

AIMR Floats New GIPS® Leverage and Derivatives Standards for Comment

BY LORI PIZZANI

Exactly how should investment managers convey the use and risk of derivative securities, or explain and calculate the potential impact of their hedging techniques and leveraging strategies? Proposed new standards aim to answer that important question.

In mid-October 2002, a subcommittee of the Investment Performance Council (IPC) of AIMR floated for public comment a series of new standards that tackles investment managers' use of derivative securities as well as currency hedging and other leverage strategies. If adopted later this year, the new proposals — about which comments can be made through 30 April 2003 — could become the newest section added to the association's Global Investment Performance Standards (GIPS®). While the new standards don't try to provide guidance for every possible situation, they discuss many of the most commonly used techniques.

The new proposals won't become effective until 1 January 2005, providing those firms that are compliant with the GIPS standards sufficient time to implement the changes. This time frame also gives firms across the globe the opportunity to fully adopt the standards before these provisions are mandated. Two additional provisions, which will require that firms also disclose longer-term historical data, will be phased in beginning in 2006.

Derivatives are instruments that derive their value from price or value changes in an underlying element or security, such as a stock, commodity, or interest rate. Leverage and hedging techniques are typically used where managers expect to materially impact the return achievable on an investment by increasing or decreasing its exposure to a factor. Strategies can include the use of options, futures, margin borrowing, long-short or market-neutral strategies, or a combination of these strategies.

Why the current focus on putting derivatives, leverage, and hedging strategies under the microscope? Actually, the focus isn't new at all. Back in March 2000, the IPC created the Leverage and Derivatives Subcommittee, asking that its members craft "best practice" standards to address the calculation and presentation of investment returns that derivatives and leverage implementation impact. After two and a half years of diligent work, the subcommittee recently released its recommendations.

**“These proposals
advocate fair
representation and
full disclosure to
ensure that the end
user is fully informed.”**

—
ALECIA LICATA
Vice President of
Investment Performance Standards
AIMR

Hedging Bets with Better Disclosure

The new leverage and derivatives proposal applies to discretionary composites that use leverage. The proposal clearly defines and explains the specific techniques that fall under these new proposals, and, by supplying a variety of examples, it provides guidance as to precisely how firms are to make their calculations.

Specifically, the new proposals will advocate that investment firms:

- disclose the use of leverage, hedging, and/or derivatives, describe their frequency of use, and describe how the firm uses them;
- explain the characteristics of these securities or strategies so that risks can be identified;
- disclose the tracking error over the

most recent three-year period, as well as the methodology that the firm uses to calculate that tracking error;

- disclose the methodology that the firm uses to determine Value at Risk (VaR);
- disclose the volatility of the monthly composite's return as far back as 2001;
- present minimum, average, and maximum exposure during each period presented;
- present minimum, average, and maximum ratio of VaR for the composite and relative benchmark;
- note the minimum, average, and maximum percentage of composite assets that a stock exchange does not list or trade, which can include customized derivatives, direct real estate investments, private equity securities, special purpose vehicles, and swaps — and publicly traded bonds, despite not trading on an exchange, are excluded;
- disclose the minimum, average, and maximum percentage of composite assets held in short positions.

Additionally, beginning 1 January 2006, firms that use leverage strategies will be asked to disclose their composite's tracking error and volatility over the most recent five- and 10-year period, or from inception if less than 10 years old.

Although not a formal requirement, AIMR is also suggesting that investment professionals provide relevant risk measures, which could include beta, modified duration, or other risk metrics.

Derivatives and Leveraging Go Mainstream

“Everyone pays attention to performance numbers,” concedes Alecia Licata, AIMR vice president of Investment Performance Standards. And with the maturing and increasing sophistication

Continued on page 16

[ADVERTISEMENT]

LEVERAGE AND DERIVATIVES STANDARDS *Continued from page 14*

of the US investment management marketplace, and the increasing use of more sophisticated investment techniques and more exotic securities, AIMR realized it was time to incorporate the same type of performance standards to this burgeoning area as was done with other investment areas, she says.

Until a few years ago, “derivatives” was a word that few dared to utter out in public, Licata noted. Now, derivatives and hedging practices have truly gone mainstream. “People are more open to hedging risks, employing margins, and implementing borrowing strategies,” says Licata. “These proposals advocate fair representation and full disclosure to ensure that the end user is fully informed.”

Not only will these new provisions provide the necessary guidance and standards for professionals to use

domestically, Licata believes the provisions, where also adopted in other countries as part of the broader GIPS standards, will assure that performance touting related to these techniques is more transparent and will provide an extra level of clarity for clients and potential investors.

“The true benefit to managers is that these provisions furnish clear and concise guidelines and suggestions as to how to address certain strategies, for which many of the performance calculations are not an easy task,” Licata explains.

You may review the proposed addition of leverage and derivatives provisions and guidance to GIPS at www.aimr.org/standards. The deadline for comments is 30 April 2003. **✓**

Lori Pizzani is a New York-based freelance financial journalist and business writer.

AIMR-PPS® AND GIPS® INTERACTIVE WORKSHOPS

Two AIMR-PPS/GIPS Workshops

Choice of 2 or 3 April 2003

Boston, MA, USA

GIPS Workshop

10 June 2003

Paris, France

For details go to
www.aimr.org/standards

STANDARDS E-MAIL ALERT

The AIMR Professional Standards department now has a bi-monthly e-mail service detailing current events relating to the Investment Performance Standards (AIMR-PPS® and GIPS®). If you are interested in subscribing to our e-mail alert list, write to standards@aimr.org and enter “Standards E-mail Alert” in the subject heading, with your name, postal address, and e-mail address in the body of your message.

ISSUES OPEN FOR PUBLIC COMMENT

**Proposed Venture Capital
and Private Equity Provisions
and Valuation Principles**

Open for comment
until 31 March 2003

**Proposed Leverage
and Derivatives Provisions**

Open for comment
until 30 April 2003

Visit www.aimr.org/standards/issues or e-mail standardsetting@aimr.org for more information.

INVESTMENT PERFORMANCE COUNCIL

MEETING DATE

24 June 2003

Conference Call 7:30 a.m. – 9:00
a.m. (EST)

All meetings are open to the public. To be included in the call, e-mail standardsetting@aimr.org at least two weeks prior to the scheduled meeting date.

IPC-ENDORSED STANDARDS

as of 6 January 2003

Country Version of GIPS (CVG)

AIPS (Australia)
E-IPS (Egypt)*
DVFA-PPS (Germany)*
IPS (Ireland)
IPPS (Italy)
SAAJ-IPS (Japan)
SPPS (Switzerland)
UKIPS (UK)
AIMR-PPS (US & Canada)

Translation of GIPS (TG)

GIPS (Austria)
GIPS (Denmark)
GIPS (France)
GIPS (Hungary)
GIPS (Luxembourg)
VBA-PPS (Netherlands)
GIPS (Norway)
GIPS (Poland)*

GIPS (In English)

New Zealand
Portugal

* Indicates submission has been received,
but not yet endorsed by the IPC.

Visit www.aimr.org/standards
for more information.