

# Global Investment Performance Standards

## GUIDANCE STATEMENT ON ALTERNATIVE INVESTMENT STRATEGIES AND STRUCTURES

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Notice: This Guidance Statement applies to all firms claiming compliance with the GIPS standards and contains guidance that is relevant to firms that may not consider themselves as “alternative” investment managers.

# GIPS Guidance Statement on Alternative Strategies and Structures

## 1. Introduction and Scope

### 1.1. Introduction

Alternative investments have become increasingly popular in recent years. While there is no uniform definition of the term “alternative investments,” many investors previously thought of alternative investments as illiquid investments, including private equity, private real estate, and/or other private investments focusing on real assets, commodities, etc. The GIPS® standards already include provisions and guidance for private equity and real estate investments.

More recently, the definition of alternative investments has expanded beyond private equity and real estate to include such investments as hedge funds and derivatives-based strategies. These strategies may include illiquid, partially liquid, or fully marketable investments. Other than private equity and real estate, alternative investments and the portfolio structures typically used to manage the strategies, (e.g., hedge funds, master feeder structures) have not previously been the subject of dedicated guidance within the GIPS standards. While a firm that manages alternative investments has always been able to comply with the GIPS standards, there has been a perception that because the GIPS standards do not include guidance dedicated to such investments, compliance was not possible. The following guidance has been developed to address compliance with the GIPS standards for hedge funds and other alternative investment strategies, as well as portfolio structures typically used for those strategies and other non-traditional structures, together known as alternative investment strategies and structures.

The main body of this document addresses key areas of interest and uncertainty that have been identified by the industry, while a number of Q&As provide further guidance by addressing specific situations and examples.

It is important to note that this Guidance Statement applies to alternative investment strategies and structures that a firm may not typically consider to be an alternative investment strategy or structure. This guidance also addresses specific issues that have broader applicability and apply to other investment strategies that are not considered to be alternative investment strategies. Firms claiming compliance with the GIPS standards must consider this Guidance Statement as well as all of the provisions, guidance, and interpretations of the GIPS standards.

### 1.2. Scope

The purpose of the Guidance Statement on Alternative Investment Strategies and Structures is to provide clarity for how firms managing alternative strategies and structures can comply with the GIPS standards. While it is impossible to develop guidance that covers every situation, the GIPS standards provide a general framework that can be applied to many different circumstances. It is important to remember the underlying principles of the GIPS standards: fair representation and full disclosure.

## Guidance Statement on Alternative Investment Strategies and Structures

It is not possible to include a definitive list of every specific asset class, product, or strategy that may be described as “alternative”. Investment types and portfolio structures that are within the scope of this guidance include, but are not limited to, the following:

- Hedge funds and hedge-fund-like strategies
- Funds of funds, where the underlying funds are invested in either traditional or alternative strategies;
- Structured products requiring ongoing management of the underlying investments and where there are identifiable elements of asset management embedded in the overall product;
- Investment strategies that materially alter the potential return characteristics of the portfolio by using derivative instruments (e.g., currency and interest overlay strategies);
- Investment techniques such as portable alpha, liability-driven investment (LDI), and long–short strategies;
- Non-index-related commodities and their derivatives; and
- Strategies that invest in non-traditional assets.

This Guidance Statement applies to all asset classes. Private equity and real estate have their own provisions and related guidance that must be considered when claiming compliance with the GIPS standards. In situations where the private equity and real estate provisions and guidance do not address specific issues that are addressed by this Guidance Statement, firms managing private equity and real estate assets must also consider this Guidance Statement where applicable. Where firms engage in investment strategies or invest in asset classes other than those covered by the private equity and real estate guidance, they must also consider this Guidance Statement where appropriate.

## **2. Areas of Concern with Applying the GIPS Standards to Alternative Investment Strategies and Structures**

The following guidance elaborates on the main areas of concern with application of the GIPS standards to alternative investment strategies and structures. Further guidance addressing specific examples is provided in the Q&A section of this Guidance Statement.

### **2.1. Fundamentals of Compliance**

#### *2.1.1. Applicability of the GIPS Standards to Alternative Investment Strategies and Structures*

The GIPS standards can be applied to managed portfolios of all asset classes, including alternative investment strategies. Due to the variety of alternative investment strategies, it is not possible to explicitly mention all of them; therefore, if nothing is stated regarding any non-applicability of the GIPS standards to a particular asset class or portfolio type, the GIPS standards are deemed to be applicable.

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Compliance with the GIPS standards is not claimed for individual asset classes or composites, but rather is claimed at the firm level. If a firm manages alternative investments, nothing precludes the firm from claiming compliance with the GIPS standards. Acknowledging that many alternative investment strategies are complex and may need more explanation than traditional asset classes, firms should evaluate the potential need for increased disclosure in such situations where clarity is needed. If an investment firm applies the GIPS standards in a situation that is not addressed specifically by the GIPS standards or is open to interpretation, disclosures other than those required by the GIPS standards may be necessary. Firms must always consider the overarching principles of fair representation and full disclosure when applying the GIPS standards.

### *2.1.2. Definition of the Firm*

The definition of the firm for compliance with the GIPS standards delineates the universe of portfolios that must be included in total firm assets. Fundamental to the GIPS standards is the premise that all of the firm's actual, fee-paying, discretionary portfolios must be included in at least one composite.

In many situations, alternative investment portfolios involve complex legal relationships and multi-layered portfolio structures. As a result, in some situations it may be difficult to assess whether a particular portfolio should be included in the definition of the firm. In assessing such situations, firms must bear in mind that a "substance over form" principle should always be applied, and it would be inappropriate and against the ethical spirit of the GIPS standards to make use of formal legal structures to avoid inclusion of certain portfolios or assets in the definition of the firm.

### *2.1.3. Marketing New Alternative Investment Strategies*

The GIPS standards state that firms must make every reasonable effort to provide a compliant presentation to all prospective clients. If the firm does not have an appropriate composite to present to a prospective client, the firm must disclose that it does not currently manage the specific style or strategy. The firm must be able to clearly demonstrate the strategies and investment products it currently manages and must provide a list of composite descriptions of all firm composites upon request by a prospective client. The firm is not prohibited, however, from providing any information a prospective client specifically requests.

Firms may wish to present simulated, model, or back-tested hypothetical performance results due to the lack of an actual historical track record. Simulated, model, or back-tested hypothetical results can be presented as Supplemental Information to a compliant presentation. Firms must not link performance of simulated, model, or back-tested portfolios with actual performance. Additionally, firms must not present performance or performance-related information that is false or misleading.

## **2.2. Input Data**

The consistency of input data is critical to compliance with the GIPS standards and establishes the foundation for fair representation and comparability of investment performance presentations.

### *2.2.1. Valuations When Investments Are Not Fully Liquid*

Some alternative investments are fully liquid and have objective, observable, unadjusted quoted market prices. For such investments, that price must be used when valuing portfolios; however, there are alternative investments that are partially or completely illiquid for which no readily available market price exists.

The GIPS standards state that for periods beginning on or after 1 January 2011, portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II. All investments, regardless of their liquidity, must have valuations that adhere to the definition of fair value. The GIPS Valuation Principles provide a recommended valuation hierarchy that incorporates various degrees of liquidity. For periods beginning on or after 1 January 2011, firms must disclose if the composite's valuation hierarchy materially differs from the recommended hierarchy in the GIPS Valuation Principles in Chapter II of the GIPS standards. Additional guidance on valuation is explained further in the GIPS Valuation Principles.

Firms managing alternative investment strategies may utilize subjective, unobservable inputs (e.g., a model) to create valuations when there are no prices that are readily available or appropriate. For periods beginning on or after 1 January 2011, firms must disclose the use of subjective unobservable inputs for valuing portfolio investments if the portfolio investments that are valued using subjective unobservable inputs are material to the composite. Keeping with the underlying principles of fair representation and full disclosure, firms should disclose if pricing has been performed internally and not by an external third party.

Firms should establish a proper internal segregation of duties with respect to valuations to ensure that the valuation is carried out by a unit functionally separate from the portfolio management division or chain of command/reporting structure.

The GIPS Valuation Principles require that firms must document their valuation policies, procedures, methodologies, and hierarchy, including any changes, and must apply them consistently. It is possible that in accordance with a firm's GIPS fair valuation policy, specific illiquid investments may be carried at their last available historical market value provided that the firm considers such historical market value to be the best estimate of the current fair value of the investment. It is also possible that valuation policies for various investments in the same portfolio or composite may be different provided that all valuation policies adhere to the fair value principles of the GIPS standards.

*2.2.2. Frequency of Valuation of Portfolios*

The GIPS standards require that for periods beginning on or after 1 January 2001, portfolios must be valued at least monthly. The GIPS standards also require that for periods beginning on or after 1 January 2010, firms must value portfolios on the date of all large cash flows.

However, for some alternative investments it may not be possible to obtain valuations monthly and/or at the time of large cash flows due to their illiquidity or because the pricing source does not provide the valuations on a monthly or more frequent basis.

If the pricing source does not provide monthly or more frequent valuations, firms must create a valuation policy that addresses how to determine fair values with the frequency required by the GIPS standards. If the underlying investments of a fund do not lend themselves to monthly valuations and the fund itself is open to client cash flows only on a less frequent (e.g., quarterly) basis, it may be appropriate that valuations are performed on a less frequent than monthly basis. The subscription and redemption cycle for the pooled fund would drive the choice of the periodicity for investment valuation and performance measurement. In all cases, valuations must be conducted at least on an annual basis. Firms must disclose if they choose to opt out of the monthly valuation.

*2.2.3. Estimated versus Final Values*

For some alternative investments, such as funds of hedge funds, the fund administrators provide estimated values of the underlying funds within a reasonable time period after period-end, while the final valuations are provided with a significant time lag (e.g., three months after period-end).

This issue frequently exists for funds of funds or portfolios invested in third-party hedge funds or other alternative investment strategy assets, where the final valuations of the underlying funds or assets are not available on a timely basis and the administrators and/or custodians have to work with estimated values of the underlying funds to determine the total fund-of-funds and/or portfolio value.

In the case of a pooled fund, estimated values are frequently used to determine the official fund NAV, at which investors can buy or sell units of the fund. In this case, the NAV becomes an effective tradable market price and, therefore, satisfies the requirements regarding fair valuation.

In the case of a managed segregated portfolio of an individual investor investing in funds, if estimates are used, the valuation of the underlying funds may not necessarily properly reflect the value of the portfolio, unless the estimated value of each underlying fund is effectively its tradable price.

For both pooled funds and segregated portfolios firms must assess to what extent the estimated values represent the current fair value and can be used for GIPS compliance purposes and how they will fit within the composite-specific valuation policies and procedures. Possible scenarios include, but are not limited to, the following:

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- a) The firm uses estimated values of the underlying funds to determine fair value and the valuation of the portfolio to produce the compliant presentation on a timely basis. If using estimated values, the firm should obtain an understanding of the process of determining estimated values by the fund administrators and determine whether reliance can be placed on this process. If using estimated values, the firm must consider them to be the best approximation of the current fair value and this must be defined in the firm's fair valuation policy.
- b) The firm uses the last available historical final values of the underlying funds to determine fair value and the valuation of the portfolio to produce the compliant presentation on a timely basis. If using the last available historical final values, the firm must consider them to be the best approximation of the current fair value and this must be defined in the firm's fair valuation policy.
- c) The firm does not publish compliant presentations until the final valuations have been received, and these final valuations are used to produce the compliant presentation. As a result, the compliant presentations may only become available to prospective clients with a significant time lag.

Firms must define the use of estimated values, last available historical values and the treatment of subsequent final values in their composite-specific fair valuation policy, which must be followed consistently and made available upon request. If the firm uses estimated values or the last available historical values, when final values are received the firm must assess the differences in values and the impact on composite assets, total firm assets, and performance. If the final values and resulting performance are materially different, firms must determine whether any adjustments to the composite must be made on a prospective basis or retroactively. If composite valuations are revised retroactively, firms must consider the Guidance Statement on Error Correction and the firm's error correction policies. Differences between final and estimated values are not necessarily errors, but are treated in a similar manner as under the GIPS Guidance Statement on Error Correction. If differences between the estimated and final values are consistently material, the firm should reassess whether it is proper to use estimates as the fair value.

It is important to remember the underlying principles of the GIPS standards: fair representation and full disclosure. If using estimated values to determine fair value, firms must disclose this fact in compliant presentations and should also disclose the percentage of assets in the composite that are valued using estimated values to provide enough information for a prospective client to interpret the performance record.



## 2.3. Calculation Methodology

### 2.3.1. Return Calculation and Treatment of Fees

#### *Return Calculation*

Achieving comparability among firms' performance presentations requires uniformity in methods used to calculate returns. The GIPS standards mandate the use of certain calculation methodologies for both portfolios and composites. The Guidance Statement on Calculation Methodology and the related Q&As provide guidance for calculating returns in accordance with the GIPS standards. The "Leverage/Derivatives" section of the GIPS Q&A database focuses on the calculation of returns for portfolios that utilize leverage and/or derivatives.

#### *Investment Management Fees*

The Guidance Statement on Fees addresses the treatment of fees and expenses, which is equally applicable for alternative investment portfolios and composites. In addition to a fixed asset-based investment management fee, some alternative investment portfolios may utilize variable performance-based fees. The GIPS standards define investment management fees to include both asset-based and performance-based fees. If a firm presents net-of-fees returns, the net-of-fees return must be calculated by reducing the gross-of-fees return by all investment management fees, including performance-based fees. The GIPS standards recommend that firms accrue investment management fees. Composite returns may be presented either on a gross-of-fees or net-of-fees basis and must be clearly identified as gross-of-fees or net-of-fees.

If presenting gross-of-fees returns for a fund of funds composite strategy, firms must present the gross-of-fees returns net of all of the underlying funds' fees and expenses. This is typically achieved because the value of the underlying funds (e.g., NAV per share) reflects the deduction of all of the underlying funds' fees and expenses. If presenting net-of-fees returns for a fund of funds composite strategy, firms must present the composite net of both the overall fund-of-funds investment management fee and all of the underlying funds' fees and expenses.

In some fund of funds structures where both the fund of funds and the underlying funds are managed by the same firm, an investment management fee model may be structured in a way that it is split and charged both at the fund of funds and the underlying funds level (e.g., 20% of the total investment management fee at the fund of funds level and 80% of the total investment management fee at the underlying fund level). In this situation it would be appropriate to combine investment management fees paid by both the fund of funds and the underlying funds for purposes of calculating gross-of-fees returns because these two pieces represent the total management fee of the fund of funds.



Firms may calculate gross-of-fees returns that do not deduct the underlying funds' fees only when the following criteria are met:

1. Both underlying funds and the fund of funds are managed by the same firm and there is effectively a fee rebate or waiver at the fund of funds level for those fees charged at the underlying fund level.
2. A fund of funds resembles a master-feeder structure or a segregated portfolio invests in one or multiple underlying funds managed by the same firm and its investment management fee model is structured so that the investment management fee is either partially or fully charged at the underlying fund level.

When the above criteria are met and a firm is presenting gross-of-fees returns for a fund of funds composite strategy, the firm can present the gross-of-fees returns gross of the underlying funds' investment management fees but net of the underlying funds' trading and other expenses.

### *Master-Feeder Structures — Fees*

If a firm manages a fund-of-funds with a master-feeder structure and the firm manages both the master fund and the feeder fund, where investment management fees are not charged in the master fund but are charged at the feeder level, the return of the master fund would be considered a gross-of-fees return. If calculation of the net-of-fees return is desired and a firm uses the master fund return in the composite, the gross-of-fees return of the master fund will require an adjustment. The firm may identify the relevant investment management fees charged in the feeder funds and use these fees to reduce the gross-of-fees return of the master fund to arrive at the net-of-fees return. Alternatively, when calculating net-of-fees composite returns, a firm may calculate gross-of-fees composite returns and deduct a model fee, which must be the highest investment management fee incurred by portfolios (either at the master fund level or at the feeder level, wherever the investment management fees are charged) in the composite. In some situations, it may be impossible to definitively determine which investment management fee is the highest among all portfolios within a composite, such as when portfolios use a mix of fixed and performance-based management fees. In this example, it is acceptable to use the highest model fee applicable to the specific prospective client or the intended recipient of the compliant presentation as long as doing so results in net-of-fees returns that are no higher than those that would have been calculated if actual fees had been used.

If a firm manages a fund of funds with a master-feeder structure and the firm manages both the master fund and the feeder fund, where investment management fees are not charged in the feeder funds but at the master fund level, the returns of the feeder funds would be considered net-of-fees returns if the feeder funds hold shares of the master fund that are already net-of-fees.

Sometimes a fee charged at the feeder fund level may lead to a cash outflow at the master fund level, or vice versa. Firms may consider the corresponding cash flow as an external cash flow for the calculation of the return at either the master level or the feeder level. Firms must take care to ensure that any external cash flow between a master fund and a feeder fund is properly treated for the calculation of gross-of-fees and net-of-fees returns.

Firms are reminded that the GIPS standards state that when presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and trading expenses; if model or actual investment management fees are used; and if returns are net of any performance-based fees. In addition, if a firm uses model fees to calculate net-of-fees returns, the firm must disclose the methodology used to calculate the net-of-fees returns.

## 2.4. Composite Construction

The creation of meaningful composites is critical to the fair presentation, consistency, and comparability of performance over time and among firms.

### 2.4.1. *Unique Alternative Investment Strategies*

Many alternative investment vehicles and hedge funds follow a unique investment strategy and are not necessarily comparable between each other or with other managed portfolios. The Guidance Statement on Composite Definition states that firms are not permitted to include portfolios with different investment mandates, strategies, or objectives in the same composite. 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.

In this respect, the firm should assess (1) whether the managed alternative investment vehicles could be included in any of the firm's existing composites, (2) if they can be grouped into new composites, or (3) if separate single-portfolio (e.g., fund) composites should be created.

The latter may be the most straight-forward solution for alternative investment vehicles employing a unique investment strategy.

When composites that include several alternative investment funds or portfolios are to be created, these funds/portfolios must possess similar investment strategies. For example, among other criteria, the following parameters may be applied for composite construction when dealing with alternative investment strategies:

- a) Investment mandate, objective, or strategy of the fund/portfolio: The composites can be single-style oriented (e.g., long-short equity, event driven, global macro, managed futures, relative value) or represent a mix of styles or asset classes.
- b) Degree of diversification: This may specifically apply to the concentration of the strategy employed or, in the case of a fund of funds, may relate to the underlying funds. The number of underlying funds in the fund of funds may also affect the ability of the investment manager to diversify and may, therefore, affect composite construction.
- c) Leverage: Hedge funds and alternative investment strategies frequently use derivatives and leverage extensively, so the level of leverage of the fund itself or of the underlying funds (in the case of a fund of funds) can be a relevant criterion for defining composites.

- d) Risk objectives: Portfolios may be managed to target various risks, both quantitative and qualitative. Risk may be a critical determinant for creating composites and differentiating among strategies.

#### *2.4.2. Master-Feeder Structures — Composite Construction*

Firms managing alternative investment strategies and structures may manage funds of hedge funds that have a multi-level master-feeder structure, where funds may be invested in each other. In this case, the firm must determine which level of the master-feeder structure is relevant for composite inclusion.

A feeder fund may conduct virtually all of its investing through the master fund but may be the level at which investors effectively invest into the investment structure. Firms should consider the following aspects when dealing with this issue:

- The level of the investment structure that is effectively subject to investment management decisions, and
- The level of the investment structure in which prospective clients can effectively invest.

In most cases, the level at which prospective clients can effectively invest would be included in a composite and not the intermediary levels within the investment structure. However, in the case of a master-feeder structure, it may instead be appropriate to include the master fund in the composite, as opposed to including the individual feeder funds. Firms must decide how they will treat each composite, document policies and procedures, and apply them consistently.

Firms may disclose which types of portfolios/funds are included in the composite, (e.g., pooled vehicles, individual accounts, master funds, feeder funds).

In the case of master-feeder or similar structures, firms must also assess and eliminate the double-counting of assets. The GIPS standards do not permit double-counting when calculating composite assets and total firm assets. In the case of master-feeder structures with “cross investments”, elimination of double-counting of assets at the composite level and firm assets level is required.

#### *2.4.3 Segregated Investments (“side pockets”)*

A “side pocket” (also known as a segregated investment or parallel fund vehicle) is a type of account used mainly in pooled funds, such as hedge funds, funds of funds, and other alternative investment strategy funds to separate illiquid or distressed assets from other, more liquid investments or to segregate investments held for a special purpose from other investments.

Typically, once an investment enters a side pocket account, only the investors in the pooled fund at the time the side pocket was created are entitled to a share of the side pocket's returns. Future investors may not receive a share of the proceeds in the event the side pocket's assets are sold and returns are realized. Investors entitled to participate in the returns of the side pocket who leave the pooled fund may be required to keep their share in the side pocket and only receive proceeds after the side pocket is liquidated. Illiquid assets (e.g., shares of a delisted company, distressed assets, and underlying funds with a redemption suspension) may receive this type of treatment because illiquid assets in a standard hedge fund may cause a liquidity problem and investment strategy distortion for the whole pooled fund when investors liquidate their positions.

For pooled funds that create a side pocket for investment purposes at the discretion of the firm, that side pocket performance must be included in the performance of the entire pooled fund if the side pocket includes assets managed by the firm on a discretionary basis. In such a case, the performance that must be included in the composite is the performance generated by the pooled fund, not the performance experienced by an individual shareholder. The fact that future investors will not be participating in the performance of the side pocket is not a valid argument to exclude the side pocket from the pooled fund performance. In many situations, pooled funds may be closed or no longer available for future investors, but side pocket performance still must be included in the historical track record of the pooled fund and related composite.

If the side pocket is classified as discretionary, firms must present returns both including and excluding the side pockets, provided that the fund with a side pocket is the only portfolio in the composite (single-fund composite). This requirement applies when presenting gross-of-fees returns, net-of-fees returns, or both. The reason for this requirement is that although prospective investors are interested in seeing the performance history that includes the impact of the side-pocketed assets, they will be equally interested to understand the performance history without the impact of the side pocket because prospective investors will not be participating in the performance of the side pocket going forward.

If the side pocket is created to hold assets that are no longer discretionary, the value of non-discretionary assets and any change in value of these assets until the assets are moved into the side pocket must be reflected in the pooled fund's performance. Firms must not claim that illiquid securities are non-discretionary just because of their illiquidity in order to exclude the performance of the illiquid securities from the portfolio or the composite.

If previously discretionary investments in the side pocket are no longer discretionary, firms must apply their definition of discretion to determine if the investments or the entire side pocket is still eligible for inclusion in the appropriate pooled fund and related composite. A side pocket can only be classified as non-discretionary if all of the following criteria are met:

1. The side pocket is segregated in a separate sub-portfolio (e.g., at the custodian bank or in the portfolio management system of the firm).
2. The side-pocketed assets are no longer considered in the fund asset allocation and portfolio investment process.

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3. There are no investment decisions for the side-pocketed assets, except for monitoring and liquidating.
4. There are no or reduced investment management fees charged on the side-pocketed assets.

If it is determined that the firm does not continue to have discretion over the investments or the entire side pocket, the firm must not continue to include the investments or the entire side pocket in the performance of the pooled fund and related composite. If it is determined that the firm continues to have discretion over the investments, the firm must continue to include the investments and side pocket in the performance of the pooled fund and related composite.

A side pocket created at the express direction of a client may be considered non-discretionary and excluded from the performance of the composite, as if it were an unmanaged asset.

Firms must disclose in a compliant presentation if a portfolio or fund in the composite creates a side pocket. This applies to both discretionary and non-discretionary side pockets.

### 2.5. Disclosure and Presentation

To comply with the GIPS standards, firms must disclose and present certain information about their composites and firm in their compliant presentations. Due to the complexity of many alternative investment strategies and structures, firms should carefully consider if certain events (e.g., market-related events or events related to a composite or the firm) are significant. Firms must disclose all significant events that would help a prospective client interpret the compliant presentation.

#### *2.5.1. Disclosure of alternative Investments Strategies in Compliant Presentations*

Strategies that utilize derivative instruments, leverage, and/or short positions are often complex, tend to behave differently from traditional strategies, and generally have different risks associated with them. As a result, managers investing in such strategies must disclose the presence, use, and extent of leverage, derivatives, and/or short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks.

The GIPS standards also require that firms disclose the composite description. The composite description is defined as general information regarding the investment mandate, objective, or strategy of the composite. The composite description may be more abbreviated than the composite definition but must include all key features of the composite and must include enough information to allow a prospective client to understand the key characteristics of the composite's investment mandate, objective, or strategy. A composite's definition, which is not a required disclosure, must include detailed criteria that determine the assignment of portfolios to composites and must be made available upon request.

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In the case of firms employing complex investment strategies, the composite description should be more detailed to enable investors to understand the strategy, and it may be advisable to disclose the associated risks of the composite as well as the full composite definition. For example, firms may consider disclosing in the compliant presentation whether the investment manager has discretion to cross trade positions internally between products and/or enter into agreements to swap the performance of underlying positions among internal products or with third parties.

The following is a sample composite description for a hedge fund with a long–short equity strategy:

“The objective of XYZ Composite is to achieve upside performance comparable to the long-term returns of a diversified global equity portfolio, but for significantly lower levels of risk. The manager takes long and short positions in undervalued and overvalued equities, respectively. The strategy involves adopting variable net long or short exposure and can be focused on different regions, sectors and market capitalization segments. The maximum leverage limit is 30%. Derivative contracts (currency forwards) are used to systematically hedge the currency risk.”

Appendix C: Sample List of Composite Descriptions of the GIPS standards includes additional samples of composite descriptions for more complex investment strategies.

### *2.5.2. Illiquid Investments*

If illiquid securities are a significant part of the composite strategy or if there is a strategic intent to invest in illiquid investments, firms must disclose this in the composite description.

In addition, if a portfolio contains investments that suddenly become illiquid, they must be valued at fair value with the resulting losses reflected in performance. Firms must not claim that illiquid investments are non-discretionary just because of their illiquidity in order to exclude them from the portfolio or the composite. If an illiquid investment ceases to be managed in a discretionary manner (e.g., due to a change in the client agreement), its performance impact must be reflected in the composite performance until the date of such a change.

Additionally, firms must determine whether this situation rises to the level of a significant event. Firms must disclose all significant events that would help a prospective client interpret the compliant presentation.

### *2.5.3. Benchmarks*

The GIPS standards require benchmark returns to be presented in compliant presentations; however, the lack of proper benchmarks for alternative investment strategies is well-known. Firms apply various solutions when selecting a benchmark for alternative investment strategy composites. Some use traditional market indices, while others may present a peer group index, an absolute return target, and/or pension plan liability targets. Firms are required to disclose the benchmark description.

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Managers of hedge funds and other alternative investment strategies often use peer group benchmarks, such as hedge fund peer group universe indices. Common problems of hedge fund peer group benchmarks are:

- Self-reporting bias (only some hedge funds choose to report performance data);
- Frequency of reporting (not all hedge funds deliver performance on a timely basis);
- Investability (some hedge funds within a benchmark are closed to new investors);
- Survivorship bias (closed unsuccessful funds may not be included); and
- Categorization (not always fully transparent which style a hedge fund follows).

Firms must determine which benchmark(s) are most appropriate for their composites. When determining which benchmarks to present in compliant presentations, firms should be guided by the ethical spirit of the GIPS standards. Firms may utilize custom benchmarks for alternative investment strategy composites. If a custom benchmark or combination of multiple benchmarks is used, the firm must disclose the benchmark components, weights, and rebalancing process. In the case where the firm determines that no appropriate benchmark for the composite exists, the GIPS standards state that the firm must disclose why no benchmark is presented.

When using benchmarks that exhibit limitations such as those listed for peer group benchmarks, firms should describe these limitations in compliant presentations.

### *2.5.4. Risk Measures*

For periods ending on or after 1 January 2011, a firm must present, as of each annual period-end, the three-year annualized *ex-post* standard deviation (using monthly returns) of the composite and the benchmark. If a firm determines that the three-year annualized *ex-post* standard deviation is not relevant or appropriate for the composite, the firm must also present an additional three-year *ex-post* risk measure for the composite and the benchmark.

For composites with investments that do not lend themselves to monthly valuations and in which the underlying fund is open to client cash flows only on a less frequent (e.g., quarterly) basis, it may be appropriate that valuations are performed on a less frequent than monthly basis (see discussion under Item 2.2.2). In this situation, monthly composite returns will not be available and firms will not be able to calculate the three-year annualized standard deviation of the composite returns. Firms are recommended to present the three-year annualized standard deviation of the benchmark returns, provided that monthly returns of the benchmark are available. Firms must disclose that the three-year annualized *ex-post* standard deviation is not presented for the composite (and benchmark if applicable) because monthly returns for the composite (benchmark) are not available.

A manager of alternative investment strategies should also consider whether additional risk measures beyond those required by the GIPS standards should be presented. The choice of which risk measures to include in a compliant presentation for alternative investment strategies should take into account the investment strategy of the composite and investment instruments employed. Firms must also consider any provisions and interpretive guidance related to risk. Firms must



## Guidance Statement on Alternative Investment Strategies and Structures

remember the overarching principles of fair representation and full disclosure when presenting compliant presentations to prospective clients. If firms believe that the presentation of additional risk measures would help a prospective client understand the compliant presentation, firms should add those risk measures to the compliant presentation.

For example, in the case of alternative investment strategies, especially those generating a non-traditional or non-linear risk/return profile, it would be beneficial for prospective clients for firms to present the appropriate risk measures in addition to those already required by the GIPS standards. Disclosing proper risk measures is crucial for demonstrating the altered risk/return profile of a leveraged or non-linear payoff portfolio when compared with a traditional strategy. Useful risk measures and other information for leveraged strategies may include the effective delta-adjusted exposure, value-at-risk; expected shortfall, downside volatility, drawdown, the percentage of composite assets that are not traded on a stock exchange or equivalent, and the percentage of composite assets invested in short positions.

### **3. Effective Date**

Firms are required to apply this guidance beginning 1 October 2012. Firms are encouraged, but not required, to apply this guidance prior to the effective date. This Guidance Statement is not required to be applied retroactively, and no restatement of GIPS-compliant performance is required. Firms may voluntarily choose to apply this Guidance Statement retroactively and in this case must disclose if any restatement of the historical track record was necessary as a result of the retroactive application.

## 4. Questions & Answers

The following Q&As provide additional guidance to specific situations when applying the GIPS standards.

### 4.1. Fundamentals of Compliance

*4.1.1. Question: We market a number of structured products, such as index trackers, CPPI (Constant Proportion Portfolio Insurance), leveraged mini-futures, and reverse convertible products. Should these strategies be included in total firm assets?*

Answer: It is not possible to definitively state which structured products must be included in total firm assets. Each strategy within a firm must be evaluated to determine whether or not it is a managed strategy. If holding the asset does not involve any investment management activity and does not exhibit the features of a managed investment portfolio, it must not be included in total firm assets or any composite.

However, some structured products may be considered managed investment products (e.g., those products where the underlying is represented by a variable actively or passively managed collection of investments) and it may be necessary to include them in the definition of the firm and in an appropriate composite.

*4.1.2. Question: Some of our hedge funds are domiciled in offshore locations; however, a local legal entity formally acts as a fund manager to fulfill the local regulations. Our firm formally acts as investment advisor to this local entity, which is theoretically free to follow our advice or not. However, in actuality all of our investment advice is implemented so our firm effectively makes all investment decisions with respect to those funds. Are we allowed to include these funds in the definition of the firm and the relevant portfolio universe?*

Answer: Yes. The definition of the firm delineates the universe of “all” portfolios that must be included in total firm assets. Fundamental to the GIPS standards is the premise that all of the firm’s actual, fee-paying, discretionary portfolios must be included in at least one composite.

In the case of hedge funds registered off-shore, the investment management function may be formally assigned to a third-party entity that is not actually performing the portfolio management function, and the firm may be named as having an advisory-only role. In assessing such situations, a “substance over form” principle should be applied and a great degree of judgment is required to assess whether a fund is effectively managed or only advised by the firm with another entity making the final investment decisions. In the above example, if the firm can demonstrate that it effectively exercises discretionary investment management and can provide documented evidence that all investment advice has been implemented accordingly, it must include the funds concerned in the definition of the firm.

In addition, it would be inappropriate and against the ethical spirit of the GIPS standards to make use of formal advisor–manager structures to avoid inclusion of certain funds or portfolios in the firm.

*4.1.3. Question: Our fund of hedge funds (Fund A) is invested in underlying funds (Fund B and Fund C), which are also part of the firm for purposes of compliance with the GIPS standards. In addition, the fund of hedge funds (Fund A) and Fund C are invested in the same strategy and should belong to the same composite. How should we handle such cases for the purpose of calculating total firm assets and composite assets?*

Answer: The GIPS standards do not permit double-counting for the purpose of presenting total firm and/or composite assets. If double-counting is not eliminated, this will “inflate” the composite assets and total firm assets and result in a misstated compliant presentation.

In the case of master-feeder structures with cross-fund investments, elimination of the double-counting of assets at the composite level and firm assets level is required.

For example:

- The GIPS firm includes three funds: A (€400m), B (€300m), and C (€200m).
- Fund A is invested in Fund B with €200m and in Fund C with €100m.
- Fund A and Fund C are included in the same composite: X.

Total firm assets will be calculated as €400m + €300m + €200m – €200m – €100m = €600m.

The composite assets for composite X will be calculated as €400m + €200m – €100m = €500m.

## **4.2. Input Data**

*4.2.1. Question: The GIPS standards require that the trade date principle must be used when accounting for investment transactions. The GIPS standards define trade date accounting as recognizing the asset or liability on the date of the purchase or sale and not on the settlement date; recognizing the asset or liability within three days of the date the transaction is entered into satisfies the trade date accounting requirement for purposes of the GIPS standards. When subscribing to or redeeming from hedge funds, transactions often cannot be recognized on the trade date because the fund administrator’s confirmation with the final settlement quantity and price may be provided only several days or even weeks after the subscription/redemption trading order has been submitted. In such a situation, it may not be possible for the hedge fund of funds manager to account for the subscription/redemption on the trade date (or within three days of the trade date) because the final quantity and settlement price of the transacted fund is not known until the administrator’s confirmation has been received. How can such a situation be handled in terms of GIPS compliance?*

Answer: The T+3 principle for trade date accounting defined in the GIPS standards is valid for all investment transactions. For alternative investments, firms may need to differentiate between the date of placing a subscription/redemption order and the date of the effective asset ownership transfer. The date of the execution or transfer of ownership (in this case when the definitive quantity and settlement price of the asset being purchased/sold is determined and becomes known) should be considered the trade date.

### 4.3. Performance Measurement

4.3.1. Question: Can unleveraged performance for funds and portfolios that are leveraged with derivatives be included in composites? Please demonstrate how a firm may calculate the performance of derivatives on an unleveraged basis.

Answer: An “unleveraged” return is hypothetical, and it is not appropriate to include such a return in a composite, regardless of whether the leverage arising from derivatives is discretionary (decided by the firm) or non-discretionary (required by the client). Unleveraged performance is only permitted to be presented as supplemental information in accordance with the Guidance Statement on Supplemental Information. A firm may calculate the performance of derivatives on an “unleveraged” basis by using their delta-adjusted exposure. For example, the exposure of an option can be calculated by multiplying the market value of the underlying instrument by the option delta. Using the exposures instead of the effective portfolio capital in the denominator would “deleverage” the performance. The following example illustrates this for a portfolio containing three call options.

Instrument	Beginning-of-Day Value	End-of-Day Value	Beginning-of-Day Underlying Value	Delta	Exposure	Performance	
						Leveraged	Unleveraged
Call Option A	100	110	1,000	0.9	$1,000 \times 0.9 = 900$	$(110 - 100) / 100 = 10\%$	$(110 - 100) / 900 = 1.11\%$
Call Option B	200	210	5,000	0.8	$5,000 \times 0.8 = 4,000$	$(210 - 200) / 200 = 5\%$	$(210 - 200) / 4,000 = 0.25\%$
Call Option C	300	360	10,000	0.7	$10,000 \times 0.7 = 7,000$	$(360 - 300) / 300 = 20\%$	$(360 - 300) / 7,000 = 0.86\%$
<b>Total</b>	<b>600</b>	<b>680</b>			<b>11,900</b>	<b>13.33%</b>	<b>0.67%</b>

If the use of derivatives is non-discretionary (required by the client) and, as a result, the leverage arising in the portfolio can be considered non-discretionary, the non-discretionary derivatives positions can be removed from the portfolio in accordance with the allowed treatment to exclude a non-discretionary investment from the composite as stated in the Guidance Statement on Composite Definition: “In the case of client-restricted securities, the firm may choose to classify the restricted portion of the portfolio as non-discretionary.”

The following table summarizes the possible options for the treatment of leverage:

	<b>Option 1 Leveraged return</b>	<b>Option 2 Unleveraged return</b>	<b>Option 3 Removing derivatives</b>
Meaning:	Derivatives are included in the portfolio and their return contribution is based on their market value (13.33% in the above example).	Derivatives are included in the portfolio and their return contribution is based on their effective underlying exposure (0.67% in the above example).	Derivatives are entirely removed from the portfolio as if they had never existed, i.e., their return contribution is nil.
Treatment:	Must be presented regardless of whether the use of derivatives is discretionary or non-discretionary.	Must not be presented as GIPS-compliant information. Only allowed to be presented as supplemental information.	Only allowed for non-discretionary derivatives.

*4.3.2. Question: A firm manages a hedge fund with several share classes, which are similarly invested but have a different base currency. The non-HKD share classes are systematically hedged in HKD in order to achieve a return similar to that of an investor in the HKD-denominated share class. Should the non-HKD share classes be included in the HKD-denominated composite?*

Answer: Portfolios with different base currencies may be included in the same composite but their returns must be expressed in the same currency as that of the composite. Although the hedged returns of portfolios denominated in different currencies are intended to be similar if they are managed to the same strategy, there will be a difference in returns (even with perfect hedging) equivalent to the cost (or benefit) of hedging. This cost (or benefit) of hedging caused by the interest rate differential between currencies is potentially significant over time. In this situation, including non-HKD share classes in the HKD-denominated composite may not be appropriate.

If a firm wishes to include each share class in the composite, the firm may convert the returns and assets for all of the share classes to HKD for inclusion in the composite; however, it is important to recognize that the act of hedging from different base currencies to HKD may create different investment strategies warranting more than one composite.

The firm may also use the HKD share class as the proxy for the performance for the total fund; however, the composite assets must include all of the assets from all of the share classes.

*4.3.3. Question: For the weighting of individual portfolio returns within a composite, our policy is to take the portfolio values as of the end of the previous month (assuming they are equal to the value at the beginning of the current month). This suffices for all portfolios except for our hedge fund because external cash flows are always booked in the hedge fund on the first day of the month due to the subscription/redemption timing. As a result, there may be a significant difference between the portfolio's beginning value and the value after the first business day of the month. Can we incorporate the external cash flows in the portfolio weighting method?*

Answer: The GIPS standards require that composite returns must be calculated by asset weighting the individual portfolio returns using beginning-of-period values or a method that reflects both beginning-of-period values and external cash flows. The Guidance Statement on Calculation Methodology elaborates on three acceptable methods, which are:

- Beginning Assets Weighting Method;
- Beginning Assets plus Weighted Cash Flow Method, and
- Aggregate Return Method.

In this situation, the Beginning Assets plus Weighted Cash Flow Method may be used as one of the acceptable methods allowed by the GIPS standards. Using this method would take into account the external cash flows occurring on the first day of the month.

Firms must create a policy for weighting portfolios within a composite using any of the three methods above and apply the policy to the composite consistently.

4.3.4. *Question: Our funds of funds have master-feeder structures, and some composites include funds invested in other funds, which are also part of the firm. Additionally, an investor fund may invest in underlying funds, which belong to the same composite as the investor fund. How should we handle such cases for the purpose of calculating composite performance?*

Answer: This problem is not limited to alternative investment strategies and may occur in any composite that includes portfolios with cross-investments. The GIPS standards do not permit double-counting of assets when calculating composite assets and total firm assets. In the case of master-feeder structures with “cross-investments,” it is required for double-counting of assets for the calculation of composite assets and total firm assets to be eliminated. When calculating portfolio returns, firms may choose to adjust the actual holdings to eliminate any cross-investments for the calculation of portfolio and composite performance, although this is not required. Firms should consider if it is appropriate to include these portfolios in the same composite where double-counting of assets occurs. If a firm would like to present portfolio or composite performance eliminating “cross-investments,” it must disclose this fact in the compliant presentation.

Consider the following example for how to eliminate cross-investments for the calculation of performance:

- The composite includes two funds: A and B.
- Fund A invests 50% of its value in Fund B and 50% in other third-party funds.
- Assume that the total return of Fund B and the third-party funds are 10% and 0%, respectively.

a) Scenario without elimination of double-counting:

Fund	Value at the Beginning of the Period, USD millions	Period Return
Fund A (invests 50% in fund B)	100	5.00%
Fund B	200	10.00%
<b>Composite</b>	<b>100+200=300</b>	<b>5%×(100/300)+10%×(200/300)=8.33%</b>

b) Scenario with elimination of double-counting:

Fund	Value at the Beginning of Period, USD millions	Period return
Fund A (invests 50% in fund B)	100	5.00%
- Contribution of fund B to fund A	50	10.00%
- Contribution of other funds to fund A	50	0.00%
Fund B	200	10.00%
<b>Composite</b>	<b>100+200-50=250</b>	<b>0%×(50/250)+10%×(200/250)=8.00%</b>

#### **4.4. Composite Construction**

*4.4.1. Question: A firm has an offshore hedge fund that has four different share classes (A through D), each with its own investment management fee, which includes a performance-based fee. Because of the different fee structures, each share class may have different net returns. Over 80% of the fund is invested in Class A which is the oldest share class. The firm mostly markets to prospective clients that will invest in Class A. The fund is the only portfolio in the composite. Can the compliant presentation include the net-of-fees return of Class A since it is most applicable to the prospective client, or must the firm present the net-of-fees return of the total pooled fund? Which net-of-fees return should a firm present if there are multiple series within Class A that were created to consider the different timing of new investors?*

Answer: Firms have the following options when calculating net-of-fees returns that will be included in compliant presentations that are presented to prospective clients:

- Calculate gross-of-fees returns and deduct the highest investment management fee rate of any individual share class in the fund to arrive at the net-of-fees return.
- Calculate net-of-fees returns using all actual net-of-fees returns from all share classes and series.

In some situations, it may be impossible to definitively determine which investment management fee is the highest among all portfolios within a composite, such as when portfolios use a mix of fixed and performance-based management fees. In this example, it is acceptable to use the highest model fee applicable to the specific prospective client or the intended recipient of the compliant presentation as long as doing so results in net-of-fees returns that are lower than those that would have been calculated if actual (effectively charged) fees had been used. Such treatment would mean producing different versions of the specific composite's compliant presentation for different prospective clients.

When calculating net-of-fees returns using model fees, the model fee must reflect the current fee schedule. When initially calculating net-of-fees returns for historical periods, the firm must determine whether it is appropriate to use the current fee schedule or the fee schedule that was in effect for the respective historical period. In all cases, net-of-fees returns calculated using model fees must result in net-of-fees returns that are no higher than those that would have been calculated if investment management actual fees had been used.

Different fund share classes are usually issued to differentiate between certain investor groups for tax reasons and/or to allow for different fee structures. Firms may calculate gross-of-fees returns and apply the most applicable investment management fee to the prospective client, which in this instance is the investment management fee from Share Class A (i.e., the net-of-fees return of Share Class A will effectively be presented).

Firms may also present gross-of-fees returns to a prospective client. Additionally, whether presenting gross-of-fees or net-of-fees returns, firms must disclose the fee schedule appropriate to the compliant presentation.



Firms may show returns from the different share classes or series as additional information. If there are multiple series within Share Class A, and the firm is presenting net-of-fees composite returns based on Share Class A, the firm should either present a weighted net-of-fees return of all series within Share Class A or should reduce the gross-of-fees return by the investment management fee from the oldest or initial series to reflect the performance a prospective client would have received had it been invested in that strategy since its inception.

While a firm must disclose if model or actual fees are used to calculate net-of-fees returns, where net-of-fees returns are not straight forward and/or have multiple assumptions, additional disclosure about net-of-fees return calculations may be needed to ensure that the principle of full disclosure is met. In addition, if a firm uses model fees to calculate net-of-fees returns, the firm must disclose the methodology used to calculate the net-of-fees returns.

*4.4.2. Question: A firm manages a fund of hedge funds. Subscriptions and redemptions in the underlying investee hedge funds can only be made at the beginning of month. As a result, cash paid in by investors in the fund of hedge funds for subscriptions prior to the beginning of the next month is parked in a non-discretionary account because this cash cannot be invested effectively during the month of the cash flow. How should such external cash flows be treated in terms of discretion, performance calculation, and composite allocation?*

Answer: Some hedge funds only accept subscriptions and redemptions on a monthly or quarterly basis. Therefore, external cash flows occurring during the month would not be invested according to the investment strategy. Including these contributions in the fund returns prior to their investment would not be appropriate.

*4.4.3. Question: If a hedge fund has a situation where there were 95% withdrawals in May and the manager took two months to liquidate 99% of the portfolio to pay the withdrawals, is it proper to exclude the hedge fund from the composite after April?*

Answer: The firm must first determine if and when the hedge fund is no longer considered discretionary. When the firm has determined this, the firm must then follow the composite's closed portfolio exclusion policy. In this case, if the firm determines that discretion ended in May, the fund must be excluded from the composite after April. If the firm determines that the fund continued to be discretionary despite the large withdrawals, the firm must continue to include the fund in the composite provided that the portfolio is not excluded from the composite due to the composite-specific significant cash flow policy. Terminated portfolios must be included in the historical performance of the composite up to the last full measurement period that each portfolio was under management.

*4.4.4. Question: Our firm is hired to manage Liability Driven Investment ("LDI") portfolios by pension fund clients. The typical objective of the LDI strategy is to manage the portfolio such that the duration of the portfolio's assets matches the duration of the total pension liability. We accomplish this objective by creating a portfolio that includes two components: a swaps overlay alongside an actively managed bond portfolio. We enter into swaps to adjust the duration of the bond portfolio to match the client's liability. We view the swaps element to be effectively non-discretionary in that we have no control over the liability-matching requirement. We thus include*

*only the actively managed portion (the bond portfolio) in a composite and do not include the entire bond with swaps portfolio in a composite. Is this the correct approach?*

Answer: The issue here is to determine whether the firm is (1) managing the entire LDI strategy, including both the fixed income and the swaps element of the portfolio, or (2) simply a fixed income manager that offers a bond strategy as its discretionary product and, as far as LDI is concerned, merely implementing the overlay swaps according to the client instructions (i.e., the overlay swaps component is considered non-discretionary).

In the first instance, the firm has been hired for an LDI strategy that includes both the bond portfolio and the swaps. The entire portfolio must be included in an appropriate composite. If the bond-only portfolio meets the requirements to qualify as a carve-out, the firm may include the bond-only portfolio in a composite, but this is optional.

In the second case, the firm is allowed to consider either the whole portfolio or the overlay swaps portion of the portfolio as non-discretionary in accordance with the treatment in the GIPS Guidance Statement on Composite Definition: “In the case of client-restricted securities, the firm may choose to classify the restricted portion of the portfolio as non-discretionary.”

#### **4.5. Presentation and Disclosure**

*4.5.1. Question: We manage hedge funds with complex fee structures that we normally do not disclose to the general public. Instead, we provide individual investors with tailored fee quotes. Do we have to provide the fee schedule in the compliant presentations?*

Answer: Yes. The GIPS standards require that firms must disclose the fee schedule appropriate to the compliant presentation. The GIPS standards define fee schedule as the firm’s current schedule of investment management fees or bundled fees relevant to the particular compliant presentation. This schedule is typically listed by asset level ranges and must be appropriate to the prospective client receiving the compliant presentation. A firm may tailor the investment management fee disclosure to the individual prospective client.

If the firm does not provide a tailored compliant presentation to each prospective client, the firm must disclose a standard fee schedule and may state that fees for individual clients are subject to negotiation and may deviate from the standard fees.