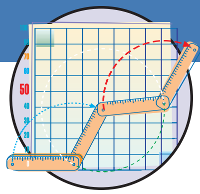

Standards IN PRACTICE

New UK Standards for Advertising Investment Performance

FSA undertakes new regulatory measure

BY MARK HARRISON, CFA

How should performance information be presented to unsophisticated individual investors? This question has been at the heart of new regulatory measures undertaken by the UK's Financial Services Authority (FSA).

"Our basic premise is that for consumers, past performance is not a useful future indicator because they don't put an appropriate context around it or understand the risk messages that it is giving," says Mary Hollinshed of the FSA Conduct of Business Standards Division, "so we looked to reduce the emphasis placed on it."

The FSA has generated a series of research papers opposed to the use of past performance, an important marketing tool for investment managers. In 1999, an FSA-sponsored report by Bacon & Woodrow, a firm of consulting actuaries, concluded that using past performance to select investment providers was "fundamentally unsound." In 2000, the FSA circulated Occasional Paper 9, "Past imperfect? The performance of UK equity managed funds," which suggested that "information on past performance cannot be exploited usefully by retail investors."

"Our Consumer division established an independent task force of advisers to look at issues surrounding past performance in 2001," says Hollinshed. In 2002, the FSA issued Consultation Paper 132 (CP132), which laid out proposals to restrict the use of performance information.

Further FSA research concluded that looking at past performance was useful but only in order to identify underperforming funds, with no evidence that overperforming funds continued to outperform. In 2003, the FSA issued Consultation Paper 183 (CP183), "Standardizing Past Performance," which included feedback on CP132. "Standardization took us so long to get to because there are more complex issues involved," says Hollinshed. "CP183 was the last of this package of measures which were designed to reduce the emphasis placed on past performance in advertising."

Benefits for Investors

"It is encouraging how many consistencies there are between the new FSA rules and the GIPS Advertising Guidelines," says John Stannard, CFA, AIMR board member and a managing director at Russell Investment Group in London, England. Stannard served as chair of AIMR's Investment Performance Council (IPC) when that group first considered advertising. "The focus on better advertising is good news for the investor," says Stannard. "The IPC recognized that managers wanted to advertise their compliance with the GIPS standards but wanted to uphold the basic standards of fair representation and full disclosure — in much the same way as proposed by the FSA."

The IPC broadly agreed with the FSA's goal of reducing emphasis on past performance. "But we recognized that managers wanted to present performance and investors wanted to see it," says Stannard. "So the challenge was to ensure that key material information was provided and the investors knew how to get access to the full GIPS-compliant presentation if they wished."

KEY POINTS

- The UK FSA has introduced a new standard for presenting performance in advertisements.
- FSA CP183 and GIPS Advertising Guidelines both allow for the publication of five annual periods of performance in advertisements.
- The FSA departs from the GIPS Guidelines by not mandating the use of a benchmark in advertisements.

Similarities to GIPS Advertising Guidelines

The FSA considered a number of options, including simple returns over different time periods, excess returns, risk-adjusted returns, and star rankings. In opting for five discrete annual periods of simple returns, the FSA believed that such an approach would be most easily understood by consumers and would avoid the conceptual complexity of risk-adjusted numbers. Simple returns also can be objectively determined and easily monitored.

"The focus on individual years chosen by the FSA for CP183 is similar to the GIPS Advertising Guidelines, which also emphasize individual-year returns," Stannard points out. "This avoids historical numbers being unduly influenced by the last month or quarter of returns."

Using individual-year returns has another advantage. "I actually prefer [it] so that you can look at the consistency of performance," says Carl Bacon, a member of the UK Investment Performance Standards (UKIPS) committee, chair of the IPC Interpretations Subcommittee, and chairman of Statpro Group in London, England. "That is a requirement of GIPS standards, and it is an option but not a requirement of the new GIPS Advertising Guidelines, which allow running-average periods." When the proposals came out, he recalls, the single-annual-period approach was much discussed by the committee. "It was a question of trying to abbreviate the information in the limited space that is available in an advertisement," Bacon explains. "I think that is unfortunate because five years of annual information would be ideal."

"There is a lot of consistency between what the FSA says and what the GIPS standards say," Stannard notes. "It tends to be five years in the US, although the SEC comes down in favor of five-, three-, and one-year periods ending in the most recent period."

Another similarity is in the use of the most recent quarterly performance periods. "The GIPS Advertising Guidelines require performance to be displayed through the most recent period end so you cannot cherry-pick time periods," says Bacon.

"There is an issue about keeping past performance up to date," says Hollinshed, who served as an FSA observer on the UKIPS advertising subcommittee. "What we originally proposed in CP183 was a monthly basis for updates, but we received representations from the industry, and we accepted those representations and moved to a quarterly basis."

The FSA's treatment of pooled fund results also is consistent with the GIPS Guidelines. "One of the core issues around the GIPS standards is the use of composites to make sure that managers are not cherry-picking their accounts to exaggerate performance," says Stannard. "It is important to ensure that advertisers are not cherry-picking their accounts."

"The FSA guidelines are not necessarily inconsistent with GIPS Guidelines in the use of composites," Bacon points out. "I would recommend putting pooled-type vehicles into single portfolio composites anyway, because the strategy when you are addressing inflows and redemptions is a consistent and unique one."

Departures from the GIPS Guidelines

In order to reduce the potential for consumers to be misled when reading advertisements, the FSA decided not to mandate the use of a benchmark because benchmark information can be used to make performance look overly persuasive. But Bacon and Stannard argue the opposite point. "It is the best performance practice to show an appropriate benchmark alongside the performance so that you can show what the excess return is rather than the absolute return," says Bacon. And according to Stannard, in most cases, AIMR would recommend using a benchmark "that clearly represents the market return, which in turn gives you a better sense of how successful the investment strategy has been."

Under the new regulations, UK firms are not allowed to advertise performance periods of less than one year. "If you are saying that every time you talk about past performance information you must include standardized data, then there is a point where the standardized data becomes meaningless," says Hollinshed. "It was felt that it was fairly common practice internationally for the line to be drawn at one year, and in fact that was the position adopted by the EU."

"In a GIPS presentation, you can show less than one period, but you must also show up to five periods," says Bacon. "I don't think that the GIPS Advertising Guidelines stop you showing less than one period. As long as the GIPS-required performance periods are shown, that could well be providing information that is useful to the client. If the quarterly information is available, I think it should be shown. I am not against showing shorter periods of performance, provided the entire history is also shown."

Regulatory vs. Self-Regulatory

The close relationship between the new FSA rules and the new GIPS Advertising Guidelines raises the question: Why didn't the FSA simply adopt the GIPS rules? "When you look in detail at CP183 and the GIPS Advertising Guidelines, there is certainly some reliance of one upon the other," says John Barrass, AIMR vice president for European affairs in London, England. "The GIPS standards are not just for institutional firm composites—they also encompass pooled funds. The GIPS standards may not necessarily work for all fund structures, but it should work for communicating retail fund performance just as it does for an institutional investor's performance. It would be pointless for the FSA to replicate a set of standards already developed by the industry itself."

"These rules are very specific to the retail audience here in the UK," says Hollinshed. "Our position is that the regulatory interest here is in advertising to consumers. … The market itself has clearly seen a need to develop standards such as the GIPS standards in other domains, particularly in relation to professionals talking to each other, which is a perfectly legitimate response."

"Regulators have certainly been actively involved in the discussions around the GIPS standards and generally seem to be supportive of the notion of self-regulation, which tends to work quite well," says Stannard. Because the GIPS standards mandate that local regulatory standards supersede the GIPS standards, Bacon observes, "There is never any contradiction or complication because the local regulations are always the main requirement. I think it is useful to have GIPS standards out there because if we did not, then I think there would be much more regulation of the industry and many more diverse rules globally about what a regulator should be doing."

"With AIMR guiding a fair and ethical process, I think that self-regulation of this nature is the way forward," says Stannard. "But clearly the regulators will at times feel that they have to get involved, and AIMR welcomes the opportunity to work with them. The more that self-regulation is effective, the less that regulators will feel the need to intervene."

Mark Harrison, CFA, is an investment officer at Merseyside Pension Fund and is based in Liverpool, England.

RECOMMENDED RESOURCES

GIPS Advertising Guidelines
(www.aimr.org/standards)

FSA Consultation Paper 183: Standardizing Past Performance
(www.fsa.gov.uk/pubs/cp/183)

"Performance Presentation Standards: Which Rules Apply When?"
Financial Analysts Journal, March/April 2001
(aimrpubs.org)