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GUIDANCE STATEMENT ON COMPOSITE DEFINITION

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GIPS GUIDANCE STATEMENT ON COMPOSITE DEFINITION

Introduction

Three of the most fundamental issues that a firm must consider when becoming compliant with the Global Investment Performance Standards (GIPS®) are the definition of the firm, the firm's definition of discretion, and the firm's composite definitions. 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 regarding the calculation and presentation of performance.

A composite is an aggregation of one or more portfolios managed according to 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. Composites must include all portfolios that meet the composite definition. 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 must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period end. 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. Non-discretionary portfolios must not be included in a firm's composites.

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 investment mandate, objective, 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 materially dissimilar investment mandates, objectives, or strategies 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 switched from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes switching appropriate. The historical performance of the portfolio must remain with the original 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 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 their policies and procedures used in establishing and maintaining compliance with 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 must maintain records to support why a portfolio was assigned to a specific composite or was excluded from all composites. 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 must review each of their portfolios (both discretionary and non-discretionary) on a regular basis to determine whether any portfolios must be re-classified. According to the GIPS verification procedures, included in Chapter IV of the GIPS standards, a verifier must determine if the firm's definition of discretion 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:

- Restrictions on trading activities due to conditional client approval,

- Restrictions on asset allocation (i.e., the firm cannot alter asset allocation established by the client),
- Tax considerations (e.g., low-cost basis stocks),
- Limits on the sale of certain securities (e.g., sentimental holdings),
- Restrictions on the purchase of certain securities or types of securities (e.g., the firm cannot buy tobacco stocks, the firm cannot buy futures, the firm cannot buy securities below a specific quality),
- 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 portfolios as non-discretionary.

In the case of client-restricted securities (e.g., low-cost basis stocks, held to maturity securities), 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 GIPS standards, this is <u>not</u> a composite and must not be included on the firm's list of composite descriptions.

Minimum Asset Level

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. 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. Firms should not present a compliant presentation of the composite to a prospective client who is known not to meet the composite's minimum asset level. Firms must disclose the minimum asset level of the composite, if one exists, in each respective compliant 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 value. Firms must determine, as part of their policies regarding minimum asset levels, which value will be used to evaluate composite portfolios against the minimum asset level (e.g., beginning value, ending value, beginning value plus cash flows). If a firm establishes a minimum asset level, 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 asset 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 asset level or new portfolios are added to the composite, the prior performance history of the composite must be shown but not mathematically linked to the ongoing composite performance.

Composite Creation Date

Firms must disclose the creation date of the composite, which is the date when the firm first groups one or more portfolios to create a composite. The composite creation date is not necessarily the same as the composite inception date (the initial date of the composite's performance record).

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 assignment of portfolios to composites and must be made available upon request. Firms must document policies and procedures 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 of, description of, and reason for the redefinition. Changes to composites must not be applied retroactively. It is required that firms disclose any changes to the name of a composite. Terminated composites must continue to be listed on the firm's list of composite descriptions for five years after termination. When requested, firms must provide a compliant presentation for any composite on the firm's list of composite descriptions.

Firms are only permitted to move portfolios into and out of composites due to documented changes to a portfolio's investment mandate, objective, or strategy or in the case where the re-definition of the composite makes it appropriate. For purposes of the GIPS standards, documentation can include, but is not limited to, letters, faxes, e-mails, and/or internal memorandums documenting conversations with clients. The historical performance of the portfolio must remain with the original 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 GIPS standards and benefits current and prospective clients when firms define composites 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 Class***
  Composites based on a broad asset class are the most basic and should be representative of the firm's products. Firms may further define asset classes by country or region.
  Examples: Equity, fixed income, balanced, real estate, venture capital, U.S. fixed income, European equities
- ***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.
  Examples: Growth, value, active, indexed, asset class sector (e.g., telecommunications)
- ***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.
  Examples: Swiss Market Index, S&P 500 Index, Barclays Capital Aggregate Index

- ***Risk/Return Characteristics***
  Portfolios with different risk characteristics (e.g., targeted tracking error, beta, volatility, and information ratio) and return objectives may be grouped together into different composites.
  Example: A 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)
  Client type alone must not be used as the primary criterion 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 criterion 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., private equity 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, mandates, or strategies that are unique to each particular office, branch, or division. Thus, it is the investment objective, mandate, 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.
- **Internal Dispersion of Portfolio Returns within a Composite**
  While internal dispersion is one measure to determine how consistently the firm 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. An internal 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 internal dispersion of portfolio returns versus a narrow, “exclusive” composite with a more narrow internal dispersion measure.

- **Treatment of Fees**
  Different types of investment management fees should not be used as a criterion for composite definition.

Effective Date

The effective date for this Guidance Statement is 1 January 2011. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).