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EXPOSURE DRAFT OF GIPS®
GUIDANCE STATEMENT ON RISK

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CFA Institute

www.gipsstandards.org

GIPS GUIDANCE STATEMENT ON RISK

Introduction

Understanding and interpreting investment performance requires the consideration of both risk and return. In the spirit of fair representation and full disclosure, and to provide prospective clients with a more comprehensive view of a firm's performance, the 2010 edition of the GIPS standards included new provisions related to risk. This Guidance Statement on Risk discusses and interprets both the requirements and recommendations of those risk-related provisions.

Scope of the Guidance Statement on Risk

The risks that this Guidance Statement addresses are those that are specific to the composites being presented in compliant presentations. The Guidance Statement indicates how the risks that are characteristics of the composite being presented in a compliant presentation could be described, both quantitatively and qualitatively, so that the prospective client receives full and fair information. Disclosure of both qualitative descriptions and quantitative measures are encouraged, and in some cases required, to be presented in compliant presentations. The Guidance Statement indicates when and where it is appropriate, required, and recommended for firms to include information related to risk in compliant presentations. Quantitative risk measures may be either ex-post (backward looking) or ex-ante (forward looking). Ex-post calculations are based on actual historical return data, whereas ex-ante risk measures are based on current portfolio holdings and estimations of future risk levels. Both historical and forward-looking risk measures may be examined in either absolute terms or relative to an index, a portfolio, or a composite, and each type has its advantages, but useful comparison between the types of risk measures can be challenging. The GIPS standards require and recommend ex-post measures.

Invitation to Comment

Exposure Draft of the Guidance Statement on Risk

CFA Institute established the GIPS Executive Committee as the governing body for the Global Investment Performance Standards (GIPS). The GIPS Technical Committee, responsible for technical oversight of the GIPS standards, seeks comment on the proposal set forth here regarding the Guidance Statement on Risk.

Comments must be submitted and received no later than 26 September 2017. Responses will be accepted by email, hard copy, and fax. Please submit your comments as early as possible to facilitate the review process. Unless you request otherwise, all comments and replies will be made public on the GIPS standards website (www.gipsstandards.org). Comments may be submitted as follows:

Email: standards@cfainstitute.org
Fax: +1 (434) 951-5687
Post:

CFA Institute
Global Investment Performance Standards
Re: Guidance Statement on Risk
915 East High Street
Charlottesville, VA 22902
USA

Discussion and Interpretation of Risk Provisions

Risk-Related Requirements and Recommendations

The GIPS standards currently include the following risk-related provisions:

5.A.2. For periods ending on or after 1 January 2011, firms must present, as of each annual period end:

a. The three-year annualized ex-post standard deviation (using monthly returns) of both the composite and the benchmark; and
b. An additional three-year ex-post risk measure for the benchmark (if available and appropriate) and the composite, if the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate. The periodicity of the composite and the benchmark must be identical when calculating the ex-post risk measure.

4.A.34. If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must:

a. Describe why ex-post standard deviation is not relevant or appropriate, and
b. Describe the additional risk measure presented and why it was selected.

With the introduction of this guidance statement, provision 5.A.2.b. is removed and thus a firm will not be required to present an additional three-year ex-post risk measure.

Provision 4.A.34, which is related to provision 5.A.2.b, will also be removed.

5.A.2 will be amended to read as follows:

> 5.A.2. For periods ending on or after 1 January 2011, FIRMS MUST present, as of each annual period end, the three-year annualized EX-POST STANDARD DEVIATION (using monthly returns) of both the COMPOSITE and the BENCHMARK.

Question 1) Do you agree with the removal of provision 5.A.2.b, which reads "For periods ending on or after 1 January 2011, FIRMS MUST present, as of each annual period end: b. An additional three-year EX-POST risk measure for the BENCHMARK (if available and appropriate) and the COMPOSITE, if the FIRM determines that the three-year annualized EX-POST STANDARD DEVIATION is not relevant or appropriate. The PERIODICITY of the COMPOSITE and the BENCHMARK MUST be identical when calculating the EX-POST risk measure."?

Firms will continue to be required to present the three-year annualized ex-post standard deviation (using monthly returns) of both the composite and the benchmark for annual periods ended after 1 January 2011.

A new requirement is proposed that requires firms to disclose whether the gross or net returns of the composite were used in the calculation of the composite three-year annualized ex-post standard deviation.

Question 2) Do you agree with the new requirement to disclose whether gross or net returns for the composite were used in the calculation of the three-year annualized ex-post standard deviation?

Question 3) Should firms presenting gross (net) returns be required to use gross (net) returns in the calculation of the three-year annualized ex-post standard deviation?

Question 4) If both gross and net returns are presented, should firms be required to present the three-year annualized ex-post standard deviation for each type of return presented?

A new recommendation is proposed that firms should present additional, relevant ex-post risk measures for the composite and the benchmark. When an ex-post risk measure is calculated and presented for both the composite and the benchmark, the periodicity of the composite and benchmark returns must be identical.

Question 5) Do you agree that when a firm includes an additional composite and benchmark ex-post risk measure that the periodicity of the composite and benchmark returns must be identical?

If, as recommended, an additional, relevant composite and benchmark ex-post risk measure is presented, firms will be required to describe the additional risk measure presented and its relevance to the strategy.

Question 6) Do you agree with the requirement to disclose a description of the additional risk measure presented and how the measure is relevant to the strategy?

A benchmark is defined in the GIPS glossary as a point of reference against which the composite's performance and/or risk is compared. A firm may present more than one benchmark for a composite, but each benchmark must reflect the composite's investment mandate, objective, or strategy and must be accompanied by all the data and disclosures required of a benchmark.

The requirement to present three-year annualized ex-post standard deviation for periods ending on or after 1 January 2011 assumes that firms have been calculating composite returns monthly for the prior 36 months. Firms were not required to calculate composite returns using monthly periodicity until 1 January 2010. Therefore, a firm with an inception date for the composite prior to 1 January 2010 may have only generated 2 years of monthly composite returns by the end of 2011, with 36 monthly returns being available only from 1 January 2013.

If composite returns were calculated daily, then the firm must compound the daily composite returns to calculate the required monthly returns that are used to calculate the three-year annualized ex-post standard deviation. The same is true for benchmark returns.

Provision 4.A.33 states that firms must disclose if the three-year annualized ex-post standard deviation of the composite and/or benchmark is not presented because 36 monthly returns are not available.

If 36 monthly returns are not available for the composite, firms are not required to present the three-year annualized ex-post standard deviation for either the benchmark or the composite.

Firms must disclose that 36 monthly returns are not available for the composite. Firms may choose to present the three-year annualized ex-post standard deviation for the benchmark if 36 monthly benchmark returns are available.

If 36 monthly returns are not available for the benchmark but are available for the composite, firms are required to present the ex-post standard deviation for only the composite but must disclose that the measure is not presented for the benchmark because 36 monthly returns are not available.

Firms must not present a three-year ex-post standard deviation for the benchmark calculated using data points that are not monthly returns.

Provision 4.A.13 also references risk and requires that firms must disclose the presence, use, and extent of leverage, derivatives, and short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks.

The following recommendations are intended to encourage firms to present risk-related information in addition to the required information:

- Provision 5.B.3. For periods prior to 1 January 2011, firms should present the three-year annualized ex-post standard deviation (using monthly returns) of the composite and the benchmark as of each annual period end.
- Provision 5.B.4. For each period for which an annualized ex-post standard deviation of the composite and the benchmark are presented, the corresponding annualized return of the composite and the benchmark should also be presented.
- Provision 5.B.5. For each period for which an annualized return of the composite and the benchmark are presented, the corresponding annualized ex-post standard deviation (using monthly returns) of the composite and the benchmark should also be presented.

Calculation of the Standard Deviation Measure

Acknowledging that there are calculation variations in widespread use, the GIPS standards do not prescribe a specific methodology for calculating composite and benchmark three-year annualized ex-post standard deviation. Firms are required to select a methodology on a composite-specific basis, document them in their policies and procedures, and consistently apply the methodology for both the composite and the benchmark.

Firms should not present non-annualized standard deviation. The presentation of a non-annualized standard deviation measure could be considered as misleading because all required and recommended standard deviation measures are annualized. A non-annualized standard deviation will always produce a result that indicates less variability than the same standard deviation that has been annualized.

Additional Risk Measures

In addition to the required three-year annualized ex-post standard deviation, there are other ex-post risk measures that could provide helpful information to prospective clients. The following are some examples:

a. Ex-Post Tracking Error: A measure of the divergence between the return of an investment, portfolio, or composite and the return of a benchmark. This measure is typically the standard deviation of returns relative to a benchmark (variability of excess returns). It is also referred to as the active risk because it is the standard deviation of the active returns from each period.
b. Maximum Drawdown: A measure of the peak-to-trough decline of returns, during a specific period, of an investment, portfolio, or composite. Maximum drawdown is usually quoted as the percentage between the peak and the trough of the cumulative returns.
c. Ex-Post Sharpe Ratio: Using actual returns, this ratio measures the excess return, where the benchmark is the risk-free rate, relative to the total risk as indicated by the standard deviation of the composite returns.
d. Information Ratio: By dividing the composite's mean excess return relative to the assigned benchmark by the tracking error, this measure indicates how much excess return was generated from the excess risk that was taken relative to the benchmark.

Question 7) Are there additional, commonly used ex-post risk measures that provide helpful information to prospective clients that should be included as examples?

Selection of the Appropriate Risk-Free Rate (RFR)

There are generally accepted industry criteria to be considered when selecting an appropriate benchmark. But the selection of an appropriate RFR, a rate that is an integral and important characteristic of several industry-recognized risk measures, is not so extensively documented. The selection of the RFR is important because it is the comparator, or hurdle, against which the portfolio or composite returns are compared or expressed. An ill-considered or biased selection of the RFR could have a significant bearing on the results that make comparisons between strategies difficult at best or misleading at worst, and this would be in direct conflict with the GIPS provision that prohibits the presentation of false or misleading performance or performance-related information.

When determining the appropriate RFR, the selection criteria will be similar to the criteria used for selecting benchmarks, including appropriateness for the strategy to which it is being applied, accessibility of the rate so that the impact of the RFR on the return measure can be understood, and consistent application such that a single RFR is used in the measure for a composite for all time periods presented.

A new requirement is that if a risk measure is presented that uses a risk-free rate, the risk-free rate used must be included in the description of the measure.

Question 8) Do you agree with the requirement that if a risk measure is presented that uses a risk-free rate, the risk-free rate used must be included in the description of the measure?

Selection of an Additional Risk Measure

Beyond standard deviation, there are several risk measures and statistics that can be calculated and are used in portfolio management, analytics, and performance reporting. One of the primary challenges for fair representation is the selection of the appropriate set of risk measures given the composite's investment mandate, objective, or strategy.

Presenting a Proprietary Risk Measure

The firm may present a proprietary ex-post risk measure as an additional risk measure. The firm must describe the measure, how it is calculated, the inputs used, and any other information germane to its construction and why the measure is relevant for the strategy. If a firm chooses to include an additional proprietary measure in a compliant presentation, the firm should include it consistently.

When selecting an additional risk measure, firms should consider the following:

- Relevance: The additional risk measure should be relevant to and reflect the specific key investment risks in the composite strategy.
- Consistency: The selected risk measure and its component pieces, such as the risk-free rate and the benchmark or target that is incorporated in the measure, should be consistent with the investment process or composite strategy.
- Changes: Frequently changing the additional risk measure that is included in a compliant presentation could be considered misleading.
- Effectiveness: Some measures may be used more effectively with products that produce normal return distributions rather than with products that produce asymmetric return distributions.
- Computational transparency: A risk measure may follow several calculation methodologies. Firms should select a methodology that is well documented and accepted.
- Interpretational transparency: The results generated by the measure should be able to be readily and accurately interpreted with respect to the performance record presented.
- Risk measure stability: Although the measure needs to be responsive to changes in the portfolio or market, excessive sensitivity or variability in the measure could make interpretation of the output and comparability of returns difficult.

When selecting an additional risk measure, the firm should also consider the following:

- Maintaining comparability between investment managers
  As noted above, there are many risk measures that could be chosen. In determining an additional risk measure, the relevance and reliability across time periods and market environments are key factors for the firm to consider, particularly when a comparison of composites supplied by two or more firms is likely to occur. In the spirit of the GIPS standards, a firm should consider using a measure that is comparable with those likely to be provided by other firms.
- Credibility
  Also as noted above, many risk measures require assumptions and estimates to be made. The more estimates and assumptions included in the generation of a measure, the more vulnerable the measure is to manipulation and modification, reducing the credibility of the measure. As opposed to returns, whose calculations fall into one of a few acceptable methods, risk measure calculations can have many varieties and options. It is critical that a risk measure is credible, which particularly applies to a proprietary risk measure if presented.

Ex-Post Measures Are Additional, Ex-Ante Are Supplemental

Any additional risk measure presented must be calculated on an ex-post basis and are based on actual historical data. Any ex-ante risk measure, a risk measure that uses the current portfolio and estimates of how the portfolio investments have behaved together historically to estimate or predict future behavior, and a risk-adjusted return measure would be considered supplemental information and must be appropriately labeled (please refer to the Guidance Statement on the use of Supplemental Information).

The following are examples of ex-ante measures:

- Ex-Ante Tracking Error: A technique used to estimate the forecast tracking error of an investment, portfolio, or composite based on current holdings and risk factor models.
- Value at Risk (VaR): Many variations of ex-ante VaR exist, from the straightforward to the more involved—for example, incremental, marginal, parametric, and Monte Carlo simulation VaR.

Risk Description as Part of the Composite Description

The meaning of “risk” can differ for a firm and its prospective clients depending on their perspective. Although some forms of risk are quantifiable, it is also important to consider the risks that are described qualitatively. Acknowledging that disclosing every risk associated with investing in a strategy would produce a compliant presentation overloaded with disclosure, it is important to disclose the material risks of the strategy in the composite description.

The GIPS standards require disclosure of the composite description in the compliant presentation. The intent of this requirement is for the firm to provide material information in the composite description that summarizes the composite’s investment strategy and aids the prospective client when considering an investment product and when reviewing a compliant presentation. The composite description is not meant to replace more comprehensive descriptions of the investment strategy included in the composite definition, investment management agreement, and/or prospectus, but it should provide enough information about the strategy to be informative while remaining concise. It must provide enough information to prospective clients to make them aware of any significant features of an investment strategy that may distinguish the strategy from similar strategies within and between firms.

Acknowledging that all investment products or strategies have some degree of inherent common risk, such as, but not limited to, market, currency, investment-specific, inflation, or interest rate risk, it is not expected that the composite description includes reference to every one of these generic, systemic risks unless any is materially more significant to a composite strategy than typically expected. Firms must provide sufficiently detailed information for the prospective client to understand the key characteristics of the composite strategy.

Examples of strategy features that need to be considered for inclusion in the composite description include

- investment concentration,
- correlation of returns,
- changes in liquidity,
- exposure to counterparty creditworthiness risk, and
- ability to employ significant leverage in a portfolio.

The risks that are discussed as part of the strategy development and by the product and fund managers should be considered when determining the risk description to be included in the composite description.

It is recognized that some strategies can be highly dynamic or may be profoundly affected by market-driven events. Firms are reminded that the composite descriptions must be maintained and reflect material changes in the risks in the strategies caused by market events or changes imposed by the firm.

Examples of composite descriptions from the 2010 Edition of the GIPS standards, Appendix C,[1] that include comprehensive descriptions of risk are listed below and included in Appendix B at the end of this guidance statement:

- Emerging Market High-Yield Fixed Income Composite
- UK Liquidity Plus Composite
- Leveraged Bond Composite
- Global Commodity Composite

In contrast, also included are two examples of composite descriptions from Appendix C that do not require a more comprehensive description of risk. These strategies do not contain any unusual or material risks beyond those typically associated with these strategies:

- Large-Cap Equity Growth Composite
- Balanced Growth Composite

Description of Risks

The following are some of the risks and possible descriptions that should be considered for inclusion in composite description as required by provision 4.A.3. The composite description should include those risks that could have had a significant influence on the historical returns, or that are a key feature of the strategy and need to be considered alongside the future return expectations. Some quantitative description of risks could be included in the composite description along with qualitative description—for example, noting that the strategy invests up to 20% in bonds rated below BBB or includes a tracking error limit.

Liquidity Risk: Considered here as the risk associated with market value losses that may occur when changes (generally a decline) in the liquidity of one or more securities or instruments limits or restricts the

[1]Appendix C in the *Global Investment Performance Standards Handbook*, 3rd Edition, 2012, can be found on page 73 of the handbook: http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2012.n4.full.

manager’s ability to trade the quantity necessary to reflect the manager’s investment decisions or realize a client’s investment within the client’s desired time frame. The lack of liquidity may necessitate a restriction being imposed on the trading of the product. It may also cause a dislocation to occur between estimated values for assets with no recent market-based transactions and realized values and thus impact the relevance of measures that have incorporated the estimated values.

Illiquidity may be a key feature of components of the investment strategy or the total strategy and, as a key feature, it must be included in the composite description. Examples of components that may be considered as illiquid would be direct real estate investments or private equity holdings within a strategy, an opportunistic strategy that has limited investment opportunities or has limited exit strategies available, or a financial product that has a limited secondary market. The description of this key feature might take the form of the following statement: “This strategy allows for investment of up to 25% in non-marketable US private companies.”

Leverage and Derivatives: A strategy may employ leverage using one or more financial instruments or borrowed capital to take additional advantage of a perceived investment opportunity in the pursuit of superior absolute performance or relative outperformance of an underlying benchmark, securities market, or peer group.

A portfolio is considered leveraged if the ratio of market (economic) exposure to capital employed exceeds 100% or if the deployment or utilization of certain instruments will potentially affect the magnitude of the returns of that strategy compared with the underlying securities market or benchmark.

The use of leverage and derivatives can have the effect of altering the risk and return characteristics of a strategy. The GIPS standards require firms to disclosure (if material) the presence, use, and extent of leverage, derivatives, and short positions. In the case of levered strategies, it should be remembered that the requirement to present the three-year annualized ex-post standard deviation is the minimum requirement. Firms should consider presenting an additional risk measure that more comprehensively captures the risks inherent in these strategies, particularly where the use of these instruments could lead to asymmetric or non-linear returns.

In addition to the requirements and recommendations with respect to leverage and derivatives, firms may be subject to regulation that includes requirements for the monitoring, measurement, and reporting of derivative exposures through the firm’s risk management process. Firms may want to consider presenting risk measures required under regulatory authorization or further measures that the firm believes best capture and illustrate a leveraged composite’s altered risk/return profile in addition to those required by the GIPS standards.

Credit/Issuer Risk: This risk can be considered as potential market value losses relating to changes in the creditworthiness of issuers of securities or instruments inherent to the investment strategy. Issuers are rated by various agencies, with those ratings often being included in the description of an instrument to indicate the level of creditworthiness of the issuers of the securities (the issuers’ ability to fulfil their financial obligations). The less favorable the rating, the higher the payment the issuer will have to make in order to compensate investors who will be taking on that perceived higher risk of default. If the rating is downgraded, there is a risk the value of the security will fall.

Counterparty Risk: The risk associated with changes in the creditworthiness of corporate entities a firm conducts business with that may become unable to meet its obligations. Counterparty risk is an important characteristic to consider when using derivative transactions within a strategy, particularly if the proportion in the strategy is significant.

Interest Rate Risk: The market value risks arising from movements in interest rates.

Concentration Risk: The risk that exposures within a strategy introduce a bias toward one or more factors that could generate a material impact on the portfolio return or risk given certain market outcomes. An example of a concentrated strategy might be one that limits the number of holdings in a portfolio—for example, the European Activist strategy typically invests in 13–15 stocks—or a strategy that specifically indicates in its name that there is a limit to the number of holdings, such as a “Global 30.” Alternatively, there may be a deliberate bias toward a particular industry—for example, concentration in commodities to the exclusion of others industries or concentration in a particular issuer. For the strategies in which concentration is considered to be a key characteristic, this factor must be included in the composite description.

Question 9) Is the description of risks that could have significant influence on returns adequate, or are there additional risks that should be included?

Relationship with Regulatory Requirements

The GIPS standards are endorsed by multiple country sponsors and are implemented globally. Many national or regional regulators have specific and distinct regulations that relate to return and risk measurement and how the data is presented. To claim compliance with the GIPS standards, firms must comply with all requirements and must also comply with all applicable laws and regulations regarding the calculation and presentation of performance, which includes both risk and return. Firms must determine whether any risk-related information required by laws or regulations should also be included in compliant presentations and any conflict with the requirements of the GIPS standards must be disclosed.

Record Keeping Requirements

The GIPS standards state that all data and information necessary to support all items included in a compliant presentation must be captured and maintained. This requirement also applies to all risk measures included in a compliant presentation, including additional and supplemental information and the disclosures relating to risk.

Policies and Procedures

The GIPS standards state that firms must document their policies and procedures used in establishing and maintaining compliance with the GIPS standards, including ensuring the existence and ownership of client assets, and must apply them consistently. This includes policies and procedures relating to risk. Some firms may be required to maintain a risk policy document as part of the requirements of the authorized firm’s regulator. Although it is expected that such regulatory required policies and procedures will be broader than those required by the GIPS standards, it is possible that the policies and procedures regarding the calculation and presentation of risk may be sufficient to satisfy the policies and procedures requirement of the GIPS standards. Policies and procedures for the selection of additional risk measures and methodology, including documentation of proprietary risk measures presented for any composite, must be included.

Effective Date

The effective date for this Guidance Statement is 1 January 2019

Appendix A: Q&As

1. **Question:** We use a proprietary risk measure because we believe it offers a better comparison of risk and return than standard or traditional methods. If the proprietary risk measure is included in the compliant presentation, do we have to disclose the methodology?

   Answer: Sufficient information about the proprietary risk measure needs to be provided so that the relevance and appropriateness of the measure can be understood by a prospective client. It is a requirement that all data and information necessary to support all items included in a compliant presentation are maintained and that policies for calculating performance are available upon request. Given that performance is a combination of risk and return, as indicated in the Guidance Statement on Calculation Methodology, the firm must be prepared to provide the risk measure calculation methodology if requested by a prospective client.

2. **Question:** Historically, we have provided Sharpe ratios as an additional risk measure, but we now believe that tracking error and information ratio provide a superior view. Do we have to disclose the fact that we have changed the additional risk measure in the compliant presentation?

   Answer: Firms are not required to disclose where there have been changes in the additional risk measure presented. But firms should select an additional risk measure that is appropriate to the composite strategy, present it consistently, and not change the risk measure simply to show the composite in a more favorable light.

3. **Question:** A global equity composite is benchmarked against an index for which only quarterly returns are available from the third party. How can we meet the requirement to present a three-year annualized ex-post standard deviation for the benchmark? We also would like to show another three-year risk statistic for this composite and benchmark, but because the composite performance is calculated monthly, this does not appear possible because they fail the periodicity test. What can we do?

   Answer: Because the benchmark is not calculated monthly, a disclosure that the three-year annualized ex-post standard deviation for the benchmark is not presented because 36 monthly returns are not available is required. Because 36 monthly returns are available for the composite, the firm is required to present only the three-year ex-post standard deviation for the composite. Because the periodicity of the composite and the benchmark must be the same when calculating an additional ex-post risk measure, you can calculate a three-year annualized ex-post risk measure using quarterly returns for both the composite and the benchmark.

4. **Question:** Why is it a requirement to show the three-year ex-post risk measure alongside annual composite and benchmark returns?

   Answer: The three-year annualized risk measure using 36 monthly returns is considered to include sufficient data points for the result to be meaningful, and 24 data points would decrease that considerably. A measure using 36 data points provides a level of confidence that is more than 40% tighter than when using only 12 observations. The 36-month requirement is a good compromise between the level of confidence and the time frames that are presented and ensures comparability between firms by requiring a standardized time period.

5. **Question:** In the past, we have used significant leverage within our High Alpha composite, but in the future, the leverage is expected to be much more modest. This change is likely to affect the risk profile of the strategy and thus the future returns. How should we describe these changes in leverage?

   Answer: The GIPS standards require that the presence, use, and extent of leverage, derivatives, and short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks, both historical and expected, to be disclosed. An anticipated change to the extent of leverage should be disclosed along with the relevant time frame.

6. **Question:** Our money market funds have exposure to near-cash instruments that we know can change the risk profile of the fund given possible market conditions. How should this be disclosed?

   Answer: It is a requirement that a composite description be disclosed and that description must include all key features of the composite and include enough information for a prospective client to understand the key characteristics, including risks, of the composite's investment mandate, objective or strategy. In this instance, the firm is required to accurately describe the risks specifically associated with this strategy and disclose how under certain specified market conditions, the risk profile of the strategy could change materially.

7. **Question:** The compliant presentation includes both net and gross composite returns. Are we required to present the three-year annualized ex-post standard deviation for both return streams?

   Answer: For periods ending on or after 1 January 2011, a three-year annualized ex-post standard deviation (using monthly returns) of the composite is required. Firms may choose which returns to use to calculate the three-year annualized ex-post standard deviation and must disclose which composite returns are used.

8. **Question:** There are variations in the way standard deviation is calculated. Is there a preferred methodology?

   Answer: No, the GIPS standards do not prescribe one particular methodology. Firms are required to select a methodology on a composite-specific basis, document it in the policies and procedures, and apply it consistently. Firms should select a single methodology and apply it to all composites.

9. **Question:** Is it permitted to calculate the three-year annualized ex-post standard deviation using daily returns?

   Answer: It is a requirement that for periods ending on or after 1 January 2011, the firm present, as of each annual period end, the three-year annualized ex-post standard deviation using monthly returns for both the composite and the benchmark. Daily returns could be used in this calculation only if the daily returns are linked to produce monthly returns. Requiring all firms to use monthly returns ensures comparability between firms.

10. **Question:** Are we required to describe the risks inherent in our composite strategy in the composite description, and which risk factors are we required to describe?

    Answer: Firms are required to provide sufficient information within the composite description such that a prospective client can understand the key characteristics of the composite strategy, which includes material influences and exposures inherent within the strategies.

Appendix B: Composite Descriptions

Emerging Market High-Yield Fixed Income Composite

The Emerging Market High-Yield Fixed Income Composite includes all institutional and retail portfolios invested in high-yield debt securities issued by countries outside the OECD. The strategy allows for investment in foreign currency–denominated assets over which the manager has full discretion on hedging. The strategy aims to deliver a total return primarily through income but with some capital growth. High-yield bonds carry increased levels of credit and default risk and are less liquid than government and investment-grade bonds. Investment in less regulated markets carries increased political, economic, and issuer risk. The benchmark is the J.P. Morgan Emerging Market Bond Index (EMBI+).

UK Liquidity Plus Composite

The UK Liquidity Plus Composite includes all institutional portfolios invested in a broad range of short-dated interest-bearing deposits, cash equivalents, short-term commercial paper, and other money market investments issued by major UK clearing banks and lending institutions. The strategy has a targeted modified duration of less than one year. The principal investment objectives are preservation of capital, maintenance of liquidity, and provision of yield greater than that available for the benchmark, which is the three-month Libor rate. The UK Liquidity Plus strategy differs from more conventional cash strategies in that it additionally holds short-term commercial paper, which has a greater exposure to credit risk.

Leveraged Bond Composite

The Leveraged Bond Composite includes all institutional segregated portfolios invested in a diversified range of high-yield corporate and government bonds with the aim of providing investors with a high level of income while seeking to maximize the total return. The portfolios are invested in domestic and international fixed-income securities of varying maturities. The strategy allows investment in exchange-traded and OTC derivative contracts (including, but not limited to, options, futures, swaps, and forward currency contracts) for the purposes of risk, volatility, and currency exposure management. The strategy allows leverage up to but not exceeding twice the value of a portfolio's investments through the use of repurchase financing arrangements with counterparties. Inherent in derivative instrument investments is the risk of counterparty default. Leverage may also magnify losses as well as gains to the extent that leverage is used. The benchmark is the Barclays Capital Global Aggregate Bond Index.

Global Commodity Composite

The Global Commodity Composite includes institutional portfolios that globally invest in a diversified range of companies that provide exposure to commodities, energy, and materials. Investment is primarily through the common or ordinary stock of these companies. Investment directly in raw materials is allowable to a maximum exposure of 10%. Exchange-traded funds and exchange-traded commodity securities up to a maximum 20% exposure are also allowed. The base currency is US dollars, and any or all of the currency risk associated with investments in currencies other than dollars may be hedged between 0% and 100% at the manager's discretion. The strategy cannot gear or otherwise deploy leverage but may use exchange-traded derivative instruments for efficient portfolio management. Investments directly or indirectly in commodities may add to portfolio volatility. Global commodity prices can be affected by changes in legislation, national and supra-national policies, and behaviors. In times of commodity price volatility, the liquidity of directly held commodities and the correlation with the broad market can change quickly. The benchmark is the Dow Jones–UBS Commodity Index Total Return.

Large-Cap Equity Growth Composite

The Large-Cap Equity Growth Composite includes all institutional portfolios that invest in large capitalization US stocks that are considered to have growth in earnings prospects that are superior to that of the average company within the benchmark, the Russell 3000® Growth Index. The targeted tracking error between the composite and the benchmark is less than 3%.

Balanced Growth Composite

The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap US equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50% and 70%, the typical allocation is between 55% and 65%.