Proposed GIPS® Guidance Statement On Benchmarks

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Introduction

- Many outstanding issues around benchmarks
- Helpdesk receiving many good questions regarding benchmark use
- GUIDANCE statement was clearly required
- Inundated with volunteers – narrowed to 12
- Benchmark Working Group first call in February 2016
- Asset managers, administrators, index vendors, academia
- Now out for public comment

- Go through Guidance Statement topics
- Sample Disclosures in Guidance Statement
- Answer questions
The Role of Benchmarks

- Benchmark Relative: In this category, investment decisions are made relative to benchmark weights, exposures, and risks. The portfolio may be very similar to the benchmark in this instance (e.g., passive and active index strategies).

- Benchmark Aware: In this category, benchmark relativity is observed or the benchmark serves as an investable universe. Generally, there will be distinct differences between the portfolio and the benchmark (e.g., concentrated strategies).

- Benchmark Neutral: In this category, benchmarks are treated more as target returns or hurdles to beat or there is no appropriate benchmark. This is common with absolute return and alternative strategies and for strategies not covered by index providers. In these instances, a predefined target return that is not based on a market index may be used.
Presentation and Reporting of Benchmarks

When an appropriate benchmark exists, firms must present the benchmark total return for each annual period in compliant presentations. In addition to the required annual benchmark returns, firms must also present benchmark returns for any additional periods for which composite returns are presented. For example, if the compliant presentation includes partial periods or quarterly composite returns, matching benchmark returns must also be included.
Selecting an Appropriate Benchmark

The benchmark is usually the first place to start when measuring the success or failure of an investment strategy. Each portfolio will likely have a benchmark that it is compared to that is often selected by the client or prospective client. In some cases, however, the portfolio benchmark is chosen by the firm; whereas in all cases, the composite benchmark is chosen by the firm.
Selecting an Appropriate Benchmark

A benchmark is **appropriate** if it reflects the composite’s investment mandate, objective, or strategy, but multiple benchmarks may meet this single criterion. Firms should also consider the qualities of **good** benchmarks. A good composite benchmark has many of the following properties. It is

- **specified in advance.** Although this may not always be the case, firms should select a composite benchmark prior to the evaluation period.
- **relevant.** The benchmark reflects the investment mandate, objective, or strategy of the composite.
- **measurable.** The benchmark is quantifiable.
- **unambiguous.** The constituents of the investable universe can be clearly identified and priced.
- **representative** of current investment opinions. The firm has current knowledge of the investable universe.
- **accountable.** The firm selects the benchmark and is accountable for any deviations from the benchmark.
- **investable.** The benchmark offers a passive alternative that is a realizable and alternative opportunity genuinely open to the investor.
- **complete.** The benchmark provides a broad representation of the sector of the market to which it pertains.
Selecting an Appropriate Benchmark

- The process for determining the benchmark for a composite should be maintained in the firm’s policies and procedures. This documentation should include any review and approval processes.

- The GIPS standards require that all actual, fee-paying, discretionary portfolios must be included in at least one composite. Composites must be defined according to investment mandate, objective, or strategy, and include all portfolios that meet the composite definition. Just because portfolios are included in the same composite because they meet the same composite definition, it does not mean that the underlying portfolios have the same benchmark.

- The composite benchmark is used to evaluate how the firm manages a specific strategy. The benchmark must reflect the investment mandate, objective, or strategy of the composite. Firms should disclose material differences between the benchmark and the composite’s investment mandate, objective, or strategy.
Types of Benchmark

- Market Indexes
- Blended Benchmarks
- Custom
- Absolute Value/Target Return
- Peer Groups and Universes
- Factor Based Models
- Returns Based
- Exchange Traded Fund (ETF)
- Portfolio-Weighted Composite Benchmark
No Appropriate Benchmark

Benchmarks are important tools that aid in the planning, implementation, and review of an investment strategy. They also help facilitate discussions with prospective clients regarding the relationship between composite risk and return. As a result, the GIPS standards require firms to provide benchmark total returns in all compliant presentations. The benchmark must reflect the investment mandate, objective, or strategy of the composite. If the firm determines that no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.
Practical Considerations

- Currency
- Currency Hedging
- Geographical Exposure
- Breadth or Concentration of the Index
- Asset Mix
- Style
- Sector
- Net/Gross Withholding Tax Returns
- After-Tax Benchmarks
- Custom Net-of-Fees Benchmarks
- Frequency of Rebalancing
- Other Considerations
Private Equity and Real Estate

- Private equity and closed-end real estate composites are made up of closed-end, fixed-life, fixed-commitment portfolios that have no client-driven external cash flows. Firms must present a since inception internal rate of return (SI-IRR) for these composites and their benchmarks.

- Standard public market indexes may be appropriate benchmarks for private equity and closed-end real estate composites. However, public market indexes are typically calculated using a time-weighted return. If a firm chooses to present a public market index, it should do so using the public market equivalent (PME) method as described below. Firms may also choose to present a non-PME benchmark as supplemental information.

- Benchmarks for private equity and real estate strategies are not widely available and are typically vintage year peer universes available only through commercial vendors. Firms may use public market indexes as benchmarks, but the public market indexes by themselves are not directly comparable to the SI-IRR of a private equity or closed-end real estate composite because of the different return methodology.
Private Equity and Real Estate

The PME method is when a public market index is used to create a comparable SI-IRR from a series of cash flows that replicate those of the composite and that can be compared to the SI-IRR of the composite. Firms that choose to present a composite’s PME as a benchmark must disclose the index used to calculate the PME. There are several ways to calculate a PME, but a common method is to invest the composite’s external cash flows in a public market index to create a hypothetical investment that earns the returns of a public market index. By combining the composite’s cash flows with the hypothetical investment, firms can calculate the IRR of a benchmark to which the composite’s SI-IRR is comparable. Firms may choose the PME benchmark calculation method they consider appropriate provided that the method is applied consistently. Given the bespoke nature of PME benchmarks, they will be unique to the composite.

Some PME benchmark calculation methods are known to fail to produce a result under certain patterns of external cash flows. Firms have the option not to present any benchmark if the firm determines no appropriate benchmark for the composite exists. Firms must disclose why no benchmark is presented.
Real Estate

For closed-end real estate fund composites, the following performance metrics are required: SI-IRR, total time-weighted rate of return (TWRR), and capital and income TWRRs. When an appropriate benchmark for the composite does exist, it is possible that not all of these metrics are available. Firms are recommended to present the component returns of the benchmark, if available. In addition, the GIPS standards require that the SI-IRR benchmark has the same vintage year as the composite vintage year.
Alternative Strategies

- Smart Beta
- Liability Driven Investing (LDI)
- Unconstrained
- Long/Short Strategies
Total Return vs Price-only Return

The GIPS standards require that all composite and benchmark returns are presented as total return in a compliant presentation. This is required because it can be misleading to compare a composite return that includes income (i.e., a total return) against a benchmark return that does not also take in income (i.e., a price-only return). In this instance, the price-only benchmark return will be lower than a total-return benchmark and thus will artificially inflate the relative composite return.

There are some asset classes that do not create income (e.g., commodities), and so the total return and price-only return for such asset classes will be identical. An index composed solely of these assets will also have an identical total return and price-only return. These indexes are considered to be total return indexes under the GIPS standards.
Income Sweeping

Some clients require income distributions to be paid to them directly and they are not included in the portfolio’s transactions. In this scenario, firms should generate the income transactions in the portfolio and then balance these transactions using cash withdrawals. This workaround may show a very small difference in performance compared with portfolios that retain the income for reinvestment. Total return benchmarks assume the reinvestment of income. Although this solution may address the recognition of income in the portfolio return, it does not address the incremental return arising in the future from the reinvestment of income. In this instance, however, a total return benchmark must be presented.
Benchmark Changes

Firms must disclose any changes to the composite benchmark over time. A composite benchmark change can take two forms:

- The composite benchmark is changed from one benchmark to another at a given point in time, perhaps as a minor strategy change (i.e., prospectively).
- The composite benchmark is changed for all periods (i.e., retroactively).
Benchmark Changes - retroactive

In most cases, the firm should only change the composite benchmark prospectively and not change it retroactively. However, there may be times when a firm determines that it is appropriate to change the benchmark for a given composite retroactively. For example, because benchmarks are continually evolving, if the firm finds that a new benchmark is a better representation of an investment strategy, the firm may consider changing the benchmark retroactively. The firm must disclose the date the benchmark is changed, the description of the change, and the reason for the change. The firm must disclose that the benchmark has been changed retroactively. In addition, firms are encouraged to continue to present the old benchmark. If the firm changed a benchmark retroactively, it is important that the disclosure of the change remain in the compliant presentation for as long as it is meaningful. If appropriate, the firm must create a policy for determining the length of time that retroactive benchmark changes are disclosed, and apply that policy consistently.
Benchmark Changes - prospective

- If a benchmark has changed prospectively, firms must disclose the date of, description of, and reason for the benchmark change for as long as returns for the old benchmark are included in the compliant presentation.

- Firms must not make changes to the benchmark primarily intended to make performance look better by lowering the benchmark return.
Multiple Benchmarks

It is permissible to include more than one benchmark within a compliant presentation. For example, a firm has a single investment process for its UK equity strategy and implements this strategy for clients with similar benchmarks (e.g., FTSE Allshare and Freedom All Stock). The composite is based on the investment process, so the firm discloses the returns of both benchmarks in the compliant presentation with equal prominence. Any and all benchmarks provided within a compliant presentation (including supplemental information) must adhere to the requirements and recommendations of the GIPS standards. The firm may distinguish composite benchmarks as primary or secondary, and so on, but the GIPS standards do not differentiate between primary and secondary or other benchmarks. For example, firms must disclose

- a description for all composite benchmarks.
- reasons for a change to (or deletion of) any composite benchmark.
- the three-year standard deviation of all composite benchmarks.

If the firm distinguishes between primary and secondary benchmarks, it must disclose when these designations change (e.g., if a primary benchmark becomes a secondary benchmark). For example, a firm designates the primary benchmark of its composites to be the market index and the secondary benchmark to be the relevant peer group. In all instances, if there are multiple composite benchmarks and one or more of the benchmarks is removed from the compliant presentation, the firm must disclose this fact.
Data Sources

For periods beginning on or after 1 January 2011, firms must disclose and describe any known material differences in exchange rates or valuation sources used among the portfolios within a composite, and between the composite and the benchmark. Firms should also disclose any known material difference in pricing sources used among the portfolios within a composite and between the composite and the benchmark.
Off-Benchmark Assets

A good way of understanding the role of the benchmark in an investment strategy is to know how much the firm can invest in assets not held within the composite benchmark (off-benchmark assets). Depending on the role of the benchmark (benchmark relative, benchmark aware, or benchmark neutral), the percentage of off-benchmark assets can provide important information about the appropriateness of the benchmark to the strategy. As such, firms may consider disclosing the percentage range that the strategy is allowed to deviate from the composite benchmark. Firms should disclose material differences between the benchmark and the composite’s investment mandate, objective, or strategy.
The GIPS standards require that firms must disclose the benchmark description in each compliant presentation. The benchmark description is defined as general information regarding the investments, structure, and/or characteristics of the benchmark. The description must include the key features of the benchmark or the name of the benchmark for a readily recognized index or other point of reference. Each firm must decide for itself whether a benchmark is widely recognized. If the firm is not certain about whether the benchmark is widely known, the firm must include the benchmark description. An index that is readily recognized in some markets (e.g., ISEQ in Ireland) may not be readily recognized outside of the local market. It is the firm’s responsibility to ensure that any potential prospective clients receiving a compliant presentation will be familiar with the benchmark if only the benchmark name is provided. If the firm is uncertain about whether the benchmark is readily recognized by any potential prospective client, the firm must include the benchmark description. For example, compliant presentations on company websites must have the benchmark description. The reason is because the firm may have little or no control over who might access the compliant presentations and therefore the firm will be unable to determine whether the benchmark is readily recognizable to the prospective client accessing the website. While it is acceptable to produce compliant presentations with different benchmark descriptions dependent on the prospective client, it is operationally simpler to provide a consistent benchmark description in all compliant presentations for a composite.
Standard Deviation and other Risk Measures

- Evaluating past performance requires an understanding of the risks taken to achieve the results and so the GIPS standards require the presentation of “external standard deviation,” which is a measure that quantifies the variability of the composite and benchmark returns over time.

- For periods ending on or after 1 January 2011, firms must present the three-year annualized ex-post standard deviation (using monthly returns) of both the composite and the benchmark. If 36 monthly returns are not available for the composite, firms are not required to present the ex-post standard deviation for either the benchmark or the composite.
Error Correction

Please refer to the Guidance Statement on Error Correction. It should be noted that an error is defined as any component of a compliant presentation that is missing or inaccurate and, as such, this includes all benchmark information.
Firms must consider the benchmark-related requirements in the GIPS Advertising Guidelines.

The benchmark presented in the advertisement must be consistent with the benchmark presented in the compliant presentation. If more than one benchmark is included in the compliant presentation, firms should consider whether multiple benchmarks should be presented in the advertisement. Only benchmarks presented in the compliant presentation may be presented in an advertisement.

In addition to presenting benchmark total returns, firms must also disclose the benchmark description. This disclosure must be consistent with the disclosure of the benchmark description included in the corresponding compliant presentation unless the disclosure included in the advertisement is a more current benchmark description that has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation.

The GIPS standards require firms to present total returns for a benchmark that reflects the investment mandate, objective, or strategy of the composite. In instances where no benchmark is provided because an appropriate benchmark does not exist, the firm must explain why no benchmark is presented. This disclosure must be consistent with the disclosure required in the corresponding compliant presentation unless the disclosure included in the advertisement is more current and has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation.
Supplemental Information

- Supplemental information is defined as any performance-related information included as part of a compliant presentation that supplements or enhances the required and/or recommended provisions of the GIPS standards. For example, a smart beta composite would be benchmarked against a smart beta index and, as such, the compliant presentation would contain information on that index. The firm may want to explain how the choice of the smart beta strategy has been beneficial by providing details on the opportunity cost associated with the choice of a smart beta index versus a market-capitalization index with similar constituents. As such, the firm may decide to enhance the compliant presentation by providing a comparison of the strategy and the smart beta index versus the market index as supplemental information.

- Including other index data as supplemental information can show the opportunity costs of investing in another strategy. For example, a fixed-income composite compliant presentation may include real estate, cash, or equity benchmarks as supplemental information. If other benchmarks are presented and labelled as supplemental information, all of the required benchmark disclosure and presentation items are required to be presented for all benchmarks included in the compliant presentation (please see the section on Multiple Benchmarks).
Policies and Procedures

- Firms must document policies and procedures used in establishing and maintaining compliance with the GIPS standards. This includes policies and procedures for complying with all benchmark-related requirements and any recommendations with which the firm chooses to comply. The following statements are found within the body of this document under their relevant sections, but are also included in this section for completeness:

- The process for determining the benchmark for a composite should be maintained in the firm’s policies and procedures.

- Any difference in hedging between the composite and the benchmark that the firm deems material must be disclosed. The firm must create a policy for materiality and apply it consistently.

- If appropriate, the firm must create a policy for determining the length of time that retroactive benchmark changes are disclosed, and apply that policy consistently.
PUBLIC COMMENT PERIOD

• Your input will shape the Benchmark Guidance Statement
  - Public Comment period 30 October 2017 – 29 January 2018
  - Expected Effective Date 1 January 2019

• Please provide your comments by 29 January 2018.
  - We are asking for your input
  - Your thoughts matter
  - We need to hear from you
QUESTIONS
RESOURCES

- The GIPS standards website:
  - Complete List of Guidance Statements
  - Q&A Database
  - Free Webcasts
  - How to Become Compliant
- The GIPS standards Handbook
- Helpdesk: gips@cfainstitute.org
- GIPS Newsletter
- Twitter: @MarketIntegrity
- Certificate in Investment Performance Measurement (CIPM): cfainstitute.org/cipm

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