Global Investment Performance Standards

GIPS® TREATMENT OF FEES SURVEY

Executive Summary

The GIPS Guidance Statement on Fees describes fees as falling into one of three main categories: investment management fees, trading expenses, and administrative fees. The Global Investment Performance Standards (GIPS) define an investment management fee as "a fee payable to a firm for management of a portfolio," trading expenses as "the actual costs of buying and selling investments," and administrative fees as "all fees other than trading expenses and investment management fees." The GIPS standards further define gross-of-fees returns as "the return on investments reduced by any trading expenses," including transaction expenses for real estate and private equity incurred during the period, and net-of-fees returns as "the gross-of-fees return reduced by investment management fees (including performance-based fees and carried interest)." With the exceptions of real estate, private equity, and wrap fee/separately managed account (SMA) composites, which all require net-of-fees returns (and gross-of-fees returns in the case of private equity), firms are not specifically required to present gross-of-fees or net-of-fees performance but are allowed to present either, or both with equal prominence, as long as the returns are clearly labeled and accompanied by the required disclosures to help the prospective client understand how the measure(s) have been prepared.

In 2015, the United States Investment Performance Committee (USIPC), in conjunction with CFA Institute, conducted a survey regarding the treatment of fees as it relates to calculating and presenting investment performance. The purpose of this survey was to learn how these measures are being prepared in practice and determine whether there is an industry standard in this area. The USIPC sought answers to these questions by collecting information from industry practitioners on the various aspects of the treatment of fees, including but not limited to composites, funds, alternative investments, and performance-based fees. This executive summary analyzes the results of that survey, outlines what can be learned from it, and when appropriate, suggests some best practices for firms to consider.

Demographics, Local Regulations, and Rates of Compliance

In order to interpret the results properly, we gathered some general demographic information from the respondents:

- Of the respondents, 70% were from the United States, 6% from the United Kingdom, 4% from Canada, 3% from Germany, 3% from Switzerland, and the remaining 14% were from countries throughout South America, Europe, the Middle East, Africa, and Asia.
- Of the respondents, 61% confirmed that their local regulatory body has net-of-fees reporting requirements for the purpose of advertising, whereas 9% confirmed that their local regulator does not and the remaining 30% were unsure of their local regulations.
- Of the respondents, 75% confirmed that the firm they represent is claiming compliance with the GIPS standards, whereas 21% confirmed that their firm does not and the remaining 4% were unsure or possibly did not work for an investment adviser.
- Of the respondents, 84% confirmed that their firm is calculating and presenting net-of-fees returns for composites, whereas 11% confirmed that their firm does not and the remaining 4% were unsure or possibly did not work for an investment adviser.

The large majority of the respondents are based in the United States but most other significant markets around the world were represented. We found that three out of four respondents worked for firms claiming compliance with the GIPS standards, and most firms are calculating and presenting net-of-fees performance for composites. Although the majority of the respondents are aware of local regulations regarding the presentation of net-of-fees performance, a significant portion were unsure of their local regulations. This lack of knowledge about local regulations could be a potential concern because firms must comply with their local regulations as well as maintain compliance with the GIPS standards unless the local requirement conflicts with the GIPS standards.

Composite Net-of-Fees Returns: Actual vs. Model

The GIPS standards allow for flexibility on whether firms use actual fees or model fees to reduce their composite gross-of-fees returns:

- Of the respondents, 46% confirmed that their firm is using actual fees, 29% are using model fees, 22% are using some combination of the two, and 3% did not know or indicated that the question does not apply to their firm.
- Of the firms using actual fees, 44% are accounting for these fees on an accrual basis, whereas 39% are accounting for them on a cash basis (i.e., as they are paid), 11% are applying both methods or a mix of the two, and 6% either did not know or indicated that the question does not apply to their firm.

- Of the firms using actual fees, 53% are reflecting fees paid from outside the portfolio in their net-of-fees calculation, whereas 23% are not and 24% either did not know or indicated that the question does not apply to their firm.
- Of the firms using model fees, 71% are applying the highest tier on the composite's fee schedule and 29% are applying the highest actual fee charged to an account in the composite.
- Of the firms using model fees for composite reporting, 46% are periodically testing whether the model fees are as high as or higher than the actual fees, whereas 50% are not testing and 4% did not know.
- Of the firms using model fees for composite reporting, 14% confirmed that they maintain different compliant presentations using different fee structures to present to different client types (e.g., institutional or public), whereas 36% do not engage in this practice and 50% indicated that this approach does not apply to their firm.

The use of actual or model fees is allowed under the GIPS standards and by some local regulators. The decision regarding which to use may come down to the type of account/fund, operational ease, and/or the timing and availability of actual fee data. In *Complying with the Global Investment Performance Standards (GIPS®)*, Bruce Feibel, CFA, and Karyn Vincent, CFA, CIPM, observed that, "Generally, the larger the firm, the more likely it is that the firm will not use actual fees when calculating net returns and will instead use model fees" (p. 213),[1] which the data collected in this survey seem to support (see **Table 1**). When using actual fees, it is important to remember that all management fees, including those paid from outside of the portfolio, must be factored into the calculation of net-of-fees performance. Firms using model fees do have options on how to apply the model fees as long as the model fee net-of-fees performance is not higher than actual fee net-of-fees performance; it is considered a best practice to test this relationship periodically. Keep in mind that when including non-wrap/SMA accounts in wrap/SMA composites, firms should apply the highest fee charged to a wrap/SMA account. Firms are allowed to present compliant presentations using the fee structure that is most applicable to the prospective client, but firms should consider the operational effort required because strong controls are needed for tracking the delivery of compliant presentations to prospective clients.

Table 1. Percentage of Firms Using Actual Fees, Model Fees, or Both, Based on Firm Assets

Firm Assets	Actual	Model	Both	Not sure
Less than $250 million	70%	10%	20%	0%
$250 million to $1 billion	50%	33%	17%	0%
$1 billion to $5 billion	45%	25%	25%	5%
$5 billion to $20 billion	61%	30%	9%	0%
$20 billion to $50 billion	31%	38%	23%	8%
$50 billion to $250 billion	29%	35%	29%	6%
More than $250 billion	38%	29%	33%	0%

Wrap Fee/SMA Accounts

The wrap fee/SMA accounts space in the investment advisory industry stands out in the discussion about the treatment of fees because how fees are treated for these accounts is a defining element of the product:

- Of the respondents, 46% confirmed that their firm is including wrap fee/SMA accounts in composites, whereas 50% confirmed that their firm is not and 4% did not know or indicated that this does not apply to their firm.
- Of the respondents, 80% confirmed that their firm's wrap fee/SMA composites' net-of-fees results are being reduced by the entire wrap/bundled fee, whereas 9% confirmed that their firm is deducting the portion of the total fee charged for investment management, 4% are deducting the portion of the total fee charged for trading costs, and 7% did not know or indicated that this does not apply to their firm.
- Of the respondents, 58% confirmed that their firm's wrap fee/SMA composites' gross-of-fees results are being presented gross of the entire wrap/bundled fee, whereas 22% confirmed that their firm is deducting the entire

[1]Bruce J. Feibel and Karyn D. Vincent, *Complying with the Global Investment Performance Standards (GIPS®)* (Hoboken, NJ: John Wiley & Sons, 2011).

wrap/bundled fee, 7% are deducting the portion of the total fee charged for trading costs, 2% are deducting the portion of the total fee charged for investment management, and 11% did not know or indicated that this does not apply to their firm.

In addition to wrap fee/SMA accounts meriting their own section in the provisions of the GIPS standards, there is the SEC Division of Investment Management No-Action letter issued in 1996 in response to a letter from the Association for Investment Management and Research (the former name of CFA Institute) that contains a section specific to wrap fee/SMA accounts. Firms should keep in mind that when presenting to a prospective wrap fee/SMA client (rather than an existing sponsor with their specific composite), performance must be net of the entire wrap fee and "pure" gross-of-fees returns (gross of the entire wrap fee) can only be shown as supplemental information.

Performance-Based Fees and Alternative Fund Structures

As the use of performance-based fees becomes more prevalent in investment management and the adoption rate of the GIPS standards in alternative investment funds continues to grow, we are faced with more focused questions on the treatment of fees in performance calculations:

- Of the respondents, 60% confirmed that their firm has accounts with performance-based fee structures in composites, whereas 39% confirmed that their firm does not and 1% did not know or indicated that this does not apply to their firm.
- Of the respondents, 52% of those that use model fees confirmed that their firm is reflecting performance-based fees in composites' net-of-fee performance figures, whereas 33% confirmed that their firm is not and 15% did not know or indicated that this does not apply to their firm.
- Of the respondents, 62% of those that accrue performance-based fees confirmed that their firm's adjustments to accruals are being applied to only the current period, whereas 26% confirmed that their firm's adjustments are applied to prior month's reporting periods and 12% did not know or indicated that this does not apply to their firm.
- Of the respondents, 23% of those that have alternative investment funds with multiple fee structures based on different lock-up periods (i.e., liquidity premium) confirmed that their firm is calculating and presenting fund net-of-fees performance for all fee structures, whereas 19% confirmed that their firm is doing so only for the highest fee, 6% are using a weighted fee, and 52% did not know or indicated that this does not apply to their firm.
- Of the respondents, 25% of those that have funds with master/feeder structures confirmed that their firm is showing feeder returns separately, whereas 9% confirmed that their firm is choosing one feeder as a proxy for the fund, 9% are using a blended return, and 57% did not know or indicated that this does not apply to their firm.

Firms that have accounts or funds with performance-based fees in composites need to keep in mind that the GIPS standards define net-of-fees returns as "the gross-of-fees return reduced by investment management fees (including performance-based fees and carried interest)" and that model fees used in the calculation of net-of-fees returns cannot be lower than actual fees. Also, although both approaches are acceptable, firms that accrue performance-based fees should consider the operational effort required to revise prior period net-of-fees returns versus maintaining gross and net return streams that may not appear intuitively correct as a result of having adjustments affect only the most recent reporting period, resulting in net-of-fees performance that is higher than gross-of-fees performance. Alternative investment funds with different fee structures should consider producing the actual net-of-fees returns (asset weighting all fee structures) or the most conservative approach (applying the highest fee) instead of using a blended fee (especially if included in a composite) for the sake of operational ease and because it may understate the fee amount in the net-of-fees calculation depending on how this calculation is performed.

What Are Industry Practitioners' Biggest Concerns?

When given the opportunity to choose from a list provided by the USIPC, the following top five responses were considered the biggest challenges facing industry practitioners with respect to the treatment of fees in performance calculations (percentage of respondents shown in parentheses):

1. Ensuring that composites' model fees are as high as or higher than actual participant fees (28%)
2. Balancing the availability of actual fee data with marketing deliverable deadlines (24%)
3. Transparency on all of the different fee types (e.g., consulting, referral) and how they should be treated (i.e., administrative versus investment management) (23%)

4. “Grossing up” the returns of NAV-based [net asset value] funds appropriately (20%)
5. (Tie) Accruing performance-based fees and capturing fees for accounts that do not have fees debited directly from the portfolio (e.g., client pays by check) (19%)

Practitioners were given an open forum to express what they considered the biggest challenges facing the industry with respect to the treatment of fees in performance calculations; the following are some of the more interesting responses, in no particular order:

- Fees are becoming very creative/complex, and sometimes a client's negotiated fee structure encompasses more than one strategy. This situation presents challenges for their calculation, proportionally designating fees to the correct composites, and verifying that actual fee amounts are as high as or higher than the fees disclosed in the composite presentation.

- The 1996 SEC No-Action letter does not provide sufficient guidance to deal with the many complex issues that fees present, and yet, it is still referred to as the standard. In many cases, by attempting to apply the SEC and GIPS standards to return data, the result is not representative for the actual prospective client.

- Are net-of-fee returns truly comparable across compliant competitors? Are these returns in line with the goal of comparability in the GIPS standards? Are these net returns a better indication of negotiating skills? How would the highest fee schedule negotiated by a client years ago be useful to a current prospect?

- Placing a high bundle fee on net-of-fees performance is not reasonable. Most managers do not charge that level of fees, and firms need to explain to new and prospective clients that this is not a true representation of what they will be charged. I believe a standardized 2% of net-of-fee performance for equity SMAs should be considered.

- There is a lot of confusion and lack of consistency among the different limited partners with respect to reporting of private equity and hedge fund fees. If disclosure and reporting of incentive fees becomes the norm, then the net profits should also be disclosed to give proper context. There needs to be better transparency and reporting by the general partners so that investors can more easily determine the fees being charged.

- The present GIPS methodology for calculating fees can appear impractical. It would not surprise me if fees are calculated in different ways even if they have the same fee rate. This goes against the idealistic reason for firms to adopt the GIPS standards in the first place.

The increasing complexity of fees is, in part, a result of the growing industry trend toward multi-strategy, multi-asset class, and multi-fund structured mandates to satisfy client demand for customized investment objectives. This trend does present firms with challenges on the treatment of fees as well as composite construction.

When complying with the GIPS standards, firms are required to comply with their local regulator’s requirements, and when there is a conflict, firms are required to comply with the local laws and regulations and make full disclosure of the conflict in the compliant presentation. For firms that are subject to the regulations of the SEC, they must also consider SEC No-Action letters, such as the No-Action letter responses to the Association for Investment Management and Research in 1996, to J.P. Morgan Investment Management in 1996, to the Investment Company Institute in 1988, and to Clover Capital Management in 1986, when calculating and presenting net-of-fees performance. The J.P. Morgan No-Action letter establishes the requirement that when using a model fee, performance figures must be no higher than if actual fees were charged. Although this requirement is also a GIPS requirement, firms are allowed to disclose the fee schedule that is most relevant to the prospective client that is receiving the compliant presentation. This allowance may be of little comfort to firms when net-of-fees return streams are compared if actual fees or the model fee used to calculate net-of-fees returns are higher, but it does allow the investment adviser the opportunity to address the issue with the prospective client.

Takeaways

Among the primary goals in the creation and ongoing development of the GIPS standards is the goal to break down barriers to entry and act as a “passport” for investment managers to market their results worldwide. The basis for the creation of GIPS-compliant presentations for composites is to allow for greater comparability of returns and increased transparency of information provided to investors. At the same time, the GIPS standards acknowledge that it is impossible to cover every situation and that the GIPS standards are meant to provide a framework that is applicable to many situations. The manner in which fees are applied in the investment management industry varies widely across regions, products, and firms, which makes it difficult to effectively cater to each specific set of circumstances.

Although we did not clearly identify an industry standard (or standards) for the treatment of fees with respect to calculating and presenting performance for the purposes of marketing, we did identify trends that offer perspective to advisers dealing with these issues. As always, it is important to keep in mind that the underlying principles of the GIPS standards are fair representation and full disclosure. These principles are very much in line with the SEC prohibition in the No-Action letter response to Clover Capital Management in 1986 against distributing “directly or indirectly, any advertisement that contains any untrue statement of a material fact or that is otherwise false or misleading.” When searching for a happy medium between what investment advisers believe is an accurate portrayal of their firm’s net-of-fees performance and complying with the voluntary and non-voluntary requirements for presenting net-of-fee performance to prospective clients, there are many issues to consider. Including additional disclosures and related measures may provide the increased transparency and additional context with which to better interpret performance figures. Then, ultimately, it may be the investors, consultants, and asset owners that determine the industry standard(s) while attempting to evaluate investment adviser performance on an even playing field for the various scenarios they face in comparing net-of-fees performance.