G·I·P·S

Global Investment Performance Standards

GIPS® Guidance Statement on Composite Definition

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Guidance Statement on Composite Definition (Revised)

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 individual portfolios representing a similar investment mandate, objective or strategy and is the primary vehicle for presenting performance to prospective clients. The firm must include all actual, 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 as of the end of each annual period. 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 without documented changes in client guidelines or the redefinition of the composite make it appropriate). 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.

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 similar investment objectives and/or strategies. 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, it may be necessary for the firm to create numerous single-portfolio composites.
- Portfolios must not be moved into and out of composites except in the case of documented, client-driven changes in investment objectives or guidelines or in the case of the redefinition of the composite. The historical record of the portfolio must remain with the appropriate 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.

Firms must document, in writing, their policies and procedures used in establishing and maintaining compliance with all the applicable requirements of the GIPS standards. As such, each firm must document its definition of discretion and must apply the definition consistently. Ideally, discretion is defined at the firm level, but may be defined at the composite level or by asset class. 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 actual, 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, available in the GIPS standards at Section III. Verification, 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:

- Restricting trading activities due to conditional client approval,
- Restricting asset allocation (i.e., firm cannot alter asset allocation established by client),
- Tax considerations (e.g., low-cost basis stocks, etc.),
- Limiting the sale of certain securities (e.g., sentimental holdings),

- 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.),
- Cash flow requirements (e.g., the client requires large cash distributions on a regular basis), or
- Legal restrictions.

Few 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.

Non-discretionary portfolios are not permitted to be included in the firm's composites (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 composite 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 provision 3.A.9 provides that if the firm sets a minimum asset level for portfolios to be included in a composite, no portfolios below that asset level can be included in that composite. GIPS provision 4.A.3 provides 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 should not market a composite to a prospective client who has assets to invest which are 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 asset 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 must 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. 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 Creation Date

Firms must disclose the creation date of the composite, which is the date when the firm first groups the portfolios to create a composite. This is not necessarily the earliest date for which performance is reported for the composite (i.e., composite inception date).

Composite Definition

Creating meaningful composites is critical to fair presentation, consistency, and comparability of results over time and among firms. A composite's definition must include detailed criteria that determine the allocation of portfolios to composites and must be made available upon request. Firms must document principles and polices related to composite definition.

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 required that firms 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.

Firms are only permitted to move portfolios into and out of composites due to documented changes in client guidelines or in the case where the re-definition of a composite make it appropriate. 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. The historical record of the portfolio must remain with the appropriate composite.

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. 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 must 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 the treatment of taxes 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 must 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 must 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.

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

Additional Considerations

- **Multiple Asset Class Portfolios**

Multi-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 can 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, must 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 or not to redefine the composite. 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 was originally effective 1 April 2002 and was revised to reflect the changes to the GIPS standards effective as of 1 January 2006. Firms are required to apply this revised guidance to all periods.

Key GIPS Provisions Specifically Applicable to Composite Definition
3.A.1 All actual, fee-paying, discretionary portfolios must be included in at least one composite. Although non-fee-paying discretionary portfolios may be included in a composite (with appropriate disclosures), nondiscretionary portfolios are not permitted to be included in a firm's composites.

3.A.2 Composites must be defined according to similar investment objectives and/or strategies. The full composite definition must be made available on request.

3.A.3 Composites must include new portfolios on a timely and consistent basis after the portfolio comes under management unless specifically mandated by the client.

3.A.4 Terminated portfolios must be included in the historical returns of the appropriate composites up to the last full measurement period that the portfolio was under management.

3.A.5 Portfolios are not permitted to be switched from one composite to another unless documented changes in client guidelines or the redefinition of the composite make it appropriate. The historical record of the portfolio must remain with the appropriate composite,

3.A.9 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 that composite. Any changes to a composite-specific minimum asset level are not permitted to be applied retroactively.

3.B.3 Firms should not market a composite to a prospective client who has assets less than the composite's minimum asset level.

4.A.2 Firms must disclose the availability of a complete list and description of all of the firm's composites.

4.A.3 Firms must disclose the minimum asset level, if any, below which portfolios are not included in a composite. Firms must also disclose any changes to the minimum asset level.

4.A.22 If a firm has redefined a composite, the firm must disclose the date and nature of the change. Changes to composites are not permitted to be applied retroactively.

4.A.23 Firms must disclose any changes to the name of a composite.

4.A.24 Firms must disclose the composite creation date.

Applications:

1. *Firm A has a client that has multiple accounts (e.g., personal trust and a personal investment account) and manages these accounts as one "master" portfolio. For purposes of the Standards, can Firm A treat these accounts as one portfolio and include them in an appropriate composite?*

If multiple portfolios are managed as one "master" portfolio, the firm can treat this "master" portfolio as any other portfolio and include it in an appropriate composite. Firms must treat this as one portfolio for purposes of calculating the dispersion measure and the number of portfolios within the composite. Firms must consider if account restrictions, such as tax considerations, of any of the individual portfolios affect the overall asset allocation process or the implementation of the firm's strategy for the "master" portfolio. Firm must be careful not to double count assets (e.g., counting both the "master" portfolio and underlying portfolio assets) when calculating composite and total firm assets.

2. *If we currently have a composite for a particular strategy, and the strategy changes, can the performance track record continue to be associated with the new strategy? The change in question is the addition of resources to the investment process. To be precise, we have added a fundamental portfolio manager to a strategy that was previously run using a quantitative (models) process. The new portfolio manager is an additional layer added on top to further refine the stock picks. The quant models will still be used as before.*

As most firms evolve, they modify their investment process through the use of new technologies and resources. It would seem clients would expect their firm to refine and improve the investment process.

A composite is an aggregation of a number of portfolios into a single group that represents a particular investment objective or strategy. The Standards require that composites must be defined according to similar investment objectives and/or strategies. In the situation you present, if the investment objective of the portfolios in the composite remains constant as the firm modifies its investment process, the firm should not create a new composite. If, however, the investment objective/strategy of the portfolios in the composite has changed, the firm should create a new composite, and the performance track record starts for that new composite when portfolios meeting the definition of the new composite are added to it. The firm should clearly document its decision and decision-making process in the event the creation of a new composite is questioned by a verifier/regulator.

3. *We are starting an investment strategy but currently do not have any clients. As such, we would like to start the strategy with a proprietary portfolio. However,*

once we receive a client account managed in this strategy (which may happen up to 2-3 years later) we will close the proprietary portfolio.

Can we create a composite and continue to use the historical performance of the proprietary portfolio by simply adding any subsequent client accounts we receive to the composite? The composite would contain the historical performance of the proprietary portfolio but would continue on with only the new client portfolios, just as a normal composite would.

Yes, the situation you describe is appropriate. Performance of a proprietary portfolio (also known as a seed or incubator fund) may be included in a composite if the fund is composed of actual assets under management. As with any other terminated account, the performance history of the proprietary portfolio will remain in the composite up to the last full measurement period that the proprietary portfolio was under management. As other portfolios managed to the same strategy are added to the composite, the historical performance of the composite will continue to include the proprietary portfolio's performance.

4. *If a fund invests in publicly traded equities for both limited partnerships and for separately managed accounts, should the manager set up different composites for each legal structure?*

A composite should include all portfolios that are managed according to the same strategy. Differences in legal structure alone would not warrant separate composite definitions. However, it is up to the firm to decide how results can presented in the most meaningful way, and if differences in legal structure cause the results of portfolios to differ, then the manager would split limited partnerships and separately managed accounts into separate composites.

5. *Can a firm include a single portfolio in more than one of the firm's composites?*

Yes. The Standards state that firms must include all discretionary fee-paying portfolios in at least one of the firm's composites. Portfolios must be included in each composite for which it meets the prescribed criteria for inclusion. For example, a firm may have an all-cap equity composite and a large-cap equity composite. If the firm manages a portfolio that meets the criteria for inclusion in the all-cap equity composite as well as the large-cap equity composite, the firm must include the portfolio in both composites.

6. *Why should each discretionary fee-paying portfolio be included in at least one composite? If a portfolio represents a style we never plan to market in the future, why should we have to include it in a composite?*

The Standards are ethical guidelines for firms to follow when presenting their performance results. The Standards are based on the principles of fair representation and full disclosure. They are not marketing guidelines.

The requirement for firms to include all fee-paying discretionary portfolios in at least one composite ensures that firms record an accurate picture of the firm's complete performance record. Without this requirement, there is a potential for firms to exclude poor performing portfolios from the appropriate composites. Portfolios that might otherwise belong in the composite could be grouped with “unmarketed” portfolios. Because the intent of the Standards is to accurately and fairly represent firm performance, all fee-paying discretionary portfolios must be included in at least one of the firm’s composites.

Firms are also required to disclose that a complete list of the firm’s composites is available on each compliant presentation. Potential clients can review descriptions of all composites to determine if any similarities exist. Prospective clients can also request to see additional information on the firm’s historical performance record through other composites on the list. These requirements exist to provide prospective clients with a complete picture of the firm’s investment performance achieved on all accounts under the firm’s discretion.