

INVESTMENT PERFORMANCE COUNCIL ADOPTION OF THE GUIDANCE STATEMENT ON COMPOSITE DEFINITION

SUMMARY: In October 2001, the Association for Investment Management and Research (AIMR[®]) released for public comment the proposed Guidance Statement on Composite Definition.

The Guidance Statement on Composite Definition provides clarification to the Global Investment Performance Standards (GIPS[®]) relating to how the firm defines its composites.

ADDITIONAL INFORMATION: For further information on this Guidance Statement and the GIPS standards, contact AIMR's Professional Standards and Advocacy department via facsimile at 4344-951-5320, via e-mail at gips-info@aimr.org, or at 560 Ray C. Hunt Drive, P.O. Box 3668, Charlottesville, VA 22903-3668.

I. PURPOSE OF GUIDANCE STATEMENTS

Guidance Statements are developed to respond to questions that raise new and novel issues that are beyond the scope of the simple application of the Standards and/or require additional interpretation and clarification. They incorporate all of the applicable existing interpretations that have been published on a subject in an effort to consolidate all related information and add clarification.

II. SUMMARY OF COMMENTS

In general, most of the comments received during the public comment period were in support of the objectives of the Guidance Statement. Below is a summary of the comments received along with the changes generated by the comments. The firm or individual making each comment is indicated using the following abbreviations:

CAPS:	Karyn Vincent, CFA; CAPS, Inc.
NSFA:	The Norwegian Society of Financial Analysts
PWC:	Kelvin Laing-Williams and Peter McNamara; PricewaterhouseCoopers
SAAJ:	The Security Analysts Association of Japan
STAT:	Carl Bacon, StatPro
SBA:	The Swiss Bankers Association
TRPA:	T. Rowe Price Associates, Inc.
UBS:	Robert Clark, CFA, William McCoy, CFA, and Paul Weller; UBS Asset Management
UKIPC:	United Kingdom Investment Performance Committee

VBA: Vereniging van Beleggingsanalisten (Dutch Financial Analysts Society)

WM: The WM Company – GIPS Verification Department

1. Comments on Discretion

The original proposal included a discussion of Discretion, including potential reasons to classify a portfolio as non-discretionary. The proposal also included an option for firms to classify a portion of a portfolio as non-discretionary.

Comment: We do not believe that firms should be allowed to exclude a portion of a portfolio as non-discretionary as such a task would be cumbersome and non-practical. (PWC, UKIPC)

Comment: In general, firms should be allowed to classify a portion of a portfolio as non-discretionary. However, this is often not feasible in practice. Exclusion of a non-discretionary portion of a portfolio would require the creation and administration of “sub-accounts” which would be very difficult to implement. (SBA)

Comment: We agree with the draft Guidance Statement. Specifically with regards to handling particular portions of portfolios that may be non-discretionary (sometimes referred to as “parked” assets), most current systems can classify these holdings as unmanaged. This allows the manager to implement strategy correctly and performance calculations to accurately reflect that strategy. (UBS)

Comment: If a firm classifies a portion of a portfolio as non-discretionary, the non-discretionary portion must be treated like a carve-out (e.g., must have cash allocated to it). (NSFA, SAAJ, WM)

Firms should be allowed to designate a portion of a portfolio as non-discretionary, provided that the remainder of the portfolio is representative of a composite strategy. If a firm designates a portion of a portfolio as non-discretionary it is generally because a particular security is restricted in some way (e.g., low cost basis, etc.). Because the restricted positions are not actively managed they do not qualify as carve-outs and are not required to have a cash allocation (i.e., the cash remains with the discretionary portion of the portfolio). When a portion of a portfolio is classified as non-discretionary and excluded from the portfolio performance, consistent, systematic record keeping should support such action.

Revision: None.

Comment: The Guidance Statement should make it clear that a portfolio may be considered non-discretionary due to documented client imposed restrictions and legal regulations. (PWC)

It is important to remember that the GIPS standards require firms to adhere to all local laws and regulations. If legal regulations hinder the firm's ability to implement its strategy (e.g., the firm cannot sell a restricted stock), then the portfolio, or portion of the portfolio, may be classified as non-discretionary.

Revision: *Added "legal regulations" as possible reason for non-discretionary status.*

Comment: The Guidance Statement should offer additional guidance as to how and how often a firm should review its portfolios to determine if they should be re-classified. (PWC)

In general, the Standards attempt to not be overly prescriptive. It is recommended that firms review their portfolios at least annually, but could do so more frequently. Firms must determine how frequently they will review their portfolios to ensure that non-discretionary portfolios are not included in a composite and that discretionary portfolios are not excluded.

Revision: *Added language clarifying that the firm is responsible for reviewing its portfolios to ensure that the appropriate portfolios are included and excluded from each composite.*

Comment: The Discretion section state "Firms are only permitted to move portfolios into and out of composites due to changes in discretion resulting from documented changes in client guidelines or in the case of redefinition of a composite." The Guidance Statement requires clarification as to whether documentation needs to be sent to clients contemporaneously with oral conversations or whether an internal memo (contemporaneous or not) is adequate if documentation is not otherwise received from the client as to the change requested. Clarification should also be provided on the "redefinition of a composite" and what the required communications should be when a firm determines that a strategy will no longer be offered. (PWC)

Firms must determine what type of documentation is needed for its own purposes as well as to satisfy the requirements imposed by the local regulatory agency. The purpose of requiring documentation is not to burden the firm with additional work, but to substantiate and record the reasons for any changes. In most contractual relationships, written documentation from the client is typically needed. In all cases, some form of communication (internal or external) is required. For example, an internal memorandum documenting a telephone conversation with the client is acceptable. The Standards do not specify how firms must communicate that they are no longer offering a particular strategy.

Revision: *Added language clarifying documentation requirements.*

Comment: The UKIPC suggests that the definition of discretion should be oriented toward keeping those portfolios that qualify as non-discretionary to an absolute minimum. The IPC should even possibly prescribe a maximum proportion of assets that can be defined as non-discretionary as obviously, if a firm were earning a fee for managing a portfolio, it would follow that there must be some element of discretion being exercised. (UKIPC)

Discretion deals with how client imposed restrictions impact the ability of the firm to implement its strategy. Requiring firms to limit the amount of non-discretionary portfolios would either cause firms to turn away clients or force firms to include portfolios in a composite that would normally be considered non-discretionary. It would not, therefore, be appropriate to limit the percentage of assets that are non-discretionary.

Revision: *None.*

Comment: If a portfolio has a client-imposed restriction that prevents the implementation of the firm's intended strategy, then the only option should be for the firm to classify the portfolio as non-discretionary and exclude it from entering any composite. A firm should not be allowed to enter such a portfolio into any composite. (WM)

Comment: The draft discusses degrees of discretion and states that firms may consider classifying portfolios with certain restrictions into a separate composite. It is suggested that this statement should read "should where possible" rather than "may" reducing the opportunity for individual interpretation or choice. (UKIPC)

In general, firms should not reclassify portfolios from non-discretionary to discretionary status unless there has been a change in the restrictions. The firm should, where possible, choose to create a composite according to the specific restriction (e.g., no tobacco stocks) if the firm determines that this is a strategy that it would potentially like to offer.

Revision: *Modified wording to reflect that firms should, where possible, classify these portfolios as discretionary and create a separate composite.*

2. Comments on Minimum Asset Level

The original proposal included a discussion regarding the option for firms to establish a minimum asset level for a composite. The proposal discussed factors that should be considered when establishing a minimum asset level and offered guidance as to how portfolios should be treated when they fall below the minimum.

Comment: Firms should be required to remove portfolios from a composite if they fall below the minimum, regardless of the reason why they fell below the minimum. It is impractical to require acknowledgement from a client if a portfolio falls below the minimum as a result of market movements. (CAPS, PWC, STAT, SAAJ, SBA, UKIPC, UBS)

The Investment Performance Council agrees that firms should not be required to specify the reason a portfolio falls below the minimum or receive client acknowledgment. At times it may be difficult to determine the cause for a portfolio to fall below the minimum and, in some cases, it may be due to a combination of client withdrawals and market movements. In addition, it is much more practical to systematically apply a minimum if it applies to all situations.

Revision: *Changed language to treat portfolios that fall below the minimum due to client withdrawals and market movements consistently.*

Comment: Firms should review portfolios for compliance with composite minimums at the beginning of the measurement period (typically a month). The portfolio should be re-included in the composite once its beginning market value exceeds the composite minimum. By evaluating portfolios at the beginning of the period, there would be a downward bias as poorly performing portfolios would be included in the composite for the period in which the market value fell below the minimum. (CAPS)

Comment: Firms should also be allowed to establish a threshold for removing portfolios (e.g., portfolios that fall within +/- 5% of the minimum may be removed). (CAPS)

Comment: In order to avoid frequently moving portfolios into and out of composites, there should be a defined time frame that portfolios must remain below a minimum prior to removing the portfolio from a composite (e.g., a portfolio must be below the minimum for two consecutive periods). (CAPS, PWC, SBA)

It is important for firms to consistently apply their policies and procedures. Firms are allowed flexibility to determine how they will evaluate portfolios against the minimum, but must do so consistently. The use of the beginning market value is not necessarily a better value to use as a portfolio could begin below the minimum and then receive a cash flow that would move it above the minimum. Portfolios that fall below the minimum are not necessarily those that are under-performing relative to the asset weighted composite return. The Investment Performance Council agrees that the application of a threshold around the Minimum Asset Level will prevent portfolios from being removed if they fall slightly below the minimum for a short time. Thresholds must be applied consistently. The Investment Performance Council also agrees that the use of a minimum time period that a portfolio must remain above or below the minimum would be helpful to firms in the administration of their composites. If firms choose to implement a minimum policy, it must be implemented consistently over time.

Revision: *Clarified language regarding application of the minimum asset level. Added suggestion that firms consider using a threshold and minimum period for the application of the minimum asset level.*

Comment: The draft Guidance Statement states “Once a portfolio is removed (from a composite), the firm must determine if the portfolio meets any other composite definition and must include it in the appropriate composite(s) in a timely and consistent manner.” If a firm has determined that a portfolio must have a certain minimum market value in order to be discretionary, then a portfolio that falls below the minimum would be considered non-discretionary and would not qualify for inclusion in any composite. The current language seems to suggest that a firm may create numerous composites using the same style, with the only difference being market values. This would contradict the philosophy behind the current guidance. We suggest deleting this language from the draft GS. (CAPS)

The Guidance Statement also states: “Composites must not be defined by portfolio size unless the size of the portfolio affects the implementation of the investment strategy. In this case, portfolios would be placed into separate composites because of differing strategies, not simply due to size.” While there are situations where a portfolio with a smaller asset level may be eligible for a different composite, the language discussing eligibility for other composites will be removed to avoid confusion. The Guidance Statement also states: “Composites must not be defined by portfolio size unless the size of the portfolio affects the implementation of the investment strategy. In this case, portfolios would be placed into separate composites because of differing strategies, not simply due to size.” Since composites are defined by strategy, moving a portfolio into a different composite would necessitate a change in strategy and, therefore, a change in client investment guideline. Suppose that a firm has an equity strategy that is implemented differently depending on the size of the portfolio. If the portfolio falls below the minimum established for the composite with the strategy for larger portfolios, it may be eligible for the composite with the strategy for smaller portfolios. It would seem that such a change would necessitate a change in client guidelines (due to the change in strategy). The portfolio would no longer belong to the original strategy, but if the strategy were to change (with the requisite documentation of change in client guidelines) then the portfolio would be eligible for inclusion in another of the firm’s composites representing a strategy that does not require the larger amount of assets.

Revision: None.

Comment: The last paragraph of “Minimum Asset Level” (“Firms should bear in mind that if all the portfolios in a composite fall below the minimum and are removed from the composite, the performance record would stop. If portfolios later....but not linked to the on-going composite performance.”) is not an issue concerning composite definition nor minimum asset level but one regarding disclosure/presentation for composite performance which discontinues because of a lack of portfolios for certain periods. Accordingly, the issue should be generally covered under another appropriate Guidance Statement. (SAAJ)

This section is included in the Guidance Statement as a reminder to firms of what can happen as a result of the application of a minimum asset level. It is important for firms to recognize that if

all of composite's portfolios fall below the minimum, they will be removed from the composite, resulting in no performance results for a period time, thus creating a gap in the performance record.

Revision: **None.**

Comment: *“Firms may establish a minimum asset level for a composite to identify portfolios that are too small to be representative of the intended strategy”. Does this imply that this is the only reason for establishing a composite minimum, and therefore does this claim have to be verified in some way? In some cases firms have defined minimum asset levels for composites for convenience and to reduce the data gathering exercise, surely this statement changes that basis and therefore has implications for compliant firms. (UKIPC)*

The Standards require that all fee-paying discretionary portfolios must be included in at least one composite. Firms must not market a composite to prospective clients with assets below the minimum asset level. Accordingly, there should not be a large number of discretionary portfolios below the minimum. If the firm is able to implement its intended strategy, then the portfolio must be included in a composite. If the portfolios are representative of the strategy, it would be inappropriate to exclude portfolios, no matter their size from a composite simply to reduce the data gathering exercise.

Revision: **None.**

Comment: *The sentence “Firms must not market to clients with assets below the minimum” should be removed. Because the minimum must be disclosed, it will be clear to the client that the composite is not appropriate. (WM)*

Comment: *“Firms must not market a composite to a prospective client with assets below the composite minimum asset level”. This is a difficult point to verify, and implies either the need for a composite of portfolios below the minimum asset level or the idea of marketing without a composite! Given the previous statement as well, it is unlikely that marketers would distinguish in practice between prospective clients who fall below the asset minimum of the composite, and they will certainly not be happy to admit that below the asset minimum the portfolio may not be representative of the strategy. (UKIPC)*

The Firm has the obligation to present a composite appropriate to the prospective client. If the minimum represents a level below which the firm cannot implement its strategy, then the firm must not use that composite to market to prospective clients whose assets are below the composite's Minimum Asset Level. If the firm markets a composite to a prospective client with assets below the minimum, the firm is, by definition, presenting a strategy that cannot be implemented at the prospective client's asset level. Some strategies are implemented differently depending on the size of the portfolios. It may seem that the size of the portfolio is a criteria for creating separate composites; in reality the size of the portfolio is actually a criteria for the

selection of the strategy. There must be a substantial difference in the strategies in order to justify separate composites.

Revision: *None.*

Comment: *If portfolios that fall below the minimum are non-discretionary, it is irrelevant that they represent a small percentage of the composite assets. In addition, it is possible that a portfolio that falls below the Minimum Asset Level may have, for that very reason, a vastly different return and could impact the overall composite return. This requirement should be removed. (PWC, WM)*

Comment: *“Portfolios below the minimum must represent a small percentage of the composite assets and thus, should not have a material impact on the asset-weighted composite return.” What would we define as material? This sentence also reinforces the idea that the data for these portfolios must be gathered and calculated alongside the main composite data. (UKIPC)*

In general, it is expected that the portfolios that are excluded from the composite due to asset size represent a small percentage of the composite’s assets, as firms are not permitted to market to clients with assets below the minimum level. However, the Investment Performance Council agrees that the percentage of composite assets below the minimum is not relevant.

Revision: *Removed requirement that portfolios below the minimum represent as small percentage of composite assets.*

3. Comments on Guiding Principles/Criteria

The original proposal included Guiding Principles that firms should follow when defining composites as well as additional criteria that should also be considered as composites are created.

Comment: *The third Guiding Principle states “Firms must disclose the definition of each composite.” Additional guidance should be provided as to what must be disclosed to meet this requirement. (CAPS, UBS, SAAJ)*

Additional guidance should also be provided to differentiate between “composite definition” as mentioned in the third principle and “composite criteria” mentioned in the fourth principle. (CAPS, UBS)

The terms “definition” and “description” in these principles have subtly different meanings. The definition of the composite captures all characteristics and/or criteria used to determine which portfolios are included in the composite. This would include any elements listed in the

Composite Definition Criteria and Constraints/Guidelines sections of this Guidance Statement. The “description” of a composite summarizes the definition and can be more general. The description does not need to include all of the criteria, constraints and or guidelines as described in this Guidance Statement.

Revision: Combined the third and fourth Guiding Principles and reworded for clarity.

Comment: *The Guidance Statement states “Discontinued composites must remain on the firm’s list of composites for at least five years after its discontinuation.” We do not see the practicality or the relevance of keeping discontinued composites on a firm’s list for five years after discontinuation. (UBS)*

Comment: *An important point that needs highlighting is the idea that “Discontinued composites must remain on the firm’s list of composites for at least five years after discontinuation”. (UKIPC)*

Disclosing discontinued composites on the firm’s list of composites provides information to the prospective client regarding changes to the firm’s products and strategies over time. The Investment Performance Council determined that five years is a sufficient amount of time where this information may remain material.

Revision: None.

Comment: *The Guidance Statement needs clarification as to when a composite may be redefined and how a firm may determine that the result of the redefinition does not cause the creation of a new composite and loss of linking the historical track record. This section also needs clarification of the disclosures necessary when a composite is redefined. (PWC)*

Comment: *If a firm redefines a composite, the draft Guidance Statement states “In case of a change, it must be fully disclosed...” We believe that a firm should also have to fully disclose a composite name change as part of the composite definition, even if the composite is not redefined. (CAPS)*

While investment strategies can change over time, in most cases firms should not change the definition of a composite. Generally, changes in strategy result in the creation of a new composite. In some very rare cases, however, it may be appropriate to redefine a composite. If a firm determines that it is appropriate to redefine a composite, it must disclose the date and nature of the change. Changes to composites must not be applied retroactively. It is recommended that firms also disclose any changes to the name of a composite. Discontinued composites must remain on the firm’s list of composites and presentations made available upon request for at least five years after discontinuation.

Revision: Added language discussing when a firm may redefine a composite.

Comment: The last part of “Guiding Principles” indicates that the old composite would continue to be listed on the firm’s list of composites and should be maintained as long as the firm manages portfolios that meet the definition. This part seems to conflict with GIPS provision 3.A.4: Terminated portfolios must be included in the historical record of appropriate composites up to the last measurement period that the portfolios were under management. Accordingly, the sentence should read, “as long as the firm manages portfolios that meet the definition or there are terminated portfolios that met the definition existing as historical performance records”. (SAAJ)

Discontinued composites must continue to be listed on the firm’s list of composites for five years after discontinuation. When requested, firms must provide a compliant presentation for any composite on the firm’s list of composites.

Revision: ***Clarified language regarding redefinition and discontinuation of composites.***

Comment: In the section “Risk/Return Characteristics”, please provide clarification of “return objectives may be grouped together into different composites”. The example provided is not clear as to whether the “Japanese Equity” and “US Equity” strategies are to be included in the same composite or in different composites. (PWC)

The risk and return characteristics are defined by the targeted performance relative to a specific benchmark and the targeted volatility. Because portfolios must be grouped into composites according to similar strategy or style, the two examples provided would be defined as separate composites.

Revision: ***Clarified example.***

4. Comments on Constraints/Guidelines

Comment: In addition to the issue of “Measurement Periods”, we recognize there are similar problems arising from differences in valuation methods and return calculations among portfolios (including trade-date vs. settlement-date valuation, time-weighted rate-of-return calculation methods, etc.). Accordingly, we recommend that the Guidance Statement should also discuss if including portfolios whose performance records have been calculated based on different valuation methods and TWR calculation methods in the same composite is appropriate. (SAAJ)

The Standards require that trade-date accounting be used for periods beginning 1 January 2005. Until that date, firms must disclose if they use settlement date valuations. The Standards also

allow for various calculation methodologies to be used so long as they use a time-weighted total return methodology that adjusts for cash flows. While different calculation methodologies may return slightly different performance figures, they are sufficiently similar that they may be included in the same composite.

Revision: *None.*

Comment: *We recommend providing a separate Constraint/Guideline clarification where composites are managed using different currencies. (PWC)*

The GIPS standards require that firms disclose the currency used to express performance. In cases where a composite contains portfolios with different base currencies, the firm must convert the individual portfolio values to the composite's base currency in order to calculate a composite return. Firms should refer to the Question and Answer on this topic in the GIPS Interpretations Library, located at www.aimr.org/standards/pps/gips_library.html.

Revision: *Added clarification regarding the inclusion of portfolios with different base currencies.*

Comment: *In the section “Size of Portfolios” we recommend that clarification be made to further describe that composites may not be defined purely by size of portfolios. It is imperative that portfolios that are managed in the same style or strategy are included in the same composite regardless of size. (PWC)*

Portfolio size must not be used as a primary criterion for composite definition. Some strategies are implemented differently depending on the size of the portfolios. For example, an index strategy may be implemented via sampling (i.e., holding a sample of the index securities) for smaller portfolios, while the strategy may be implemented via a full replication of the index for larger portfolios. In these cases, the strategy is actually different due to the difference in the implementation. It may seem that the size of the portfolio is a criteria for creating separate composites, in reality the size of the portfolio is actually a criteria for the selection of the strategy. There must be a substantial difference in the strategies in order to justify such a separation.

Revision: *Clarified language regarding Portfolio Size.*

Comment: *A clear distinction should be provided between the areas “Portfolio Types” and “Type of Client”. These topics overlap in many ways and as such, we recommend the guidance be made consistent and state that “Pooled funds, including mutual funds and unit trusts, should be treated as separate composites or combined with other portfolios into one or more composites of the same strategy, style, or objective.” (PWC)*

“Portfolios Types” are essentially referring to segregated portfolios versus pooled portfolios. As described in the Guidance Statement, pooled portfolios (e.g., mutual funds) can be included in a separate composite or combined with segregated portfolios managed according to the same strategy. “Type of Client” refers to specific groups of clients such as private clients, pension fund clients, etc. Based on subsequent discussions, the Investment Performance Council has decided to remove “Client Type” as a criterion for defining composites.

Revision: *Deleted Type of Client criterion.*

Comment: *We feel that there is a mismatch in information on how to deal with certain instruments and composite construction.*

- * *In the guidelines there is a paragraph about the extent of use of Derivatives, Hedging and/or Leverage.*
- * *In GIPS we have paragraph 3.B.2 dealing with hedging.*
- * *In GIPS we have paragraph 4.A.7 dealing with derivatives*

It would help to define a common approach regarding the above 3 items and we would suggest a guidance statement about the definition and use of above instruments. (VBA)

Comment: *Where derivatives, hedging and or leverage is used by a portfolio, the guidance still allows the firm to decide whether to split out these portfolios from a composite. The guidance could possibly be more prescriptive here or introduce the idea of materiality for the verifier to investigate whether this should be done. (UKIPC)*

The Leverage & Derivatives Subcommittee of the IPC is developing additional provisions and guidance to be included in the GIPS standards in the future that will address these issues. The IPC feels it would not be appropriate to offer any additional guidance prior to the completion of the Subcommittee’s proposal.

Revision: *None.*

5. Comments on Additional Considerations

The original proposal included a section of Additional Consideration that dealt with other factors that firms should consider and/or avoid when defining composites.

Comment: *Investment Guidelines – Multi-Asset Portfolios “Only multi-asset portfolios for which the firm has discretion over the asset mix are to be included in multi-asset composites”. This guidance is not clear with respect to what happens if the firm does not have absolute discretion over the asset mix. We suggest providing additional clarification of the term “discretion over asset mix” and the treatment of the balanced portfolios. (SBA, SAAJ, PWC)*

Comment: The statement “multi-asset portfolios with different strategic asset mixes should be grouped in separate composites,” implies, but should specifically state that the strategic asset mixes are **provided by the client in the investment guidelines**. Further, the statement “defined by the percentages of investments in the different asset classes” should be deleted since this may mislead firms to interpret that they can group such accounts on an ex post facto basis as the result of the percentages of investments in the different asset classes.

Finally, we understand that multi-asset portfolios can be grouped in accordance with a combination of asset classes regardless of the percentage allocated to each asset class and that active returns can be presented against a composite benchmark which is a combination of multi-benchmarks of individual portfolios (asset-weighted benchmark). This should also be referred to in the Guidance Statement. (SAAJ)

Composites should be constructed according to strategic ranges of asset mixes provided in the client investment guidelines, not according to the tactical percentage of assets invested in the different asset classes. Portfolios with varying, but similar strategic asset allocations can be grouped together if they collectively have the same strategy or style. Firms often have discretion to tactically alter the asset allocation in an effort to add value. Portfolios must not be moved into or out of composites due to changes in the tactical asset allocation. Only in the case of client-documented strategic asset allocation changes should portfolios be moved into different composites.

Revision: **Clarified guidance regarding multi-asset portfolios and removed statement regarding discretion over the asset mix.**

Comment: The guidance on the use of an inception date as criteria for constructing composites is useful, but may be made more prescriptive as there are only a handful of circumstances where inception date could be validly used as a composite criteria, and even in these cases it is arguable that if inception date is inherent to the strategy, that these performance numbers are not valid for marketing purposes. (UKIPC)

While grouping portfolios according to inception date is not appropriate in most cases, in some cases it is the most appropriate way to group similar portfolios. For example, venture capital assets are grouped by vintage year because of the uniqueness of the set of investment opportunities that is available at each point in time.

Revision: **None.**

Comment: In the sub-section “Firms with multiple offices, branches, or investment groups”, further clarification is necessary to describe whether this relates to composites within the same defined firm or different defined firms. (PWC)

Comment: It is suggested that the last sentence of the guidance for multiple offices should refer to location but not group. (UKIPC)

Composite definition cannot span multiple firms, so this item is specific to composites within the same defined firm. For additional guidance regarding how the firm can be defined, please refer to the Guidance Statement on Definition of the Firm. This guidance applies to investment divisions as well as to branches or separate offices. The key is to have composites defined by strategy or style.

Revision: *Reworded to clarify offices, branches, or divisions must be within a defined firm.*

Comment: The section on dispersion could possibly be tightened up and tied in with guiding principle that states that “portfolios with different investment strategies or objectives” cannot be included in the same composite as this type of composite is meaningless. Composite dispersion is a good indicator of how meaningful a composite is in displaying the performance of a particular firm. (UKIPC)

The fifth Guiding Principle addresses the creation of “junk”, “dust-bin”, or “catch-all” composites that include all the unique portfolios that are managed to their own individual investment styles, objectives or strategies. While dispersion is a measure used to determine how narrowly a firm has defined a composite and implemented a strategy, it can only be measured on an ex-post basis and, therefore, should not necessarily be used as a criterion to define a composite.

Revision: *Clarified language regarding the use of dispersion as a criterion.*

6. Additional Comments on the Guidance Statement

Comment: While not specifically addressed by the draft Guidance Statement, many firms create composites as a “subset” of a large composite. For example, a firm may have a “Total Equity Composite” that includes all equity portfolios. The firm may then create a subset Small Cap Composite composed of portfolios included in the Total Equity Composite that use a small cap benchmark. We suggest that a firm be required to disclose if a composite is a “subset” of a larger composite as part of the composite definition. (CAPS)

Composites must be defined according to strategy or style. Portfolios with different strategies should not be included in the same composite. Prospective clients should request the firm’s list of composites to determine if they have been presented the most appropriate composite. While information regarding “sub-sets” may be helpful in some situations, the GIPS standards will not require an additional disclosure at this time.

Revision: *None.*

Comment: This Guidance Statement should address the impact of internal reorganizations on composite construction and disclosures (i.e., mergers of like composites, creation of new divisions – defined as separate firms for GIPS purposes and movement of assets between GIPS compliant firms which are both part of the same legal structure). This should be addressed in detail to consider historical track records, minimum asset level of surviving composite, notification to clients, and necessary disclosures.

This guidance should provide clarification of what firms should do with historical track records of composites that may be impacted due to adoption of this guidance. (PWC)

Firms should refer to the Guidance Statement on Performance Record Portability for guidance on issues related to merger and acquisition activity. Asset transfers between separately defined firms should be treated as terminated and new portfolios for each respective firm.

Revision: None.

7. Comments on Implementation Date

Comment: The Implementation Date should be 1 January 2003. (PWC, SAAJ, SBA, UBS, UKIPC)

In order to give firms adequate time to incorporate this guidance, the Implementation date will be 1 January 2003.

Revision: Changed Implementation Date to 1 January 2003.

Comment: Please clarify the difference between “Implementation Date” and “Adoption Date” and how the guidance will apply to various composites created before or after these dates. (SAAJ)

The term “Adoption Date” was mistakenly inserted in the original draft of this Guidance Statement, instead of “Implementation Date”. The Adoption Date is the date on which the Investment Performance Council votes to adopt the Guidance Statement. The Effective Date is the date by which all firms must have applied the guidance.

As this Guidance Statement simply clarifies the meaning of the existing GIPS provisions, firms that currently claim compliance with the Standards must review this guidance and make the necessary changes to their composites prior to 1 April 2003. In addition, because the guidance is "retroactive", the entire performance history of the firm's current composites must also comply with this guidance (i.e., firms are not necessarily required to apply this guidance to terminated or discontinued composites). All composites created after 1 April 2002 must be defined in accordance with this Guidance Statement.

Revision: Reworded Implementation Date section.

III. Guidance Statement on Composite Definition

<p><u>Adoption Date:</u> 13 March 2002 <u>Effective Date:</u> 1 April 2002 <u>Retroactive:</u> Yes</p>

INVESTMENT PERFORMANCE COUNCIL (IPC)

Guidance Statement on Composite Definition

Introduction

Three of the most fundamental issues that a firm must consider when becoming compliant with the GIPS® standards are the definition of the firm, the firm's definition of discretion, and the firm's composite definition principles and guidelines. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. The firm's definition of discretion establishes criteria to judge which portfolios should be in a composite to accurately reflect the application of the firm's investment strategy. Once the firm and discretion have been defined, composites can be constructed based on the strategies implemented by the firm. Firms are reminded that, under the GIPS standards, they must comply with all applicable laws and regulations.

A composite is an aggregation of discretionary portfolios into a single group that represents a particular investment objective or strategy. Composites are the primary vehicle for presenting performance to a prospective client. The firm must include all fee-paying discretionary portfolios in at least one composite. In this way, firms cannot "cherry-pick" their best performing portfolios to present to prospective clients. Non-fee-paying portfolios may be included in the firm's composites; however, firms are required to disclose the percentage of composite assets represented by non-fee-paying portfolios. If the firm includes non-fee-paying portfolios in its composites, they are subject to the same rules as fee-paying portfolios (e.g., the firm must not move the non-fee-paying portfolio into and out of a composite with out documented changes in client guidelines). Firms are permitted to include a portfolio in more than one composite, provided it satisfies the definition of each composite.

Before defining composites, the firm must establish reasonable criteria that support the fundamental principle of fair representation. A variety of criteria must be analyzed to identify whether portfolios are similar and should be grouped together into a composite.

Discretion

Discretion is the ability of the firm to implement its intended strategy. If documented client-imposed restrictions significantly hinder the firm from fully implementing its intended strategy the firm may determine that the portfolio is non-discretionary. Non-discretionary portfolios must not be included in a firm's discretionary composites. There are degrees of discretion and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm

must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy. For example, if a client requests that the firm not purchase any tobacco stocks in their portfolio, the firm should first consider if this restriction will hinder the implementation of the intended strategy. If so, the firm could either classify this portfolio as non-discretionary (and all other portfolios with this restriction) or could choose to classify it as discretionary and create a composite for portfolios with tobacco restrictions. Firms should, where possible, consider classifying these portfolios as discretionary and grouping them with portfolios with similar restrictions in a separate composite.

Each firm must document its definition of discretion and must apply the definition consistently across all portfolios within the firm. Firms should also document the reasons for classifying a portfolio as non-discretionary. It is the firm's responsibility to ensure that all of its fee-paying discretionary portfolios are included in at least one composite. Accordingly, firms should review each of their portfolios (both discretionary and non-discretionary) on a regular basis to determine whether any portfolios should be re-classified. According to the GIPS verification procedures, a verifier must determine if the firm's definition of discretion is appropriate and has been applied consistently over time.

Examples of client-imposed restrictions that may cause a portfolio to be classified as non-discretionary include, but are not limited to:

1. Restricting trading activities due to conditional client approval,
2. Restricting asset allocation (i.e., firm cannot alter asset allocation established by client),
3. Tax considerations (e.g., low-cost basis stocks, etc.),
4. Limiting the sale of certain securities (e.g., sentimental holdings),
5. Restricting the purchase of certain securities or types of securities (e.g., firm cannot buy tobacco stocks, firm cannot buy futures, firm cannot buy securities below a specific quality, etc.),
6. Cash flow requirements (e.g., the client requires large cash distributions on a regular basis), or
7. Legal restrictions.

None of these restrictions are reason to automatically classify a portfolio as non-discretionary, as the firm must determine if the restriction will significantly hinder the implementation of the intended strategy. In addition, the outsourcing of performance measurement or record keeping by a third-party does not negate the firm's responsibility related to compliance and is not a sufficient reason to classify assets as non-discretionary.

In the case of client restricted securities (e.g., low-cost basis stocks, held to maturity securities, etc.), the firm may choose to classify the restricted portion of the portfolio as non-discretionary (also commonly referred to as "un-managed" or "un-supervised") and keep the remaining discretionary portion of the portfolio in the composite, provided the remaining portion is representative of the composite's strategy. When considering if a portion of a portfolio should be classified as non-discretionary, firms should consider if the asset(s) affect the management of the portfolio's investment strategy. All calculation and composite construction requirements would apply to the remaining discretionary portion of the portfolio.

Firms are only permitted to move portfolios into and out of composites due to changes in discretion resulting from documented changes in client guidelines or in the case of the re-

definition of a composite. For purposes of the GIPS standards, documentation can include, but is not limited to, letters, faxes, emails, and/or internal memorandums documenting conversations with clients.

Non-discretionary portfolios must not be included in the firm's composite (i.e., composites consisting of discretionary portfolios). Some firms, however, may group some or all of the firm's non-discretionary portfolios together to simplify portfolio administration. According to the Standards, this is not a composite and must not be included on the firm's list of composites.

Minimum Asset Level

The GIPS standards contain two provisions that refer to a minimum asset level. GIPS Standard 2.A.7. states, "If a firm sets a minimum asset level for portfolios to be included in a composite, no portfolios below that asset level can be included in the composite." GIPS Standard 4.A.5. also states that a firm must disclose, "The minimum asset level, if any, below which portfolios are not included in a composite." Firms may establish a minimum asset level for a composite to identify portfolios that are too small to be representative of the intended strategy. Firms must not market a composite to a prospective client that has assets less than the composite's minimum asset level. Firms must disclose the minimum asset level of the composite, if one exists, in each respective composite presentation and must consistently apply the minimum. Firms must document and disclose changes to the minimum level and must not retroactively apply the new limit. Portfolios below the minimum are not necessarily non-discretionary, however asset level can affect discretion.

Portfolios may fall below the minimum due to client withdrawals or depreciation in market value. Firms should determine, as part of their policies regarding minimum asset levels, which market value will be used to evaluate composite portfolios against the minimum asset level (e.g., beginning market value, ending market value, beginning market value plus cash flows, etc.). If a firm establishes a minimum, it must document its policies regarding how portfolios will be treated if they fall below the minimum and must apply these policies consistently. If a portfolio falls below the minimum level, it must be removed from the composite. Firms should consider establishing a threshold for the application of the minimum asset level and a minimum time period in order to minimize portfolio movement into or out of a composite. For example, the firm establishes a range of +/- 5% of the minimum asset level when determining when to remove a portfolio from the composite and/or the firm establishes that a portfolio must remain above/below the minimum for at least two periods prior to removal/addition. If a portfolio is removed from a composite, the prior history of the portfolio must remain in the composite. Like all policies, once the firm establishes a policy regarding the minimum asset level it must be applied consistently. Once a portfolio is removed, the firm must determine if the portfolio meets any other composite definition and must include it in the appropriate composite(s) in a timely and consistent manner.

Firms should bear in mind that if all the portfolios in a composite fall below the minimum level and, according to the firm's policies, are removed from the composite, the performance record of the composite would come to an end. If after a period of time, portfolios move above the minimum or new portfolios are added to the composite, the prior performance history of the composite should be shown but not linked to the on-going composite performance results.

Composite Definition

Creating meaningful composites is critical to fair presentation, consistency, and comparability of results over time and among firms. Firms must establish principles and policies related to composite definition.

Guiding Principles

The GIPS standards encourage firms to develop objective criteria for defining composites. The following are Guiding Principles that firms must consider when defining composites:

- Composites must be defined according to investment objective and/or strategy. Composites should enable clients to compare the performance of one firm to another. The firm should also consider the definition and construction of similar products found within the competitive universe. Composites must be representative of the firm's products and be consistent with the firm's marketing strategy.
- Firms must apply the criteria for defining composites consistently (e.g., the firm may not select only certain, specific portfolios (i.e., "cherry-picking") that meet the composite definition, but must include all portfolios that satisfy the criteria for inclusion).
- Firms are not permitted to include portfolios with different investment strategies or objectives in the same composite. The performance of such a composite is meaningless. In the case where there are many portfolios with unique, defining investment characteristics, the firm may create numerous single-portfolio composites.
- Portfolios must not be moved into and out of composites except in the case of valid, documented, client-driven changes in investment objectives or guidelines or in the case of the redefinition of the composite.

While investment strategies can change over time, in most cases firms should not change the definition of a composite. Generally, changes in strategy result in the creation of a new composite. In some very rare cases, however, it may be appropriate to redefine a composite. If a firm determines that it is appropriate to redefine a composite, it must disclose the date and nature of the change. Changes to composites must not be applied retroactively. It is recommended that firms also disclose any changes to the name of a composite. Discontinued composites must continue to be listed on the firm's list of composites for five years after discontinuation. When requested, firms must provide a compliant presentation for any composite on the firm's list of composites.

Composite Definition Criteria

In addition to the Guiding Principles above, firms may choose to define their composites according to relevant criteria and must document the definition of each composite, including any criteria or constraints, in its respective composite presentation. It is constructive to consider a hierarchical structure of criteria for composite definition that promotes primary and secondary strategy characteristics. It is also important to understand the defining characteristics commonly found in the marketplace for investment products. Comparability of similar strategies or products is a fundamental objective of the Standards and benefits current and prospective clients when firms define strategies similarly, using clear and unambiguous terminology.

Suggested Hierarchy for Composite Definition

The following suggested hierarchy may be helpful as firms consider how to define composites. Firms are not required to define their composites according to each level of the hierarchy.

Investment Mandate

Composites based on the summary of strategy or product description.

Example: "Large-Cap Global Equities"

Asset Classes

Composites based on a broad asset class are the most basic and should be representative of the firm's products. Firms may further define the asset class by country or region.

Example: Equity, fixed income, balanced, real estate, venture capital, U.S. fixed income, European equities, etc.

Style or Strategy

Firms may further define a composite based on the style or strategy in order to provide investors with additional insight and allow for increased comparability.

Example: Growth, value, active, indexed, asset class sector (e.g., telecommunications), etc.

Benchmarks

Firms may define composites on the basis of the portfolios' benchmark or index provided the benchmark reflects the investment objective or strategy and there are no other composites with the same characteristics. This is often the case if the benchmark also defines the investment universe.

Example: Swiss Market Index, S&P 500, Lehman Aggregate, etc.

Risk/Return Characteristics

Portfolios with different risk characteristics (e.g., targeted tracking error, beta, volatility, information ratio, etc.) and return objectives may be grouped together into different composites.

Example: Japanese Equity Composite with a targeted excess return of 1% and targeted tracking error of 2% would be in a separate composite from a Japanese Equity Composite with a targeted excess return of 3% and targeted maximum volatility of 6%.

Constraints / Guidelines

In addition to the fundamental criteria above, firms may choose to further define their composites based on relevant client constraints or guidelines. The following are example of constraints or guidelines that could result in materially different strategies and, therefore, justify separate composites.

Extent of the Use of Derivatives, Hedging and/or Leverage

In general, portfolios that use derivatives, leverage and/or hedging have a unique investment strategy from those portfolios that do not utilize these techniques or instruments. Accordingly, firms should consider whether portfolios that use leverage, derivatives, and/or hedging should be

included in separate composites from portfolios that are restricted from using such instruments or strategies.

Treatment of Taxes

The firm should define separate composites for portfolios with specific tax treatments if it hinders the firm's ability to implement a specific investment strategy as compared to similar portfolios without specific tax treatments. For example, the different tax situations of corporate or insurance clients and private clients may require different investment strategies in terms of emphasizing growth versus yield or dividend versus interest income. If so, firms are required to define separate composites appropriate to the different strategies.

Type of Client (e.g., pension fund, private client, endowment, etc.)

Client type alone should not be used as the primary criteria for defining a composite. In some cases, the client type determines the investment strategy because of characteristics that are unique to the client type. If portfolios of different client types have materially different investment strategies and/or styles that are specific to the type of client, the firm should create separate composites representing each of the different strategies.

Instruments Used (e.g., invest only in pooled vehicles versus individual securities)

If portfolios use specific instruments the firm may define separate composites.

Size of Portfolios

Differences in portfolio size may result in meaningful, material differences in investment strategy and justify the creation of separate composites. For example, an index strategy may be implemented via sampling (i.e., holding a sample of the index securities) for smaller portfolios, while the strategy may be implemented via a full replication of the index for larger portfolios. In this case, the strategy is actually different based on the size of portfolio.

Client Characteristics (e.g., cash flow needs, risk tolerances)

Firms may create composites based on multiple client characteristics. For example, a firm may choose to create a composite composed of growth equity, taxable clients that allow leverage and have a targeted tracking error of 4%.

Portfolio Types (e.g. segregated (separate portfolios), pooled portfolios (mutual funds))

Pooled funds, including mutual funds and unit trusts, may be treated as separate composites or combined with other portfolios into one or more composites of the same strategy, style, or objective.

Measurement Periods

Firms are required to value portfolios on a monthly basis (as of 1 January 2001) and are encouraged to value portfolios on the calendar month end. Portfolios within a composite must have common beginning-period and ending-period valuation dates. This does not prevent the inclusion of portfolios with different valuation frequencies in the same composite (e.g., daily versus monthly), but they must share common beginning and ending dates for the composite measurement period. For example, portfolios that are valued daily can be included in a composite with portfolios that are valued only on the last day of the month because they will have common beginning/ending valuation dates.

Firms must disclose the measurement period of the composite if the measurement period does not begin or end on a calendar month end. For example, portfolios that are valued only on Friday (and not at the end of the month) will have different performance measurement periods than portfolios that are measured on calendar month ends. In this case the Friday-valued portfolios belong in their own composite, as the performance returns are not comparable to the portfolios valued at the end of each month. In addition, the benchmark used for the composite must be shown for the same time periods as the composite.

Currency

Currency should not be a criteria used for composite definition unless it is specific to the investment strategy.

Additional Considerations

Multi-Asset Portfolios

Multiple-asset or balanced portfolios are portfolios that consist of more than one asset class. Composites should be constructed according to strategic ranges of asset mixes provided in the client investment guidelines, not according to the tactical percentage of assets invested in the different asset classes. Portfolios with varying, but similar strategic asset allocations can be grouped together if they collectively have the same strategy or style. Firms often have discretion to tactically alter the asset allocation in an effort to add value. Portfolios must not be moved into or out of composites due to changes in the tactical asset allocation. Only in the case of client-documented strategic asset allocation changes should portfolios be moved into different composites.

Inception Date

In general, firms are not permitted to create composites based solely on inception date. However, in very specific situations, it may be appropriate to group portfolios into composites according to inception date (e.g., venture capital composites, after-tax composites, municipal bond composites).

Firms with multiple offices, branches, or investment divisions

Firms are only permitted to define different composites for offices, branches, or investment divisions of a firm if the portfolios are managed according to investment objectives, styles or strategies that are unique to each particular office, branch, or division. Thus, it is the style or strategy that determines the composite, not the location or group. Composite definition cannot span multiple firms. For additional guidance regarding how the firm can be defined, please refer to the Guidance Statement on Definition of the Firm.

Dispersion of the portfolio returns within a composite

While dispersion is one measure to determine how consistently the firms has implemented its strategy across the portfolios in the composite, it can only be measured on an ex-post basis and, therefore, should not be used as a criterion to define a composite. A dispersion figure may serve as a good indicator of whether the criteria for composite definition are suitable and whether a composite should be redefined. There is no general rule for a maximum amount of composite dispersion. The firm should contemplate the definition of a broad, "inclusive" composite with a wide dispersion of portfolio returns versus a narrow, "exclusive" composite with a more narrow dispersion measure.

Treatment of Fees

Different types of management fees should not be used as criteria for composite definition.

Effective Date

This Guidance Statement clarifies the meaning of the existing GIPS standards and is effective 1 April 2002. Firms should review their current composite definitions to ensure compliance with this Guidance Statement. Firms that claim compliance with the GIPS standards as of 1 April 2002 have until 1 April 2003 to redefine their composites as necessary to comply with this Guidance Statement and must apply the guidance retroactively (i.e., composite history must also reflect new composite definition). All composites created after 1 April 2002 must be defined in accordance with this Guidance Statement.