Deadline for Global Convergence Nears

AIMR-PPS® Compliant Firms Must Move to Global Standards January 1, 2006

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Almost 20 years ago, standards for the presentation of investment performance were first introduced in North America to promote consistent and ethical representation of investment management firms' performance results. Since their establishment, the AIMR Performance Presentation Standards (AIMR-PPS) have received overwhelming acceptance from the investment industry and currently serve as the industry yardstick for investment performance measurement and reporting in the United States and Canada.

The AIMR-PPS standards are practitioner-driven and reflect an ethical approach to ensure that performance presentations achieve fair representation and full disclosure. The standards are designed to provide a level playing field and to ensure apples-to-apples comparisons between investment management firms, regardless of the domicile of a potential client or investment firm.

Moving Beyond U.S. and Canadian Borders

In the mid-1990s, several countries outside North America began to adopt the AIMR-PPS standards to serve as the foundation for developing local performance standards. In some cases countries modified the AIMR-PPS standards to reflect local regulatory or legal requirements and established country-specific standards, thus beginning a practice where each country looked to create its own standard. CFA Institute's predecessor organization—AIMR® or the Association for Investment Management and Research—realized that a proliferation of local standards would lead to confusion, hinder the ability of prospective clients to compare performance results from firms in different countries, create barriers to entry, and impact the ability of investment firms to compete in markets globally.

In 1995, AIMR established a committee to develop and publish a single, global standard by which firms in all countries could calculate and present investment performance. One standard used globally would eliminate the multiple local standards and minimize confusion in the marketplace. In 1999, AIMR adopted the Global Investment Performance Standards (GIPS®) as a set of ethical principles that promote global competition and encourage self-regulation.

With the GIPS standards serving as *the* guideline that investment firms should follow, AIMR then took a significant step in moving toward one global standard by significantly revising the AIMR-PPS standards to bring them in line with the GIPS standards. In 2001, the AIMR-PPS standards became the U.S. and Canadian version of GIPS. As a country version of GIPS (CVG), the AIMR-PPS standards include all requirements of the GIPS standards with a few additional requirements specific to North America to satisfy local, well-established practices.

These changes made it possible for North American investment managers to transport their historical investment results to many other countries without having to restate them using different calculation and presentation rules. (Conversely, it also allowed investment managers in other countries to compete for business in the United States and Canada using the global standards without having to recalculate numbers using different North American rules.)

The AIMR-PPS standards, along with eight other CVGs, continued to include country-specific differences and best practices. In addition, other countries adopted the GIPS standards—by either taking on the English version or by translating the standards into a local language. By December 2004, investment organizations in 25 countries had adopted the GIPS standards.

In February 2005, the GIPS standards experienced their first major

revision, which facilitated the move to one truly global standard. Country-specific practices were evaluated and those that were considered global best practice were incorporated into the standards, thus eliminating the need for local versions of the GIPS standards. As such, all CVGs will be phased out beginning January 1, 2006, leaving firms around the world with one standard: the GIPS standards.

Implications of Convergence

When reporting performance for periods after December 31, 2005, U.S. and Canadian firms will be required to comply with the revised GIPS standards. Firms may not claim compliance with the AIMR-PPS standards if the performance being presented includes periods that begin after December 31, 2005. For most North American firms, the transition to the GIPS standards will be a simple exercise.

While the GIPS standards do have several new requirements, most of them represent practices that have been used widely in North America for years. For example, a new GIPS requirement mandates firms to disclose a description of the composite strategy in the composite presentation. While this is a new GIPS requirement, we believe that most firms already disclose a description of the composite strategy. Other new disclosures are similar; e.g., a firm must clearly label returns as gross-of-fees or net-of-fees and must disclose which measure of dispersion is presented. Again, we believe that most firms already include such information in their presentations. If they don't, it will be a simple matter to add the additional language, and we believe this information is fundamental to a prospective client's evaluation of the performance information.

One new disclosure requirement ensures that every presentation contains the following statement: "Additional information regarding policies and procedures for calculating and reporting returns is available upon request." This new disclosure may allow some firms to eliminate previously-disclosed details concerning calculation policies, which now may be provided when requested.

The revised GIPS standards also include other disclosure requirements that may need to be made, depending on each firm's specific circumstances. For example, firms prospectively must disclose whether a sub-adviser was used, and for which periods. To help firms determine what is required to transition to the GIPS standards, a matrix that compares the GIPS and AIMR-PPS standards has been prepared by the AIMR-PPS Implementation Committee and is available on the CFA Institute's Web site at http://www.cfainstitute.org/cfacentre/ips/.

Generally, firms compliant with the AIMR-PPS standards should find that the majority of changes are related to the disclosure requirements; some disclosures may need to be added while others may need to be eliminated. With the matrix in hand, a firm should be able to easily determine the changes needed to comply with the GIPS standards.

Benefits of One Standard

Financial markets and the investment management industry have become increasingly global in nature, resulting in few firms doing business solely in their own countries. With the exponential growth of assets under management and the globalization of the investment management industry, firms need relief from tracking and complying with a variety of standards. By complying with the GIPS standards, investment management firms can reduce the effort needed to comply with different standards and efficiently compete for business globally. Standardizing the calculation and presentation of investment performance also will assist prospective clients in comparing presentations, whether from domestic firms or firms located in different countries. Finally, using one standard will help alleviate confusion concerning differences between the various standards and the GIPS standards.

Highlights of the new GIPS wrap-fee/SMA guidance

Provisions and guidance for wrap-fee portfolios, also called separately managed accounts (SMAs), have been part of the AIMR-PPS standards since 1995. A firm that manages wrap-fee/SMA portfolios and includes those assets within the firm definition for purposes of compliance with the AIMR-PPS standards must follow the existing AIMR-PPS provisions for all periods after July 1, 1995. The current guidance includes a few basic requirements, with the key concept of requiring wrap-fee returns to be presented net of the total wrap fee. By deducting the total wrap fee, prospective investors are able to see the fee's impact on total returns and can better compare investment products.

The 1999 version of the GIPS standards did not have any guidance specific to wrap-fee/SMA portfolios; however, the revised version of the GIPS standards does include broad guidance for bundled-fee portfolios. The bundled-fee guidance does not acknowledge the unique nature of wrap-fee/SMA portfolios and the wrap industry. As such, guidance was issued in August 2005 to assist firms in applying the GIPS standards to wrap-fee/SMA portfolios and has been welcomed by many in the industry.

The GIPS Wrap Fee/SMA Provisions and Guidance have an effective date of January 1, 2006, to coincide with the revisions to the GIPS standards and convergence of the AIMR-PPS standards. It is important to note, however, that that the wrap-fee/SMA guidance and provisions are required on a prospective basis only. Firms that are coming into compliance with the GIPS standards must begin to build a GIPS-compliant track record for their wrap-fee/SMA assets as of January 1, 2006.

>> "DEADLINE" CONTINUED

Because the new GIPS provisions will replace the existing AIMR-PPS provisions, firms with wrap-fee/SMA assets under management and currently compliant with the AIMR-PPS standards should have only a few changes as a result of the transition. Under the new provisions, firms will have more options for how wrap-fee/SMA performance results can be calculated and presented. Below are a few key highlights from the new guidance:

- All presentations provided to prospective wrap-fee sponsors and clients must include performance that is net of the total wrap fee.
- A firm may present the performance history of an institutional composite as a wrap-fee proxy if the institutional composite returns are netted down by the total wrap fee that will be paid.
- Once a firm manages wrap-fee/SMA portfolios, it must present wrap-fee/SMA performance to prospective clients.
- When presenting performance to a prospective sponsor and/or investor, a style-specific composite must be used. If, for example, a firm manages small-cap accounts for four different wrap-fee/SMA sponsors, the firm must create a small-cap style-specific composite that includes performance from all four sponsors.
- If requested, a firm may create a sponsor-specific composite for presenting the performance results of one sponsor to that sponsor.

Questions Consultants Should Be Asking (and Not Asking)

When presenting performance for periods after December 31, 2005, firms must comply with the GIPS standards. Once a firm presents results for periods after January 1, 2006, in a compliant presentation, it must no longer state that the presentation is in compliance with the AIMR-PPS standards. During the transition from AIMR-PPS to GIPS compliance, firms have the choice as to whether they should claim compliance with the following:

- only the AIMR-PPS standards,
- only the GIPS standards, or
- both the AIMR-PPS standards and the GIPS standards.

The AIMR-PPS and GIPS standards are very similar and have only minor differences. As such, we suggest that consultants accept compliance with the GIPS standards as equal to the AIMR-PPS standards. An appropriate question that consultants may use to inquire about compliance is: "Does your firm claim compliance with the GIPS standards and/or or the AIMR-PPS standards? If so, for which periods?"

Also, many consultant questionnaires and request for proposals wrongly inquire about whether a firm is "level I compliant" or "level II compliant." There are no levels of compliance with the standards—compliance is a yes or no answer.

Verification also is a question that is frequently raised. Verification is an independent third party's review of a firm's policies and procedures for calculating and reporting results in compliance with the GIPS standards. A verification is performed with respect to an entire firm and cannot be conducted on only a single composite. The verification report is issued to a firm, and it may cover any period for which a firm claims compliance. While verification currently is voluntary, it is expected to be mandatory in the future, but not sooner than January 1, 2010.

A proper question for inquiring about verification is: "Has your firm been verified? If yes, by whom and for which periods?"

A firm may choose to have a detailed examination of any of its composites, separate from a verification as defined in the GIPS standards. This further, more extensive, specifically focused examination (or performance audit) of a specific composite and its presentation, conducted by an independent third-party verifier, is termed a performance examination (or performance audit) under the GIPS standards. The performance examination may be performed concurrently with or upon completion of a verification. Examinations of this type are unlikely to become a requirement of the standards or to

Questions for Assessing Compliance

Consultants should ask prospective investment management firms the following questions:

- Do you comply with the GIPS (AIMR-PPS) standards?
- If so, is your claim verified? Who verifies your claim?
- Does this verifier act in any other capacity for your organization (i.e., as auditor or performance measurer)?
- How frequently is this verification carried out? (This will illustrate the manager's degree of commitment to the standards.)
- How is your firm defined for purposes of GIPS (AIMR-PPS) compliance? Which parts of your business meet the compliance requirements? (This shows the scope of the practice across the group, across products, and by business unit.)
- What do you consider the main benefits that compliance with the standards delivers to investors? (This reveals how the standards are regarded—as a marketing lever, a tool for best practice, or a mechanism for operational efficiency.)
- Who has overall responsibility for GIPS (AIMR-PPS) compliance in your organization?
- If you do not comply with the GIPS (AIMR-PPS) standards, why not?
- Do you plan to comply at some point in the future?

become mandatory. In the United States, however, it is common for firms to have a performance examination performed on one of more of the firm's composites.

A proper question to ask about this level of testing would be: "Has a performance examination been conducted on the firm's XYZ Composite? If so, by whom and for which periods?"

Similar to the discussion above about levels of compliance, the terms "level I verification" and "level II verification" are not appropriate. These were once concepts of the AIMR-PPS standards, but these terms were phased out almost five years ago. Instead, a composite has been either examined or not examined—just as a firm has been either verified or not verified. M

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Cognitive Biases Series:

Anchoring

BY MEIR STATMAN, Ph.D.

This is the second in a series.

DR. MEIR STATMAN

In the last issue of the *Monitor*, I introduced the Cognitive Biases Series and discussed the availability bias. Availability is the bias that leads us to conclude, for example, that the proportion of five-star mutual funds among all mutual funds is higher than the true proportion because mutual funds companies make images of five-star funds readily available to our memory through advertising while they hide their one-star funds. I argued that scientific knowledge can help us overcome cognitive biases and emphasized the role of investment consultants as educators. In this column, I will discuss the anchoring bias and begin with a question.

What is your quick five-second estimate of the product of 1x2x3x4x5x6x7x8? This is the question that Amos Tversky and Daniel Kahneman posed to their subjects. You probably started your way to an answer by multiplying 1 by 2 and getting 2, then multiplying 2 by 3 and getting 6, then multiplying 6 by 4 and getting 24. With your five seconds running out you jumped to a conclusion, perhaps 500, perhaps even 1,000. But you probably did not jump far enough to reach 40,320, which is the correct answer. It is as if you were anchored to the last number you got to in your multiplication, 24 or perhaps 120, by a short chain. Tversky and Kahneman found that the median estimate of their subjects was 512, and named the bias *anchoring bias*.

I had my own memorable experience with the anchoring bias when I studied the Dow Jones Industrial Average (DJIA). The DJIA was introduced in 1896 at a level of 41. By the end of October 2005 it was at 10,348. The DJIA, like the S&P 500 Index and almost all indexes, is a capital index; it does not include dividends and the compounding of reinvested dividends over time. Now think of a DJIA where dividends are reinvested and compounded over time. What is your five-second estimate of the level of that compounding DJIA at the end of October 2005? The correct answer is at the end of the article.[1]

When I saw a similar result in a spreadsheet for the first time, I was sure that I had made some mistake in my calculation. Doing the calculation in my head I started with 10,348, the level of the DJIA at the end of October 2005, and multiplied it by a large number knowing that compounding works quite quickly and forcefully. But the number I chose, and probably the number you chose, was much too small.

We should know the bias of anchoring and take precautions against it. For example, we should know that we tend to be anchored to the long-term average return of stocks and expect stock returns in any year not to deviate much from it. But stock returns in any year are likely to deviate greatly from the long-term average. For example, the