflect the same strategy and vintage year as the composite it is being compared with.

These GIPS standards incorporate many of the best practices already being followed by major private equity fund managers across the world and should help simplify the myriad of differing reporting formats requested by prospective investors and investment consultants in questionnaires.

### THE BENEFITS OF COMPLIANCE

The GIPS standards benefit three main groups: prospective or existing investors, their advisers and the fund managers themselves.

Prospective and existing investors can have a greater level of confidence in the integrity of performance presentations of a compliant firm. Performance can also be more easily compared across different fund managers.

For advisors, while GIPS certainly does not replace the need for other in-depth due diligence, compliance with the standards provides a level of credibility to the performance presentations of those fund managers who have chosen to comply.

By choosing to comply with GIPS, fund

### Top tips for GIPS

New GIPS standards take effect on January 1, 2006. The CFA Institute has compiled a list of answers to commonly asked questions regarding these revised standards, some of which are excerpted below. Source: CFA Institute Centre for Financial Market Integrity.

Our firm manages private equity strategies and it is not clear how to provide a fee schedule appropriate to the composite. Fund-of-funds do not have their 'own' fee schedule, what are we required to provide?

Within the fund-of-funds structure, there are two levels of fees. The fund-of-funds manager normally charges fees within the fund according to a schedule. This is the schedule that must be disclosed under the GIPS requirement. In addition, the underlying funds charge fees within their funds which vary according to the funds' strategy and size and include a performance element. These fees on underlying funds would be very difficult to separate out for a composite, but are fully taken into account in the fund-of-funds performance.

From time to time our firm does not have an appropriate composite that specifically meets the investment strategy a prospective client would like our firm to present. What information is our firm required to provide?

If the firm does not have a composite appropriate to present to a prospective client, the firm is exempt from this requirement. However, the firm must disclose that it does not currently manage the specific style or strategy appropriate for the prospective client. The firm must be able to clearly demonstrate the strategies and investment products the firm currently manages and must make a list and description of all firm composites available to the prospective client. The firm is not prohibited from providing any information the prospective client specifically requests. Also, supplemental information can always be provided in addition to the firm's existing composites.

In the revised version of the GIPS Standards, it states that some disclosures may not be required in all situations. Please elaborate.

If a situation described in a disclosure requirement does not exist at a firm, or is not applicable to a specific composite, no disclosure is required. Not all disclosures are necessary for all firms, only those applicable specific to the firm. For example, the GIPS Standards require that firms disclose if a composite's name has changed. When preparing a presentation for a composite that has not had a name change, no disclosure is needed with regard to this provision. The firm does not need to disclose that the composite has not changed names. No "negative assurance" language is needed for non-applicable disclosures.

We provide a compliant presentation to all prospective clients when we first meet with them. However, we often are in discussions with large prospective clients for many months, if not years. We send them updated composite information quarterly. Must the quarterly updates include all required disclosures?

No. Provided the firm has given a compliant presentation to a prospective client within the past 12 months, the firm may present additional information that does not meet the requirements of the GIPS Standards. A reference should be made that a composite presentation in compliance with the GIPS Standards is available upon request. If the prospective client is receiving investment results for the first time, the performance must meet the requirements of the Standards.

managers assure prospective investors that the historical "track record" they are reporting is both complete and fairly presented.

While the GIPS standards are voluntary, they are expected to be viewed increasingly as the norm. Thus, if a firm does not comply with GIPS standards, investors and prospective clients are expected to ask searching questions as to why they have chosen not to comply. GIPS standards also strongly urge firms to have their performance verified, ensuring that claims of compliance are genuine. The Investment Performance Council of the CFA

Institute (IPC) has stated its expectation that verification will become mandatory by 2010, allowing the asset management industry as a whole the time to meet the increasing demand globally for the number and quality of verification firms. ■

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