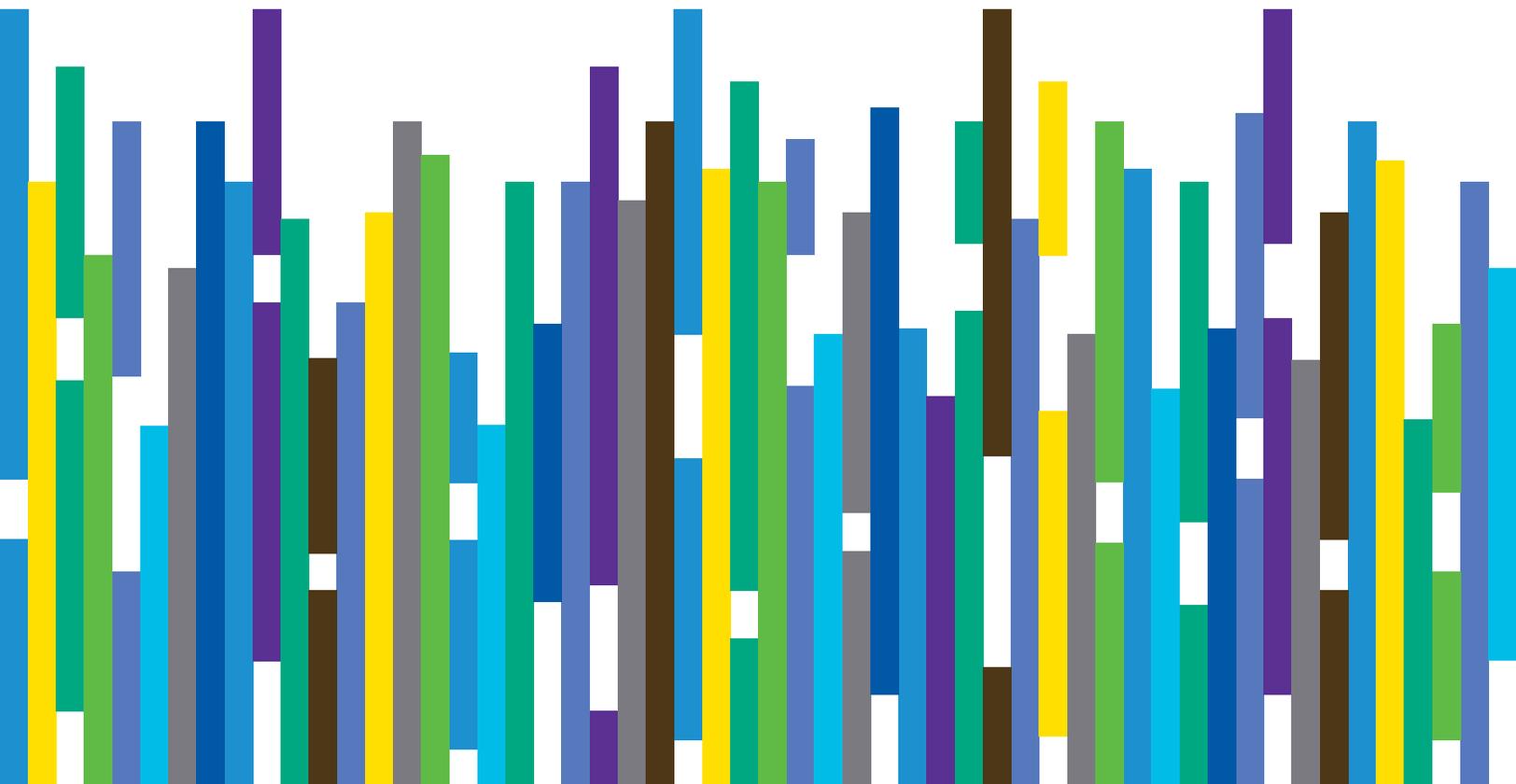




CFA Institute

GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS®) HANDBOOK

3RD EDITION
2012





CFA Institute

GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS[®]) HANDBOOK

**THIRD EDITION
2012**

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FOREWORD

The 2010 edition of the GIPS® standards introduced a number of important changes and additions. The introduction of a fair value framework for valuing all portfolios, changes to the compliance statement, and new requirements related to risk are some of the significant changes to the GIPS standards. Significant improvements have also been made with regard to the internal consistency of terminology. Similarly, the *GIPS Handbook* has been updated to reflect these changes in the standards and provide guidance and clarifications on each provision. I trust that this handbook will be a valuable resource in applying and understanding the GIPS standards.

Revising this handbook required a substantial amount of time and technical expertise. Many thanks go to the GIPS team and other CFA Institute colleagues who made this handbook possible. In addition, numerous volunteer committees and working groups, specifically the Interpretations Subcommittee and GIPS Executive Committee, made enormous contributions by reviewing the content. In particular, my sincere thanks and deep appreciation go to Beth Kaiser, CFA, CIPM, Yoh Kuwabara, Alecia Licata, and Karyn Vincent, CFA, CIPM, for their extraordinary efforts in updating and reviewing the handbook.

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1 INTRODUCTION

Objectives of the GIPS Standards

The Global Investment Performance Standards (GIPS) were created and funded by CFA Institute (formerly the Association for Investment Management and Research, or AIMR®) to provide an ethical framework for the calculation and presentation of the investment performance history of an investment management firm. The GIPS standards are a voluntary set of standards based on the fundamental principles of full disclosure and fair representation of performance results.

Having one global standard for performance measurement and evaluation benefits two major groups: investment management firms and their clients and prospective clients. Investment management firms that comply with the GIPS standards allow clients, prospective clients, and consultants the best opportunity to fairly evaluate their past performance. Compliance enables a firm to fairly compete against other firms throughout the world. The GIPS standards also provide a realistic, standardized framework and outline internal controls that are necessary to ensure performance figures are directly comparable.

Prospective clients have a greater level of confidence in the integrity of performance presentations and are able to more easily compare the track records of compliant firms. Compliance with the GIPS standards demonstrates a firm-wide commitment to ethical best practices and the employment of strong internal control processes. Additionally, current clients attempting to evaluate their manager's performance also benefit from the GIPS standards. However, compliance with the GIPS standards does not obviate the need for due diligence on the part of prospective or current clients or consultants in evaluating performance data and other important qualitative research on investment managers. Through voluntary compliance, firms can build an environment of credibility and trust in the investment industry.

History of the GIPS Standards

In the past, the investment community had great difficulty obtaining meaningful comparisons of accurate investment performance data. Making an apples-to-apples comparison of investment performance was problematic, and the existence of country-specific guidelines for performance presentation further complicated matters.

This need for a practitioner-driven set of ethical principles and a standardized, industry-wide approach to calculating and reporting investment results led AIMR (now known as CFA Institute) to sponsor, develop, and publish a minimum global standard by which firms could calculate and present their investment results.

The foundation for the GIPS standards was first laid in 1987, with the creation of the AIMR Performance Presentation Standards (AIMR-PPS®), voluntary performance guidelines for the North American investment management industry.

1 Introduction

The GIPS committee began work in 1995 toward the goal of developing one globally accepted set of standards. AIMR published the GIPS standards for public comment in February 1998 after circulating several preliminary drafts among industry participants to obtain acceptance of the concepts of the Standards. After an extensive period of public comment, AIMR's Board of Governors formally endorsed the GIPS standards in February 1999.

Since their introduction in 1999, the GIPS standards have gathered momentum, with investment management firms in 34 countries adopting these voluntary, ethical standards for calculating and presenting historical investment performance. On 1 January 2006, the first major revision to the GIPS standards went into effect, which facilitated the move to one truly global standard. All of the former country versions of the GIPS standards were eliminated with the introduction of this global standard. On 1 January 2011, the second and most extensive revision of the GIPS standards went into effect. The current edition of the GIPS standards is the outcome of a thorough, comprehensive review and includes amendments to clarify language and improve consistency throughout the standards.

Although CFA Institute owns and administers the GIPS standards, their success is the result of an alliance of experts from within the global investment industry. The GIPS standards represent the culmination of the efforts of a diverse group of investment professionals representing a number of global investment organizations.

The GIPS Executive Committee

With the release of the GIPS standards in 1999, the GIPS committee was replaced by the Investment Performance Council (IPC), which served as the committee responsible for maintaining the standards. It consisted of approximately 36 members from a variety of fields within the global investment industry and represented 15 countries. From 1999 to 2006, the IPC focused on its principle goal: to have all countries adopt the GIPS standards as *the* standard for investment firms seeking to present historical investment performance.

In February 2005, the IPC took the final step toward global uniformity when it revised the GIPS standards and created a single global standard for investment performance reporting, which increased minimum standards worldwide. It was the most comprehensive and significant upgrade to the Standards since their inception in 1999.

In order to facilitate involvement from all industry stakeholders and provide a necessary conduit for the collaboration of ideas and mutual engagement in the process, in 2006 CFA Institute transformed the IPC into the more nimble GIPS Executive Committee. Consisting of nine members, the Executive Committee serves as the effective decision-making authority for the GIPS standards.

Global Implementation

One objective of the GIPS standards is to obtain worldwide acceptance of a single standard for the calculation and presentation of investment performance in a fair and comparable format that provides full disclosure. The Executive Committee strongly encourages countries without an investment performance standard in place to accept the GIPS standards as the local standard.

The presence of a local sponsoring organization for investment performance standards (“country sponsor”) is essential for effective implementation of the GIPS standards and ongoing operation within a country. Such country sponsors also provide an important link between the Executive Committee, the governing body for the GIPS standards, and the local markets in which investment managers operate. Country sponsors ensure broad local representation and inclusivity so all interested parties are permitted the opportunity to participate at the local level. The Executive Committee has formalized a process by which the country sponsors and their adoption of the GIPS standards will be reviewed and assessed for endorsement.

The country sponsor, by actively supporting the GIPS standards and the work of the Executive Committee, ensures that the country’s interests are taken into account as the GIPS standards are developed. Compliance with the GIPS standards, as with other existing local standards, is voluntary. Local market support and competitive pressures will ultimately determine how successfully the GIPS standards will be embraced in different countries and regions around the world.

Interpretive Guidance

Firms that claim compliance with the GIPS standards must comply with all the requirements of the GIPS standards, including any updates, reports, or clarifications published by the Executive Committee, as well as the most recent edition of the *GIPS Handbook*. All clarification and updates are made available to the public via the GIPS standards website (www.gipsstandards.org) and must be considered when determining a firm’s claim of compliance.

2 THE GIPS STANDARDS

PREFACE

CFA Institute is a global not-for-profit association of investment professionals with the mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute has a long-standing history of and commitment to establishing a broadly accepted ethical standard for calculating and presenting investment performance based on the principles of fair representation and full disclosure. The goals in developing and evolving the Global Investment Performance Standards (GIPS) are to establish them as the recognized standard for calculating and presenting investment performance around the world and for the GIPS standards to become a firm's "passport" to market investment management services globally. As of January 2010, CFA Institute has partnered with organizations in 32 countries that contribute to the development and promotion of the GIPS standards.

History

In 1995, CFA Institute, formerly known as the Association for Investment Management and Research (AIMR), sponsored and funded the Global Investment Performance Standards Committee to develop global standards for calculating and presenting investment performance, based on the existing AIMR Performance Presentation Standards (AIMR-PPS®).

In 1998, the proposed GIPS standards were posted on the CFA Institute website and circulated for comment to more than 4,000 individuals who had expressed interest. The result was the first Global Investment Performance Standards, published in April 1999.

The initial edition of the GIPS standards was designed to create a minimum global investment performance standard that would:

- Permit and facilitate acceptance and adoption in developing markets;
- Give the global investment management industry one commonly accepted approach for calculating and presenting performance; and
- Address liquid asset classes (equity, fixed income, and cash).

In 1999, the Global Investment Performance Standards Committee was replaced by the Investment Performance Council (IPC) to further develop and promote the GIPS standards. The development of the GIPS standards was a global industry initiative with participation from individuals and organizations from more than 15 countries.

The IPC was charged with developing provisions for other asset classes (e.g., real estate, private equity) and addressing other performance-related issues (e.g., fees, advertising) to broaden the scope and applicability of the GIPS standards. This was accomplished when the second edition of the GIPS standards was published in February 2005.

With the release of the 2005 edition of the GIPS standards and growing adoption and expansion of the GIPS standards, the IPC decided to move to a single global investment performance standard and eliminate the need for local variations of the GIPS standards. All country-specific performance standards converged with the GIPS standards, resulting in 25 countries adopting a single, global standard for the calculation and presentation of investment performance.

In 2005, with the convergence of country-specific versions to the GIPS standards and the need to reorganize the governance structure to facilitate involvement from GIPS country sponsors, CFA Institute dissolved the IPC and created the GIPS Executive Committee and the GIPS Council. The GIPS Executive Committee serves as the decision-making authority for the GIPS standards, and the GIPS Council facilitates the involvement of all country sponsors in the ongoing development and promotion of the GIPS standards.

To maintain global relevance, and in recognition of the dynamic nature of the investment industry, the GIPS standards must be continually updated through interpretations, guidance, and new provisions. In 2008, the GIPS Executive Committee began its review of the GIPS standards in an effort to further refine the provisions as well as eliminate provisions that are no longer necessary and add new requirements and recommendations that promote best practice. The GIPS Executive Committee worked in close collaboration with its technical subcommittees, specially formed working groups, and GIPS country sponsors. These groups reviewed the existing provisions and guidance and conducted surveys and other research as part of the efforts to produce the 2010 edition of the GIPS standards.

INTRODUCTION

Preamble—Why Is a Global Investment Performance Standard Needed?

Standardized Investment Performance Financial markets and the investment management industry have become increasingly global in nature. The growth in the types and number of financial entities, the globalization of the investment process, and the increased competition among investment management firms demonstrate the need to standardize the calculation and presentation of investment performance.

Global Passport Asset managers and both existing and prospective clients benefit from an established global standard for calculating and presenting investment performance. Investment practices, regulation, performance measurement, and reporting of performance vary considerably from country to country. By adhering to a global standard, firms in countries with minimal or no investment performance standards will be able to compete for business on an equal footing with firms from countries with more developed standards. Firms from countries with established practices will have more confidence in being fairly compared with local firms when competing for business in countries that have not previously adopted performance standards. Performance standards that are accepted globally enable investment firms to measure and present their investment performance so that investors can readily compare investment performance among firms.

Investor Confidence Investment managers that adhere to investment performance standards help assure investors that the firm's investment performance is complete and fairly presented. Both prospective and existing clients of investment firms benefit from a global investment performance standard by having a greater degree of confidence in the performance information presented to them.

Objectives

The establishment of a voluntary global investment performance standard leads to an accepted set of best practices for calculating and presenting investment performance that is readily comparable among investment firms, regardless of geographic location. These standards also facilitate a dialogue between investment firms and their existing and prospective clients regarding investment performance.

The goals of the GIPS Executive Committee are:

- To establish investment industry best practices for calculating and presenting investment performance that promote investor interests and instill investor confidence;
- To obtain worldwide acceptance of a single standard for the calculation and presentation of investment performance based on the principles of fair representation and full disclosure;
- To promote the use of accurate and consistent investment performance data;

- To encourage fair, global competition among investment firms without creating barriers to entry; and
- To foster the notion of industry “self-regulation” on a global basis.

Overview

Key features of the GIPS standards include the following:

- The GIPS standards are ethical standards for investment performance presentation to ensure fair representation and full disclosure of investment performance. In order to claim compliance, firms must adhere to the requirements included in the GIPS standards.
- Meeting the objectives of fair representation and full disclosure is likely to require more than simply adhering to the minimum requirements of the GIPS standards. Firms should also adhere to the recommendations to achieve best practice in the calculation and presentation of performance.
- The GIPS standards require firms to include all actual, discretionary, fee-paying portfolios in at least one composite defined by investment mandate, objective, or strategy in order to prevent firms from cherry-picking their best performance.
- The GIPS standards rely on the integrity of input data. The accuracy of input data is critical to the accuracy of the performance presentation. The underlying valuations of portfolio holdings drive the portfolio’s performance. It is essential for these and other inputs to be accurate. The GIPS standards require firms to adhere to certain calculation methodologies and to make specific disclosures along with the firm’s performance.
- Firms must comply with all requirements of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS website (www.gipsstandards.org) as well as in the *GIPS Handbook*.

The GIPS standards do not address every aspect of performance measurement or cover unique characteristics of each asset class. The GIPS standards will continue to evolve over time to address additional areas of investment performance. Understanding and interpreting investment performance requires consideration of both risk and return. Historically, the GIPS standards focused primarily on returns. In the spirit of fair representation and full disclosure, and in order to provide investors with a more comprehensive view of a firm’s performance, the 2010 edition of the GIPS standards includes new provisions related to risk.

Historical Performance Record

- A firm is required to initially present, at a minimum, five years of annual investment performance that is compliant with the GIPS standards. If the firm or the composite has been in existence less than five years, the firm must present performance since the firm’s inception or the composite inception date.

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- After a firm presents a minimum of five years of GIPS-compliant performance (or for the period since the firm's inception or the composite inception date if the firm or the composite has been in existence less than five years), the firm must present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.
- Firms may link non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods after 1 January 2000 and the firm discloses the periods of non-compliance. Firms must not link non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance. Firms that manage private equity, real estate, and/or wrap fee/separately managed account (SMA) portfolios must also comply with Sections 6, 7, and 8, respectively, of the Provisions of the GIPS standards that became effective as of 1 January 2006.

Compliance

Firms must take all steps necessary to ensure that they have satisfied all the requirements of the GIPS standards before claiming compliance. Firms are strongly encouraged to perform periodic internal compliance checks. Implementing adequate internal controls during all stages of the investment performance process—from data input to preparing performance presentations—will instill confidence in the validity of performance presented as well as in the claim of compliance.

Firms may choose to have an independent third-party verification that tests the construction of the firm's composites as well as the firm's policies and procedures as they relate to compliance with the GIPS standards. The value of verification is widely recognized, and being verified is considered to be best practice. The GIPS Executive Committee strongly recommends that firms be verified. In addition to verification, firms may also choose to have specifically focused composite testing (performance examination) performed by an independent third-party verifier to provide additional assurance regarding a particular composite.

Effective Date

The effective date for the 2010 edition of the GIPS standards is 1 January 2011. Compliant presentations that include performance for periods that begin on or after 1 January 2011 must be prepared in accordance with the 2010 edition of the GIPS standards. Prior editions of the GIPS standards may be found on the GIPS website (www.gipsstandards.org).

Implementing a Global Standard

The presence of a local sponsoring organization for investment performance standards is essential for effective implementation and ongoing support of the GIPS standards within a country. Such country sponsors also provide an important link between the GIPS Executive Committee, the governing body for the GIPS standards, and the local markets in which investment managers operate.

The country sponsor, by actively supporting the GIPS standards and the work of the GIPS Executive Committee, ensures that the country's interests are taken into account as the GIPS standards are developed. Compliance with the GIPS standards is voluntary, and support from the local country sponsor helps to drive the adoption of the GIPS standards.

The GIPS Executive Committee strongly encourages countries without an investment performance standard to promote the GIPS standards as the local standard and translate them into the local language when necessary. Although the GIPS standards may be translated into many languages, if a discrepancy arises, the English version of the GIPS standards is the official governing version.

The GIPS Executive Committee will continue to promote the principles of fair representation and full disclosure and develop the GIPS standards so that they maintain their relevance within the changing investment management industry.

The self-regulatory nature of the GIPS standards necessitates a strong commitment to ethical integrity. Self-regulation also assists regulators in exercising their responsibility for ensuring the fair disclosure of information within financial markets. The GIPS Executive Committee encourages regulators to:

- Recognize the benefit of voluntary compliance with standards that represent global best practices;
- Give consideration to taking enforcement actions against firms that falsely claim compliance with the GIPS standards; and
- Recognize and encourage independent third-party verification.

Where existing laws, regulations, or industry standards already impose requirements related to the calculation and presentation of investment performance, firms are strongly encouraged to comply with the GIPS standards in addition to applicable regulatory requirements. Compliance with applicable law and/or regulation does not necessarily lead to compliance with the GIPS standards. In cases in which laws and/or regulations conflict with the GIPS standards, firms are required to comply with the laws and regulations and make full disclosure of the conflict in the compliant presentation.

Country Sponsors

The presence of a local sponsoring organization for investment performance standards, known as a “country sponsor,” is essential for effective implementation of the GIPS standards and ongoing support within a country. Country sponsors collectively form the GIPS Council, which provides a formal role in the ongoing development and oversight of the GIPS standards. Country sponsors:

- Promote the GIPS standards locally;
- Provide local market support and input for the GIPS standards;
- Present country-specific issues to the GIPS Executive Committee; and
- Participate in the governance of the GIPS standards via membership in the GIPS Council and Regional Investment Performance Subcommittees.

Each organization undergoes a formal review before being endorsed as a country sponsor. Additional information and a current list of country sponsors can be found on the GIPS website (www.gipsstandards.org).

Endorsed GIPS Country Sponsors (as of 1 January 2010)

Australia	Investment and Financial Services Association Limited—Performance Analyst Group
Austria	1) Österreichische Vereinigung für Finanzanalyse und Asset Management and 2) Vereinigung Österreichischer Investmentgesellschaften
Belgium	Belgian Asset Managers Association
Canada	Canadian Investment Performance Committee
Denmark	The Danish Society of Financial Analysts and CFA Denmark
France	1) Société Française des Analystes Financiers and 2) Association Française de la Gestion Financière
Germany	German Asset Management Standards Committee: 1) Bundesverband Investment und Asset Management e.V., 2) Deutsche Vereinigung für Finanzanalyse und Asset Management, and 3) German CFA Society
Greece	Hellenic CFA Society
Hong Kong	Local Sponsor: The Hong Kong Society of Financial Analysts
Hungary	1) CFA Society of Hungary and 2) the Association of Hungarian Investment Fund and Asset Management Companies
Ireland	Irish Association of Investment Managers
Italy	Italian Investment Performance Committee: 1) L'Associazione Bancaria Italiana, 2) L'Associazione Italiana degli Analisti Finanziari, 3) Assogestioni, 4) Sviluppo Mercato Fondi Pensione, 5) Assirevi, and 6) Italian CFA Society
Japan	The Security Analysts Association of Japan
Kazakhstan	Kazakhstan Association of Financial and Investment Analysts
Liechtenstein	Liechtenstein Bankers' Association
Micronesia	Asia Pacific Association for Fiduciary Studies
The Netherlands	The Netherlands Beroepsvereniging van Beleggingsprofessionals
New Zealand	CFA Society of New Zealand
Norway	The Norwegian Society of Financial Analysts
Pakistan	CFA Association of Pakistan
Portugal	Associação Portuguesa de Analista Financeiros
Russia	National League of Management Companies
Singapore	Investment Management Association of Singapore
South Africa	Association for Savings and Investment, South Africa
South Korea	Korea GIPS Committee
Spain	Asociación Española de Presentación de Resultados de Gestión
Sri Lanka	CFA Sri Lanka
Sweden	Swedish Society of Financial Analysts
Switzerland	Swiss Bankers Association
Ukraine	The Ukrainian Association of Investment Business
United Kingdom	U.K. Investment Performance Committee: 1) Association of British Insurers, 2) Investment Management Association, and 3) National Association of Pension Funds
United States	CFA Institute—U.S. Investment Performance Committee

I. PROVISIONS OF THE GLOBAL INVESTMENT PERFORMANCE STANDARDS

The provisions within the GIPS standards are divided into the following nine sections: Fundamentals of Compliance, Input Data, Calculation Methodology, Composite Construction, Disclosure, Presentation and Reporting, Real Estate, Private Equity, and Wrap Fee/Separately Managed Account (SMA) Portfolios.

The provisions for each section are categorized into requirements and recommendations. Firms must meet all the requirements to claim compliance with the GIPS standards. Firms are encouraged to implement as many of the recommendations as possible. These recommended provisions are considered to be industry best practice and assist firms in fully adhering to the spirit and intent of the GIPS standards.

- 0. Fundamentals of Compliance:** Several core principles create the foundation for the GIPS standards, including properly defining the firm, providing compliant presentations to all prospective clients, adhering to applicable laws and regulations, and ensuring that information presented is not false or misleading. Two important issues that a firm must consider when becoming compliant with the GIPS standards are the definition of the firm and the firm's definition of discretion. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. The firm's definition of discretion establishes criteria to judge which portfolios must be included in a composite and is based on the firm's ability to implement its investment strategy.
- 1. Input Data:** Consistency of input data used to calculate performance is critical to effective compliance with the GIPS standards and establishes the foundation for full, fair, and comparable investment performance presentations. For periods beginning on or after 1 January 2011, all portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles.
- 2. Calculation Methodology:** Achieving comparability among investment management firms' performance presentations requires uniformity in methods used to calculate returns. The GIPS standards mandate the use of certain calculation methodologies to facilitate comparability.
- 3. Composite Construction:** A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The composite return is the asset-weighted average of the performance of all portfolios in the composite. Creating meaningful composites is essential to the fair presentation, consistency, and comparability of performance over time and among firms.
- 4. Disclosure:** Disclosures allow firms to elaborate on the data provided in the presentation and give the reader the proper context in which to understand the performance. To comply with the GIPS standards, firms must disclose certain information in all compliant presentations regarding their performance and the policies adopted by the firm. Although some disclosures are required for all firms, others are specific to certain circumstances and may not be applicable in all situations. Firms are not required to make negative assurance disclosures (e.g., if the firm does not use leverage in a particular composite strategy, no disclosure of the use of leverage is required). One of the essential disclosures for every firm is the claim of compliance. Once a firm meets all the requirements of the GIPS standards, it must

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appropriately use the claim of compliance to indicate compliance with the GIPS standards. The 2010 edition of the GIPS standards includes a revised compliance statement that indicates if the firm has or has not been verified.

5. **Presentation and Reporting:** After constructing the composites, gathering the input data, calculating returns, and determining the necessary disclosures, the firm must incorporate this information in presentations based on the requirements in the GIPS standards for presenting investment performance. No finite set of requirements can cover all potential situations or anticipate future developments in investment industry structure, technology, products, or practices. When appropriate, firms have the responsibility to include in GIPS-compliant presentations information not addressed by the GIPS standards.
6. **Real Estate:** Unless otherwise noted, this section supplements all of the required and recommended provisions in Sections 0–5. Real estate provisions were first included in the 2005 edition of the GIPS standards and became effective 1 January 2006. The 2010 edition of the GIPS standards includes new provisions for closed-end real estate funds. Firms should note that certain provisions of Sections 0–5 do not apply to real estate investments or are superseded by provisions within Section 6. The provisions that do not apply have been noted within Section 6.
7. **Private Equity:** Unless otherwise noted, this section supplements all of the required and recommended provisions in Sections 0–5. Private equity provisions were first included in the 2005 edition of the GIPS standards and became effective 1 January 2006. Firms should note that certain provisions in Sections 0–5 do not apply to private equity investments or are superseded by provisions within Section 7. The provisions that do not apply have been noted within Section 7.
8. **Wrap Fee/Separately Managed Account (SMA) Portfolios:** Unless otherwise noted, this section supplements all of the required and recommended provisions in Sections 0–5. Firms should note that certain provisions in Sections 0–5 of the GIPS standards do not apply to wrap fee/SMA portfolios or are superseded by provisions within Section 8. The provisions that do not apply have been noted within Section 8.

Defined Terms: Words appearing in small capital letters in Chapters I–V are defined in the GIPS Glossary in Chapter V, which is located at the end of this reading.

0. Fundamentals of Compliance

Fundamentals of Compliance—Requirements

- 0.A.1. FIRMS MUST comply with all the REQUIREMENTS of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.
- 0.A.2. FIRMS MUST comply with all applicable laws and regulations regarding the calculation and presentation of performance.
- 0.A.3. FIRMS MUST NOT present performance or performance-related information that is false or misleading.
- 0.A.4. The GIPS standards MUST be applied on a FIRM-wide basis.

I. Provisions of the Global Investment Performance Standards

- 0.A.5. 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.
- 0.A.6. If the FIRM does not meet all the REQUIREMENTS of the GIPS standards, the FIRM MUST NOT represent or state that it is “in compliance with the Global Investment Performance Standards except for . . .” or make any other statements that may indicate partial compliance with the GIPS standards.
- 0.A.7. Statements referring to the calculation methodology as being “in accordance,” “in compliance,” or “consistent” with the Global Investment Performance Standards, or similar statements, are prohibited.
- 0.A.8. Statements referring to the performance of a single, existing client PORTFOLIO as being “calculated in accordance with the Global Investment Performance Standards” are prohibited, except when a GIPS-compliant FIRM reports the performance of an individual client’s PORTFOLIO to that client.
- 0.A.9. FIRMS MUST make every reasonable effort to provide a COMPLIANT PRESENTATION to all PROSPECTIVE CLIENTS. FIRMS MUST NOT choose to whom they present a COMPLIANT PRESENTATION. As long as a PROSPECTIVE CLIENT has received a COMPLIANT PRESENTATION within the previous 12 months, the FIRM has met this REQUIREMENT.
- 0.A.10. FIRMS MUST provide a complete list of COMPOSITE DESCRIPTIONS to any PROSPECTIVE CLIENT that makes such a request. FIRMS MUST include terminated COMPOSITES on the FIRM’S list of COMPOSITE DESCRIPTIONS for at least five years after the COMPOSITE TERMINATION DATE.
- 0.A.11. FIRMS MUST provide a COMPLIANT PRESENTATION for any COMPOSITE listed on the FIRM’S list of COMPOSITE DESCRIPTIONS to any PROSPECTIVE CLIENT that makes such a request.
- 0.A.12. FIRMS MUST be defined as an investment firm, subsidiary, or division held out to clients or PROSPECTIVE CLIENTS as a DISTINCT BUSINESS ENTITY.
- 0.A.13. For periods beginning on or after 1 January 2011, TOTAL FIRM ASSETS MUST be the aggregate FAIR VALUE of all discretionary and non-discretionary assets managed by the FIRM. This includes both fee-paying and non-fee-paying PORTFOLIOS.¹
- 0.A.14. TOTAL FIRM ASSETS MUST include assets assigned to a SUB-ADVISOR provided the FIRM has discretion over the selection of the SUB-ADVISOR.
- 0.A.15. Changes in a FIRM’S organization MUST NOT lead to alteration of historical COMPOSITE performance.
- 0.A.16. When the FIRM jointly markets with other firms, the FIRM claiming compliance with the GIPS standards MUST be sure that it is clearly defined and separate relative to other firms being marketed, and that it is clear which FIRM is claiming compliance.

¹ For periods prior to 1 January 2011, TOTAL FIRM ASSETS MUST be the aggregate of the MARKET VALUE of all discretionary and non-discretionary assets under management within the defined FIRM.

Fundamentals of Compliance—Recommendations

- 0.B.1. FIRMS SHOULD comply with the RECOMMENDATIONS of the GIPS standards, including RECOMMENDATIONS in any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which will be made available on the GIPS website (www.gipsstandards.org) as well as in the *GIPS Handbook*.
- 0.B.2. FIRMS SHOULD be verified.
- 0.B.3. FIRMS SHOULD adopt the broadest, most meaningful definition of the FIRM. The scope of this definition SHOULD include all geographical (country, regional, etc.) offices operating under the same brand name regardless of the actual name of the individual investment management company.
- 0.B.4. FIRMS SHOULD provide to each existing client, on an annual basis, a COMPLIANT PRESENTATION of the COMPOSITE in which the client's PORTFOLIO is included.

1. Input Data

Input Data—Requirements

- 1.A.1. All data and information necessary to support all items included in a COMPLIANT PRESENTATION MUST be captured and maintained.
- 1.A.2. 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.²
- 1.A.3. FIRMS MUST value PORTFOLIOS in accordance with the COMPOSITE-specific valuation policy. PORTFOLIOS MUST be valued:
 - a. For periods beginning on or after 1 January 2001, at least monthly.³
 - b. For periods beginning on or after 1 January 2010, on the date of all LARGE CASH FLOWS. FIRMS MUST define LARGE CASH FLOW for each COMPOSITE to determine when PORTFOLIOS in that COMPOSITE MUST be valued.
 - c. No more frequently than required by the valuation policy.
- 1.A.4. For periods beginning on or after 1 January 2010, FIRMS MUST value PORTFOLIOS as of the calendar month end or the last business day of the month.
- 1.A.5. For periods beginning on or after 1 January 2005, FIRMS MUST use TRADE DATE ACCOUNTING.
- 1.A.6. ACCRUAL ACCOUNTING MUST be used for fixed-income securities and all other investments that earn interest income. The value of fixed-income securities MUST include accrued income.
- 1.A.7. For periods beginning on or after 1 January 2006, COMPOSITES MUST have consistent beginning and ending annual valuation dates. Unless the COMPOSITE is reported on a non-calendar fiscal year, the beginning and ending valuation dates MUST be at calendar year end or on the last business day of the year.

² For periods prior to 1 January 2011, PORTFOLIO valuations MUST be based on MARKET VALUES (not cost basis or book values).

³ For periods prior to 1 January 2001, PORTFOLIOS MUST be valued at least quarterly.

Input Data—Recommendations

- 1.B.1. FIRMS SHOULD value PORTFOLIOS on the date of all EXTERNAL CASH FLOWS.
- 1.B.2. Valuations SHOULD be obtained from a qualified independent third party.
- 1.B.3. ACCRUAL ACCOUNTING SHOULD be used for dividends (as of the ex-dividend date).
- 1.B.4. FIRMS SHOULD accrue INVESTMENT MANAGEMENT FEES.

2. Calculation Methodology

Calculation Methodology—Requirements

- 2.A.1. TOTAL RETURNS MUST be used.
- 2.A.2. FIRMS MUST calculate TIME-WEIGHTED RATES OF RETURN that adjust for EXTERNAL CASH FLOWS. Both periodic and sub-period returns MUST be geometrically LINKED. EXTERNAL CASH FLOWS MUST be treated according to the FIRM'S COMPOSITE-specific policy. At a minimum:
 - a. For periods beginning on or after 1 January 2001, FIRMS MUST calculate PORTFOLIO returns at least monthly.
 - b. For periods beginning on or after 1 January 2005, FIRMS MUST calculate PORTFOLIO returns that adjust for daily-weighted EXTERNAL CASH FLOWS.
- 2.A.3. Returns from cash and cash equivalents held in PORTFOLIOS MUST be included in all return calculations.
- 2.A.4. All returns MUST be calculated after the deduction of the actual TRADING EXPENSES incurred during the period. FIRMS MUST NOT use estimated TRADING EXPENSES.
- 2.A.5. If the actual TRADING EXPENSES cannot be identified and segregated from a BUNDLED FEE:
 - a. When calculating GROSS-OF-FEES returns, returns MUST be reduced by the entire BUNDLED FEE or the portion of the BUNDLED FEE that includes the TRADING EXPENSES. FIRMS MUST NOT use estimated TRADING EXPENSES.
 - b. When calculating NET-OF-FEES returns, returns MUST be reduced by the entire BUNDLED FEE or the portion of the BUNDLED FEE that includes the TRADING EXPENSES and the INVESTMENT MANAGEMENT FEE. FIRMS MUST NOT use estimated TRADING EXPENSES.
- 2.A.6. 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.
- 2.A.7. COMPOSITE returns MUST be calculated:
 - a. For periods beginning on or after 1 January 2006, by asset-weighting the individual PORTFOLIO returns at least quarterly.
 - b. For periods beginning on or after 1 January 2010, by asset-weighting the individual PORTFOLIO returns at least monthly.

Calculation Methodology—Recommendations

- 2.B.1. Returns SHOULD be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes SHOULD be accrued.
- 2.B.2. For periods prior to 1 January 2010, FIRMS SHOULD calculate COMPOSITE returns by asset-weighting the individual PORTFOLIO returns at least monthly.

3. Composite Construction

Composite Construction—Requirements

- 3.A.1. All actual, fee-paying, discretionary PORTFOLIOS MUST be included in at least one COMPOSITE. Although non-fee-paying discretionary PORTFOLIOS may be included in a COMPOSITE (with appropriate disclosure), non-discretionary PORTFOLIOS MUST NOT be included in a FIRM'S COMPOSITES.
- 3.A.2. COMPOSITES MUST include only actual assets managed by the FIRM.
- 3.A.3. FIRMS MUST NOT LINK performance of simulated or model PORTFOLIOS with actual performance.
- 3.A.4. COMPOSITES MUST be defined according to investment mandate, objective, or strategy. COMPOSITES MUST include all PORTFOLIOS that meet the COMPOSITE DEFINITION. Any change to a COMPOSITE DEFINITION MUST NOT be applied retroactively. The COMPOSITE DEFINITION MUST be made available upon request.
- 3.A.5. COMPOSITES MUST include new PORTFOLIOS on a timely and consistent basis after each PORTFOLIO comes under management.
- 3.A.6. 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.
- 3.A.7. PORTFOLIOS MUST NOT be switched from one COMPOSITE to another unless documented changes to a PORTFOLIO'S investment mandate, objective, or strategy or the redefinition of the COMPOSITE makes it appropriate. The historical performance of the PORTFOLIO MUST remain with the original COMPOSITE.
- 3.A.8. For periods beginning on or after 1 January 2010, a CARVE-OUT MUST NOT be included in a COMPOSITE unless the CARVE-OUT is managed separately with its own cash balance.⁴
- 3.A.9. If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM MUST NOT include PORTFOLIOS below the minimum asset level in that COMPOSITE. Any changes to a COMPOSITE-specific minimum asset level MUST NOT be applied retroactively.
- 3.A.10. FIRMS that wish to remove PORTFOLIOS from COMPOSITES in cases of SIGNIFICANT CASH FLOWS MUST define "significant" on an EX-ANTE, COMPOSITE-specific basis and MUST consistently follow the COMPOSITE-specific policy.

⁴ For periods prior to 1 January 2010, if CARVE-OUTS were included in a COMPOSITE, cash MUST have been allocated to the CARVE-OUT in a timely and consistent manner.

Composite Construction—Recommendations

- 3.B.1. If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM SHOULD NOT present a COMPLIANT PRESENTATION of the COMPOSITE to a PROSPECTIVE CLIENT known not to meet the COMPOSITE’S minimum asset level.
- 3.B.2. To remove the effect of a SIGNIFICANT CASH FLOW, the FIRM SHOULD use a TEMPORARY NEW ACCOUNT.

4. Disclosure

Disclosure—Requirements

- 4.A.1. Once a FIRM has met all the REQUIREMENTS of the GIPS standards, the FIRM MUST disclose its compliance with the GIPS standards using one of the following compliance statements. The claim of compliance MUST only be used in a COMPLIANT PRESENTATION.

For FIRMS that are verified:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.”

For COMPOSITES of a verified FIRM that have also had a PERFORMANCE EXAMINATION:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates].

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The [insert name of COMPOSITE] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request.”

For FIRMS that have not been verified:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has not been independently verified.”

- 4.A.2. FIRMS MUST disclose the definition of the FIRM used to determine TOTAL FIRM ASSETS and FIRM-wide compliance.
- 4.A.3. FIRMS MUST disclose the COMPOSITE DESCRIPTION.
- 4.A.4. FIRMS MUST disclose the BENCHMARK DESCRIPTION.

2 The GIPS Standards

The GIPS Standards

- 4.A.5. When presenting GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRADING EXPENSES.
- 4.A.6. When presenting NET-OF-FEES returns, FIRMS MUST disclose:
 - a. If any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRADING EXPENSES;
 - b. If model or actual INVESTMENT MANAGEMENT FEES are used; and
 - c. If returns are net of any PERFORMANCE-BASED FEES.
- 4.A.7. FIRMS MUST disclose the currency used to express performance.
- 4.A.8. FIRMS MUST disclose which measure of INTERNAL DISPERSION is presented.
- 4.A.9. FIRMS MUST disclose the FEE SCHEDULE appropriate to the COMPLIANT PRESENTATION.
- 4.A.10. FIRMS MUST disclose the COMPOSITE CREATION DATE.
- 4.A.11. FIRMS MUST disclose that the FIRM'S list of COMPOSITE DESCRIPTIONS is available upon request.
- 4.A.12. FIRMS MUST disclose that policies for valuing PORTFOLIOS, calculating performance, and preparing COMPLIANT PRESENTATIONS are available upon request.
- 4.A.13. 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.
- 4.A.14. FIRMS MUST disclose all significant events that would help a PROSPECTIVE CLIENT interpret the COMPLIANT PRESENTATION.
- 4.A.15. For any performance presented for periods prior to 1 January 2000 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.
- 4.A.16. If the FIRM is redefined, the FIRM MUST disclose the date of, description of, and reason for the redefinition.
- 4.A.17. If a COMPOSITE is redefined, the FIRM MUST disclose the date of, description of, and reason for the redefinition.
- 4.A.18. FIRMS MUST disclose changes to the name of a COMPOSITE.
- 4.A.19. FIRMS MUST disclose the minimum asset level, if any, below which PORTFOLIOS are not included in a COMPOSITE. FIRMS MUST also disclose any changes to the minimum asset level.
- 4.A.20. FIRMS MUST disclose relevant details of the treatment of withholding taxes on dividends, interest income, and capital gains, if material. FIRMS MUST also disclose if BENCHMARK returns are net of withholding taxes if this information is available.
- 4.A.21. For periods beginning on or after 1 January 2011, FIRMS MUST disclose and describe any known material differences in exchange rates or valuation sources used among the PORTFOLIOS within a COMPOSITE, and between the COMPOSITE and the BENCHMARK.⁵
- 4.A.22. If the COMPLIANT PRESENTATION conforms with laws and/or regulations that conflict with the REQUIREMENTS of the GIPS standards, FIRMS MUST disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards.
- 4.A.23. For periods prior to 1 January 2010, if CARVE-OUTS are included in a COMPOSITE, FIRMS MUST disclose the policy used to allocate cash to CARVE-OUTS.

⁵ For periods prior to 1 January 2011, FIRMS MUST disclose and describe any known inconsistencies in the exchange rates used among the PORTFOLIOS within a COMPOSITE and between the COMPOSITE and the BENCHMARK.

I. Provisions of the Global Investment Performance Standards

- 4.A.24. If a COMPOSITE contains PORTFOLIOS with BUNDLED FEES, FIRMS MUST disclose the types of fees that are included in the BUNDLED FEE.
- 4.A.25. For periods beginning on or after 1 January 2006, FIRMS MUST disclose the use of a SUB-ADVISOR and the periods a SUB-ADVISOR was used.
- 4.A.26. For periods prior to 1 January 2010, FIRMS MUST disclose if any PORTFOLIOS were not valued at calendar month end or on the last business day of the month.
- 4.A.27. For periods beginning on or after 1 January 2011, FIRMS MUST disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE.
- 4.A.28. 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.
- 4.A.29. If the FIRM determines no appropriate BENCHMARK for the COMPOSITE exists, the FIRM MUST disclose why no BENCHMARK is presented.
- 4.A.30. If the FIRM changes the BENCHMARK, the FIRM MUST disclose the date of, description of, and reason for the change.
- 4.A.31. If a custom BENCHMARK or combination of multiple BENCHMARKS is used, the FIRM MUST disclose the BENCHMARK components, weights, and rebalancing process.
- 4.A.32. If the FIRM has adopted a SIGNIFICANT CASH FLOW policy for a specific COMPOSITE, the FIRM MUST disclose how the FIRM defines a SIGNIFICANT CASH FLOW for that COMPOSITE and for which periods.
- 4.A.33. 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.
- 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.
- 4.A.35. FIRMS MUST disclose if the performance from a past firm or affiliation is LINKED to the performance of the FIRM.

Disclosure—Recommendations

- 4.B.1. FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.
- 4.B.2. FIRMS SHOULD disclose material changes to calculation policies and/or methodologies.
- 4.B.3. FIRMS SHOULD disclose material differences between the BENCHMARK and the COMPOSITE'S investment mandate, objective, or strategy.
- 4.B.4. FIRMS SHOULD disclose the key assumptions used to value PORTFOLIO investments.
- 4.B.5. If a parent company contains multiple firms, each FIRM within the parent company SHOULD disclose a list of the other firms contained within the parent company.
- 4.B.6. For periods prior to 1 January 2011, FIRMS SHOULD disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE.

- 4.B.7. For periods prior to 1 January 2006, FIRMS SHOULD disclose the use of a SUB-ADVISOR and the periods a SUB-ADVISOR was used.
- 4.B.8. FIRMS SHOULD disclose if a COMPOSITE contains PROPRIETARY ASSETS.

5. Presentation and Reporting

Presentation and Reporting—Requirements

- 5.A.1. The following items MUST be presented in each COMPLIANT PRESENTATION:
- At least five years of performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. After a FIRM presents a minimum of five years of GIPS-compliant performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years), the FIRM MUST present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.
 - COMPOSITE returns for each annual period. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.
 - For COMPOSITES with a COMPOSITE INCEPTION DATE of 1 January 2011 or later, when the initial period is less than a full year, returns from the COMPOSITE INCEPTION DATE through the initial annual period end.
 - For COMPOSITES with a COMPOSITE TERMINATION DATE of 1 January 2011 or later, returns from the last annual period end through the COMPOSITE TERMINATION DATE.
 - The TOTAL RETURN for the BENCHMARK for each annual period. The BENCHMARK MUST reflect the investment mandate, objective, or strategy of the COMPOSITE.
 - The number of PORTFOLIOS in the COMPOSITE as of each annual period end. If the COMPOSITE contains five or fewer PORTFOLIOS at period end, the number of PORTFOLIOS is not REQUIRED.
 - COMPOSITE assets as of each annual period end.
 - Either TOTAL FIRM ASSETS or COMPOSITE assets as a percentage of TOTAL FIRM ASSETS, as of each annual period end.
 - A measure of INTERNAL DISPERSION of individual PORTFOLIO returns for each annual period. If the COMPOSITE contains five or fewer PORTFOLIOS for the full year, a measure of INTERNAL DISPERSION is not REQUIRED.
- 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; 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.
- 5.A.3. FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2000.
 - 5.A.4. Returns for periods of less than one year MUST NOT be annualized.
 - 5.A.5. For periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a COMPOSITE includes CARVE-OUTS, the FIRM MUST present the percentage of COMPOSITE assets represented by CARVE-OUTS as of each annual period end.
 - 5.A.6. If a COMPOSITE includes non-fee-paying PORTFOLIOS, the FIRM MUST present the percentage of COMPOSITE assets represented by non-fee-paying PORTFOLIOS as of each annual period end.
 - 5.A.7. If a COMPOSITE includes PORTFOLIOS with BUNDLED FEES, the FIRM MUST present the percentage of COMPOSITE assets represented by PORTFOLIOS with BUNDLED FEES as of each annual period end.
 - 5.A.8.
 - a. Performance of a past firm or affiliation MUST be LINKED to or used to represent the historical performance of a new or acquiring FIRM if, on a COMPOSITE-specific basis:
 - i. Substantially all of the investment decision makers are employed by the new or acquiring FIRM (e.g., research department staff, portfolio managers, and other relevant staff);
 - ii. The decision-making process remains substantially intact and independent within the new or acquiring FIRM; and
 - iii. The new or acquiring FIRM has records that document and support the performance.
 - b. If a FIRM acquires another firm or affiliation, the FIRM has one year to bring any non-compliant assets into compliance.

Presentation and Reporting—Recommendations

- 5.B.1. FIRMS SHOULD present GROSS-OF-FEES returns.
- 5.B.2. FIRMS SHOULD present the following items:
 - a. Cumulative returns of the COMPOSITE and the BENCHMARK for all periods;
 - b. Equal-weighted mean and median COMPOSITE returns;
 - c. Quarterly and/or monthly returns; and
 - d. Annualized COMPOSITE and BENCHMARK returns for periods longer than 12 months.
- 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.
- 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.

- 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.
- 5.B.6. FIRMS SHOULD present additional relevant COMPOSITE-level EX-POST risk measures.
- 5.B.7. FIRMS SHOULD present more than 10 years of annual performance in the COMPLIANT PRESENTATION.
- 5.B.8. FIRMS SHOULD comply with the GIPS standards for all historical periods.
- 5.B.9. FIRMS SHOULD update COMPLIANT PRESENTATIONS quarterly.

6. Real Estate

Unless otherwise noted, the following REAL ESTATE provisions supplement the REQUIRED and RECOMMENDED provisions of the GIPS standards in Sections 0–5.

REAL ESTATE provisions were first included in the GIPS standards in 2005 and became effective 1 January 2006. All COMPLIANT PRESENTATIONS that included REAL ESTATE performance for periods beginning on or after 1 January 2006 were REQUIRED to meet all the REQUIREMENTS of the REAL ESTATE provisions of the 2005 edition of the GIPS standards. The following REAL ESTATE provisions are effective 1 January 2011. All REAL ESTATE COMPOSITES that include performance for periods beginning on or after 1 January 2011 MUST comply with all the REQUIREMENTS and SHOULD adhere to the RECOMMENDATIONS of the following REAL ESTATE provisions.

The following investment types are not considered REAL ESTATE and, therefore, MUST follow Sections 0–5 of the Global Investment Performance Standards:

- Publicly traded REAL ESTATE securities;
- Commercial mortgage-backed securities (CMBS); and
- Private debt investments, including commercial and residential loans where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying REAL ESTATE.

Real Estate—Requirements

Input Data—Requirements (the following provisions do not apply: 1.A.3.a, 1.A.3.b, and 1.A.4)

- 6.A.1. For periods beginning on or after 1 January 2011, REAL ESTATE investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II.⁶
- 6.A.2. For periods beginning on or after 1 January 2008, REAL ESTATE investments MUST be valued at least quarterly.⁷
- 6.A.3. For periods beginning on or after 1 January 2010, FIRMS MUST value PORTFOLIOS as of each quarter end or the last business day of each quarter.

⁶ For periods prior to 1 January 2011, REAL ESTATE investments MUST be valued at MARKET VALUE (as previously defined for REAL ESTATE in the 2005 edition of the GIPS standards).

⁷ For periods prior to 1 January 2008, REAL ESTATE investments MUST be valued at least once every 12 months.

- 6.A.4.** REAL ESTATE investments MUST have an EXTERNAL VALUATION:
- a. For periods prior to 1 January 2012, at least once every 36 months.
 - b. For periods beginning on or after 1 January 2012, at least once every 12 months unless client agreements stipulate otherwise, in which case REAL ESTATE investments MUST have an EXTERNAL VALUATION at least once every 36 months or per the client agreement if the client agreement requires EXTERNAL VALUATIONS more frequently than every 36 months.
- 6.A.5.** EXTERNAL VALUATIONS must be performed by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser. In markets where these professionals are not available, the FIRM MUST take the necessary steps to ensure that only well-qualified independent property valuers or appraisers are used.

Calculation Methodology—Requirements (the following provisions do not apply: 2.A.2.a, 2.A.4, and 2.A.7)

- 6.A.6.** FIRMS MUST calculate PORTFOLIO returns at least quarterly.
- 6.A.7.** All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.
- 6.A.8.** For periods beginning on or after 1 January 2011, INCOME RETURNS and CAPITAL RETURNS (component returns) MUST be calculated separately using geometrically LINKED TIME-WEIGHTED RATES OF RETURN.
- 6.A.9.** COMPOSITE TIME-WEIGHTED RATES OF RETURN, including component returns, MUST be calculated by asset-weighting the individual PORTFOLIO returns at least quarterly.

Disclosure—Requirements (the following provisions do not apply: 4.A.5, 4.A.6.a, 4.A.15, 4.A.26, 4.A.33, and 4.A.34)

- 6.A.10.** The following items MUST be disclosed in each COMPLIANT PRESENTATION:
- a. The FIRM's description of discretion;
 - b. The INTERNAL VALUATION methodologies used to value REAL ESTATE investments for the most recent period;
 - c. For periods beginning on or after 1 January 2011, material changes to valuation policies and/or methodologies;
 - d. For periods beginning on or after 1 January 2011, material differences between an EXTERNAL VALUATION and the valuation used in performance reporting and the reason for the differences;
 - e. The frequency REAL ESTATE investments are valued by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser;
 - f. When component returns are calculated separately using geometrically LINKED TIME-WEIGHTED RATES OF RETURN; and
 - g. For periods prior to 1 January 2011, if component returns are adjusted such that the sum of the INCOME RETURN and the CAPITAL RETURN equals the TOTAL RETURN.
- 6.A.11.** For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

2 The GIPS Standards

- 6.A.12. When presenting GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.
- 6.A.13. When presenting NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.

Presentation and Reporting—Requirements (the following provisions do not apply: 5.A.1.i, 5.A.2, and 5.A.3)

- 6.A.14. FIRMS MUST present component returns in addition to TOTAL RETURNS. COMPOSITE component returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.
- 6.A.15. FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.
- 6.A.16. The following items MUST be presented in each COMPLIANT PRESENTATION:
- a. As a measure of INTERNAL DISPERSION, high and low annual TIME-WEIGHTED RATES OF RETURN for the individual PORTFOLIOS in the COMPOSITE. If the COMPOSITE contains five or fewer PORTFOLIOS for the full year, a measure of INTERNAL DISPERSION is not REQUIRED.
 - b. As of each annual period end, the percentage of COMPOSITE assets valued using an EXTERNAL VALUATION during the annual period.

The following provisions are additional REQUIREMENTS for REAL ESTATE CLOSED-END FUND COMPOSITES:

Calculation Methodology—Requirements

- 6.A.17. FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).
- 6.A.18. The SI-IRR MUST be calculated using quarterly cash flows at a minimum.

Composite Construction—Requirements

- 6.A.19. COMPOSITES MUST be defined by VINTAGE YEAR and investment mandate, objective, or strategy. The COMPOSITE DEFINITION MUST remain consistent throughout the life of the COMPOSITE.

Disclosure—Requirements

- 6.A.20. FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.
- 6.A.21. FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation.
- 6.A.22. FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.

Presentation and Reporting—Requirements

- 6.A.23. The following items MUST be presented in each COMPLIANT PRESENTATION:
- a. FIRMS MUST present the NET-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM's inception or the COMPOSITE INCEPTION DATE if the FIRM or the

COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance.

- b. For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS MUST present the non-annualized NET-OF-FEES SI-IRR through the initial annual period end.
 - c. For periods ending on or after 1 January 2011, FIRMS MUST present the NET-OF-FEES SI-IRR through the COMPOSITE FINAL LIQUIDATION DATE.
- 6.A.24. If the GROSS-OF-FEES SI-IRR of the COMPOSITE is presented in the COMPLIANT PRESENTATION, FIRMS MUST present the GROSS-OF-FEES SI-IRR of the COMPOSITE for the same periods as the NET-OF-FEES SI-IRR is presented.
- 6.A.25. FIRMS MUST present, as of each annual period end:
- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL;
 - b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS;
 - c. COMPOSITE cumulative COMMITTED CAPITAL;
 - d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI);
 - e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI);
 - f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE); and
 - g. RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).
- 6.A.26. FIRMS MUST present the SI-IRR of the BENCHMARK through each annual period end. The BENCHMARK MUST:
- a. Reflect the investment mandate, objective, or strategy of the COMPOSITE;
 - b. Be presented for the same time period as presented for the COMPOSITE; and
 - c. Be the same VINTAGE YEAR as the COMPOSITE.

Real Estate—Recommendations

Input Data—Recommendations (the following provision does not apply: 1.B.1)

- 6.B.1. For periods prior to 1 January 2012, REAL ESTATE investments SHOULD be valued by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser at least once every 12 months.
- 6.B.2. REAL ESTATE investments SHOULD be valued as of the annual period end by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser.

2 The GIPS Standards

Disclosure—Recommendations

- 6.B.3. FIRMS SHOULD disclose the basis of accounting for the PORTFOLIOS in the COMPOSITE (e.g., U.S. GAAP, IFRS).
- 6.B.4. FIRMS SHOULD explain and disclose material differences between the valuation used in performance reporting and the valuation used in financial reporting as of each annual period end.
- 6.B.5. For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

Presentation and Reporting—Recommendations (the following provisions do not apply: 5.B.3, 5.B.4, and 5.B.5)

- 6.B.6. FIRMS SHOULD present both GROSS-OF-FEES and NET-OF-FEES returns.
- 6.B.7. FIRMS SHOULD present the percentage of the total value of COMPOSITE assets that are not REAL ESTATE as of each annual period end.
- 6.B.8. FIRMS SHOULD present the component returns of the BENCHMARK, if available.

The following provision is an additional RECOMMENDATION for REAL ESTATE CLOSED-END FUND COMPOSITES:

Calculation Methodology—Recommendations

- 6.B.9. The SI-IRR SHOULD be calculated using daily cash flows.

7. Private Equity

Unless otherwise noted, the following PRIVATE EQUITY provisions supplement the REQUIRED and RECOMMENDED provisions of the GIPS standards in Sections 0–5.

PRIVATE EQUITY provisions were first included in the GIPS standards in 2005 and became effective 1 January 2006. All COMPLIANT PRESENTATIONS that included PRIVATE EQUITY performance for periods ending on or after 1 January 2006 were REQUIRED to meet all the REQUIREMENTS of the PRIVATE EQUITY provisions of the 2005 edition of the GIPS standards. The following PRIVATE EQUITY provisions are effective 1 January 2011. All PRIVATE EQUITY COMPOSITES that include performance for periods ending on or after 1 January 2011 MUST comply with all the REQUIREMENTS and SHOULD comply with the RECOMMENDATIONS of the following PRIVATE EQUITY provisions.

The following are provisions that apply to the calculation and presentation of PRIVATE EQUITY investments made by fixed life, fixed commitment PRIVATE EQUITY investment vehicles including PRIMARY FUNDS and FUNDS OF FUNDS. These provisions also apply to fixed life, fixed commitment SECONDARY FUNDS, which MUST apply either the provisions applicable to PRIMARY FUNDS or the provisions applicable to FUNDS OF FUNDS, depending on which form the SECONDARY FUND uses to make investments. PRIVATE EQUITY OPEN-END and EVERGREEN FUNDS MUST follow Sections 0–5 in the Provisions of the Global Investment Performance Standards. REAL ESTATE CLOSED-END FUNDS MUST follow Section 6 in the Provisions of the Global Investment Performance Standards.

Private Equity—Requirements

Input Data—Requirements (the following provisions do not apply: 1.A.3.a, 1.A.3.b, and 1.A.4)

- 7.A.1. For periods ending on or after 1 January 2011, PRIVATE EQUITY investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II.⁸
- 7.A.2. PRIVATE EQUITY investments MUST be valued at least annually.

Calculation Methodology—Requirements (the following provisions do not apply: 2.A.2, 2.A.4, 2.A.6, and 2.A.7)

- 7.A.3. FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).
- 7.A.4. For periods ending on or after 1 January 2011, the SI-IRR MUST be calculated using daily cash flows. Stock DISTRIBUTIONS MUST be included as cash flows and MUST be valued at the time of DISTRIBUTION.⁹
- 7.A.5. All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.
- 7.A.6. NET-OF-FEES returns MUST be net of actual INVESTMENT MANAGEMENT FEES (including CARRIED INTEREST).
- 7.A.7. For FUNDS OF FUNDS, all returns MUST be net of all underlying partnership and/or fund fees and expenses, including CARRIED INTEREST.

Composite Construction—Requirements (the following provision does not apply: 3.A.10)

- 7.A.8. COMPOSITE DEFINITIONS MUST remain consistent throughout the life of the COMPOSITE.
- 7.A.9. PRIMARY FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR and investment mandate, objective, or strategy.
- 7.A.10. FUNDS OF FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR of the FUND OF FUNDS and/or investment mandate, objective, or strategy.

Disclosure—Requirements (the following provisions do not apply: 4.A.5, 4.A.6.a, 4.A.6.b, 4.A.8, 4.A.15, 4.A.26, 4.A.32, 4.A.33, and 4.A.34)

- 7.A.11. FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.
- 7.A.12. FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.
- 7.A.13. FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period.
- 7.A.14. For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies.
- 7.A.15. If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied.

⁸ For periods ending prior to 1 January 2011, PRIVATE EQUITY investments MUST be valued according to either the GIPS Private Equity Valuation Principles in Appendix D of the 2005 edition of the GIPS standards or the GIPS Valuation Principles in the 2010 edition of the GIPS standards.

⁹ For periods ending prior to 1 January 2011, the SI-IRR MUST be calculated using either daily or monthly cash flows.

2 The GIPS Standards

The GIPS Standards

- 7.A.16. FIRMS MUST disclose the calculation methodology used for the BENCHMARK. If FIRMS present the PUBLIC MARKET EQUIVALENT of a COMPOSITE as a BENCHMARK, FIRMS MUST disclose the index used to calculate the PUBLIC MARKET EQUIVALENT.
- 7.A.17. FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.
- 7.A.18. For GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.
- 7.A.19. For NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.
- 7.A.20. For any performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

Presentation and Reporting—Requirements (the following provisions do not apply: 5.A.1.a, 5.A.1.b, 5.A.1.c, 5.A.1.d, 5.A.1.e, 5.A.1.i, 5.A.2, and 5.A.3)

- 7.A.21. The following items MUST be presented in each COMPLIANT PRESENTATION:
- FIRMS MUST present both the NET-OF-FEES and GROSS-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.
 - For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS MUST present the non-annualized NET-OF-FEES and GROSS-OF-FEES SI-IRR through the initial annual period end.
 - For periods ending on or after 1 January 2011, FIRMS MUST present the NET-OF-FEES and GROSS-OF-FEES SI-IRR through the COMPOSITE FINAL LIQUIDATION DATE.
- 7.A.22. For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy, FIRMS MUST also present the SI-IRR of the underlying investments aggregated by VINTAGE YEAR as well as other measures as REQUIRED in 7.A.23. These measures MUST be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES and MUST be presented as of the most recent annual period end.
- 7.A.23. FIRMS MUST present as of each annual period end:
- COMPOSITE SINCE INCEPTION PAID-IN CAPITAL;
 - COMPOSITE SINCE INCEPTION DISTRIBUTIONS;
 - COMPOSITE cumulative COMMITTED CAPITAL;
 - TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE OR TVPI);
 - SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE OR DPI);
 - SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE); and
 - RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE OR RVPI).

- 7.A.24. FIRMS MUST present the SI-IRR for the BENCHMARK through each annual period end. The BENCHMARK MUST:
- Reflect the investment mandate, objective, or strategy of the COMPOSITE;
 - Be presented for the same time periods as presented for the COMPOSITE; and
 - Be the same VINTAGE YEAR as the COMPOSITE.
- 7.A.25. For FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy and a BENCHMARK is presented for the underlying investments, the BENCHMARK MUST be the same VINTAGE YEAR and investment mandate, objective, or strategy as the underlying investments.
- 7.A.26. For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.
- 7.A.27. For periods ending on or after 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.
- 7.A.28. FIRMS MUST NOT present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, FIRMS may present non-GIPS-compliant performance.

Private Equity—Recommendations

Input Data—Recommendations (the following provision does not apply: 1.B.1)

- 7.B.1. PRIVATE EQUITY investments SHOULD be valued at least quarterly.

Calculation Methodology—Recommendations (the following provision does not apply: 2.B.2)

- 7.B.2. For periods ending prior to 1 January 2011, the SI-IRR SHOULD be calculated using daily cash flows.

Composite Construction—Recommendations (the following provision does not apply: 3.B.2)

Disclosure—Recommendations

- 7.B.3. FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end.
- 7.B.4. For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

Presentation and Reporting—Recommendations (the following provisions do not apply: 5.B.2, 5.B.3, 5.B.4, and 5.B.5)

- 7.B.5. For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by VINTAGE YEAR of the FUND OF FUNDS, FIRMS SHOULD also present the SI-IRR of the underlying investments aggregated by investment mandate, objective, or strategy and other measures as listed in 7.A.23. These measures SHOULD be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES.
- 7.B.6. For periods ending prior to 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.
- 7.B.7. For periods ending prior to 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.

8. Wrap Fee/Separately Managed Account (SMA) Portfolios

The following provisions apply to the calculation and presentation of performance when presenting a COMPLIANT PRESENTATION to a WRAP FEE/SMA PROSPECTIVE CLIENT (which includes prospective WRAP FEE/SMA sponsors, prospective WRAP FEE/SMA clients, and existing WRAP FEE/SMA sponsors). Unless otherwise noted, the following WRAP FEE/SMA provisions supplement all the REQUIRED and RECOMMENDED provisions of the GIPS standards in Sections 0–5.

Although there are different types of WRAP FEE/SMA structures, these provisions apply to all WRAP FEE/SMA PORTFOLIOS where there are BUNDLED FEES and the WRAP FEE/SMA sponsor serves as an intermediary between the FIRM and the end user of the investment services. These provisions are not applicable to PORTFOLIOS defined as other types of BUNDLED FEE PORTFOLIOS. These provisions are also not applicable to model PORTFOLIOS that are provided by a FIRM to a WRAP FEE/SMA sponsor if the FIRM does not have discretionary PORTFOLIO management responsibility for the individual WRAP FEE/SMA PORTFOLIOS. Similarly, a FIRM or overlay manager in a Multiple Strategy Portfolio (MSP) or similar program is also excluded from applying these provisions to such PORTFOLIOS if they do not have discretion.

All WRAP FEE/SMA COMPLIANT PRESENTATIONS that include performance results for periods beginning on or after 1 January 2006 MUST meet all the REQUIREMENTS of the following WRAP FEE/SMA provisions.

Wrap Fee/SMA Requirements

Composite Construction—Requirements

- 8.A.1. FIRMS MUST include the performance record of actual WRAP FEE/SMA PORTFOLIOS in appropriate COMPOSITES in accordance with the FIRM'S established PORTFOLIO inclusion policies. Once established, these COMPOSITES (containing actual WRAP FEE/SMA PORTFOLIOS) MUST be used in the FIRM'S COMPLIANT PRESENTATIONS presented to WRAP FEE/SMA PROSPECTIVE CLIENTS.

Disclosure—Requirements (the following provision does not apply: 4.A.15)

- 8.A.2. For all WRAP FEE/SMA COMPLIANT PRESENTATIONS that include periods prior to the inclusion of an actual WRAP FEE/SMA PORTFOLIO in the COMPOSITE, the FIRM MUST disclose, for each period presented, that the COMPOSITE does not contain actual WRAP FEE/SMA PORTFOLIOS.
- 8.A.3. For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.
- 8.A.4. When FIRMS present COMPOSITE performance to an existing WRAP FEE/SMA sponsor that includes only that sponsor's WRAP FEE/SMA PORTFOLIOS (resulting in a "sponsor-specific COMPOSITE"):
 - a. FIRMS MUST disclose the name of the WRAP FEE/SMA sponsor represented by the sponsor-specific COMPOSITE; and
 - b. If the sponsor-specific COMPOSITE COMPLIANT PRESENTATION is intended for the purpose of generating WRAP FEE/SMA business and does not include performance net of the entire WRAP FEE, the COMPLIANT PRESENTATION MUST disclose that the named sponsor-specific COMPLIANT PRESENTATION is only for the use of the named WRAP FEE/SMA sponsor.

Presentation and Reporting—Requirements (the following provision does not apply: 5.A.3)

- 8.A.5. When FIRMS present performance to a WRAP FEE/SMA PROSPECTIVE CLIENT, the COMPOSITE presented MUST include the performance of all actual WRAP FEE/SMA PORTFOLIOS, if any, managed according to the COMPOSITE investment mandate, objective, or strategy, regardless of the WRAP FEE/SMA sponsor (resulting in a "style-defined COMPOSITE").
- 8.A.6. When FIRMS present performance to a WRAP FEE/SMA PROSPECTIVE CLIENT, performance MUST be presented net of the entire WRAP FEE.
- 8.A.7. FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.

II. GIPS VALUATION PRINCIPLES

The GIPS standards are based on the ethical principles of fair representation and full disclosure. In order for the performance calculations to be meaningful, the valuations of PORTFOLIO investments must have integrity and fairly reflect their value. Effective 1 January 2011, the GIPS standards REQUIRE FIRMS to apply a FAIR VALUE methodology following the definition and REQUIREMENTS listed below. The GIPS Valuation Principles, including the definition of FAIR VALUE, were developed with consideration of the work done by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as well as other organizations.

The shift to a broader FAIR VALUE REQUIREMENT has implications for all FIRMS claiming compliance with the GIPS standards. For liquid securities in active markets, the change to FAIR VALUE from MARKET VALUE will typically not result in a change to valuations. FIRMS MUST use the objective, observable, unadjusted quoted market prices for identical investments on the measurement date, if available.

Markets are not always liquid and investment prices are not always objective and/or observable. For illiquid or hard to value investments, or for investments where no observable MARKET VALUE or market price is available, additional steps are necessary. A FIRM'S valuation policies and procedures MUST address situations where the market prices may be available for similar but not identical investments, inputs to valuations are subjective rather than objective, and/or markets are inactive instead of active. There is a RECOMMENDED valuation hierarchy in Section C below. FIRMS MUST disclose if the COMPOSITE'S valuation hierarchy materially differs from the RECOMMENDED valuation hierarchy.

Although a FIRM may use external third parties to value investments, the FIRM still retains responsibility for compliance with the GIPS standards, including the GIPS Valuation Principles.

FIRMS claiming compliance with the GIPS standards MUST adhere to all the REQUIREMENTS and SHOULD comply with the RECOMMENDATIONS below.

Fair Value Definition

FAIR VALUE is defined as the amount at which an investment could be exchanged in a current arm's length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation MUST be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation MUST represent the FIRM'S best estimate of the MARKET VALUE. FAIR VALUE MUST include accrued income.

Valuation Requirements

FIRMS MUST comply with the following valuation REQUIREMENTS:

1. 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 (Provision 1.A.2) Chapter II.
2. FIRMS MUST value investments using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available.
3. FIRMS MUST comply with all applicable laws and regulations regarding the calculation and presentation of performance (Provision 0.A.2). Accordingly, FIRMS MUST comply with applicable laws and regulations relating to valuation.
4. If the COMPLIANT PRESENTATION conforms with laws and/or regulations that conflict with the REQUIREMENTS of the GIPS standards, FIRMS MUST disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards (Provision 4.A.22). This includes any conflicts between laws and/or regulations and the GIPS Valuation Principles.
5. 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 (Provision 0.A.5). Accordingly, FIRMS MUST document their valuation policies, procedures, methodologies, and hierarchy, including any changes, and MUST apply them consistently.
6. FIRMS MUST disclose that policies for valuing PORTFOLIOS, calculating performance, and preparing COMPLIANT PRESENTATIONS are available upon request (Provision 4.A.12).
7. For periods beginning on or after 1 January 2011, FIRMS MUST disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE (Provision 4.A.27).
8. 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 (Provision 4.A.28).

Additional Real Estate Valuation Requirements

9. REAL ESTATE investments MUST have an EXTERNAL VALUATION (Provision 6.A.4).
10. The EXTERNAL VALUATION process MUST adhere to practices of the relevant valuation governing and standard setting body.
11. The FIRM MUST NOT use EXTERNAL VALUATIONS where the valuer's or appraiser's fee is contingent upon the investment's appraised value.
12. EXTERNAL VALUATIONS must be performed by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser. In markets where these professionals are not available, the FIRM MUST take necessary steps to ensure that only well-qualified independent property valuers or appraisers are used (Provision 6.A.5).

2 The GIPS Standards

The GIPS Standards

13. FIRMS MUST disclose the INTERNAL VALUATION methodologies used to value REAL ESTATE investments for the most recent period (Provision 6.A.10.b).
14. For periods beginning on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies (Provision 6.A.10.c).
15. For periods beginning on or after 1 January 2011, FIRMS MUST disclose material differences between an EXTERNAL VALUATION and the valuation used in performance reporting and the reason for the differences (Provision 6.A.10.d).
16. FIRMS MUST present, as of each annual period end, the percentage of COMPOSITE assets valued using an EXTERNAL VALUATION during the annual period (Provision 6.A.16.b).

Additional Private Equity Valuation Requirements

17. The valuation methodology selected MUST be the most appropriate for a particular investment based on the nature, facts, and circumstances of the investment.
18. FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period (Provision 7.A.13).
19. For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies (Provision 7.A.14).
20. If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied (Provision 7.A.15).

Valuation Recommendations

FIRMS SHOULD comply with the following valuation RECOMMENDATIONS:

1. **Valuation Hierarchy:** FIRMS SHOULD incorporate the following hierarchy into the policies and procedures for determining FAIR VALUE for PORTFOLIO investments on a COMPOSITE-specific basis.
 - a. Investments MUST be valued using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available. If not available, then investments SHOULD be valued using;
 - b. Objective, observable quoted market prices for similar investments in active markets. If not available or appropriate, then investments SHOULD be valued using;
 - c. Quoted prices for identical or similar investments in markets that are not active (markets in which there are few transactions for the investment, the prices are not current, or price quotations vary substantially over time and/or between market makers). If not available or appropriate, then investments SHOULD be valued based on;
 - d. Market-based inputs, other than quoted prices, that are observable for the investment. If not available or appropriate, then investments SHOULD be valued based on;
 - e. Subjective unobservable inputs for the investment where markets are not active at the measurement date. Unobservable inputs SHOULD only be used to measure FAIR VALUE to the extent that observable inputs and prices are not available or appropriate.

Unobservable inputs reflect the FIRM's own assumptions about the assumptions that market participants would use in pricing the investment and SHOULD be developed based on the best information available under the circumstances.

2. FIRMS SHOULD disclose material changes to valuation policies and/or methodologies (Provision 4.B.1).
3. FIRMS SHOULD disclose the key assumptions used to value PORTFOLIO investments (Provision 4.B.4).
4. For periods prior to 1 January 2011, FIRMS SHOULD disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles in Chapter II) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE (Provision 4.B.6).
5. Valuations SHOULD be obtained from a qualified independent third party (Provision 1.B.2).

Additional Real Estate Valuation Recommendations

6. Although appraisal standards may allow for a range of estimated values, it is RECOMMENDED that a single value be obtained from external valuers or appraisers because only one value is used in performance reporting.
7. It is RECOMMENDED that the external appraisal firm be rotated every three to five years.
8. FIRMS SHOULD explain and disclose material differences between the valuation used in performance reporting and the valuation used in financial reporting as of each annual period end (Provision 6.B.4).
9. For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies (Provision 6.B.5).

Additional Private Equity Valuation Recommendations

10. FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end (Provision 7.B.3).
11. For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies (Provision 7.B.4).
12. The following considerations SHOULD be incorporated into the valuation process:
 - a. The quality and reliability of the data used in each methodology;
 - b. The comparability of enterprise or transaction data;
 - c. The stage of development of the enterprise; and
 - d. Any additional considerations unique to the enterprise.

III. GIPS ADVERTISING GUIDELINES

Purpose of the GIPS Advertising Guidelines

The GIPS Advertising Guidelines provide FIRMS with options for advertising performance when mentioning the FIRM's claim of compliance. The GIPS Advertising Guidelines do not replace the GIPS standards, nor do they absolve FIRMS from presenting a COMPLIANT PRESENTATION AS REQUIRED by the GIPS standards. These guidelines only apply to FIRMS that already satisfy all the REQUIREMENTS of the GIPS standards on a FIRM-wide basis and claim compliance with the GIPS standards in an advertisement. FIRMS that choose to claim compliance in an advertisement MUST follow the GIPS Advertising Guidelines or include a COMPLIANT PRESENTATION in the advertisement.

Definition of Advertisement

For the purposes of these guidelines, an advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, FIRM brochures, letters, media, websites, or any other written or electronic material addressed to more than one PROSPECTIVE CLIENT. Any written material, other than one-on-one presentations and individual client reporting, distributed to maintain existing clients or solicit new clients for a FIRM is considered an advertisement.

Relationship of GIPS Advertising Guidelines to Regulatory Requirements

FIRMS advertising performance MUST adhere to all applicable laws and regulations governing advertisements. FIRMS are encouraged to seek legal or regulatory counsel because additional disclosures may be REQUIRED. In cases where applicable laws and/or regulations conflict with the REQUIREMENTS of the GIPS standards and/or the GIPS Advertising Guidelines, FIRMS are REQUIRED to comply with the law or regulation.

The calculation and advertisement of pooled unitized investment vehicles, such as mutual funds and open-ended investment companies, are regulated in most markets. The GIPS Advertising Guidelines are not intended to replace applicable laws and/or regulations when a FIRM is advertising performance solely for a pooled unitized investment vehicle.

Other Information

The advertisement may include other information beyond what is REQUIRED under the GIPS Advertising Guidelines provided the information is shown with equal or lesser prominence relative to the information REQUIRED by the GIPS Advertising Guidelines and the information does not conflict with the REQUIREMENTS of the GIPS standards and/or the GIPS Advertising Guidelines. FIRMS MUST adhere to the principles of fair representation and full disclosure when advertising and MUST NOT present performance or performance-related information that is false or misleading.

Requirements of the GIPS Advertising Guidelines

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines **MUST** disclose the following:

1. The definition of the **FIRM**.
2. How a **PROSPECTIVE CLIENT** can obtain a **COMPLIANT PRESENTATION** and/or the **FIRM'S** list of **COMPOSITE DESCRIPTIONS**.
3. The GIPS compliance statement for advertisements:

“[Insert name of **FIRM**] claims compliance with the Global Investment Performance Standards (GIPS®).”

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

4. The **COMPOSITE DESCRIPTION**.
5. **COMPOSITE TOTAL RETURNS** according to one of the following:
 - a. One-, three-, and five-year annualized **COMPOSITE** returns through the most recent period with the period-end date clearly identified. If the **COMPOSITE** has been in existence for less than five years, **FIRMS** **MUST** also present the annualized returns since the **COMPOSITE INCEPTION DATE**. (For example, if a **COMPOSITE** has been in existence for four years, **FIRMS** **MUST** present one-, three-, and four-year annualized returns through the most recent period.) Returns for periods of less than one year **MUST NOT** be annualized.
 - b. Period-to-date **COMPOSITE** returns in addition to one-, three-, and five-year annualized **COMPOSITE** returns through the same period of time as presented in the corresponding **COMPLIANT PRESENTATION** with the period end date clearly identified. If the **COMPOSITE** has been in existence for less than five years, **FIRMS** **MUST** also present the annualized returns since the **COMPOSITE INCEPTION DATE** (For example, if a **COMPOSITE** has been in existence for four years, **FIRMS** **MUST** present one-, three-, and four-year annualized returns in addition to the period-to-date **COMPOSITE** return.) Returns for periods of less than one year **MUST NOT** be annualized.
 - c. Period-to-date **COMPOSITE** returns in addition to five years of annual **COMPOSITE** returns (or for each annual period since the **COMPOSITE INCEPTION DATE** if the **COMPOSITE** has been in existence for less than five years) with the period end date clearly identified. The annual returns **MUST** be calculated through the same period of time as presented in the corresponding **COMPLIANT PRESENTATION**.
6. Whether returns are presented **GROSS-OF-FEES** and/or **NET-OF-FEES**.
7. The **TOTAL RETURN** for the **BENCHMARK** for the same periods for which the **COMPOSITE** return is presented. **FIRMS** **MUST** present **TOTAL RETURNS** for the same **BENCHMARK** as presented in the corresponding **COMPLIANT PRESENTATION**.
8. The **BENCHMARK DESCRIPTION**.
9. If the **FIRM** determines no appropriate **BENCHMARK** for the **COMPOSITE** exists, the **FIRM** **MUST** disclose why no **BENCHMARK** is presented.
10. The currency used to express performance.

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11. 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.
12. For any performance presented in an advertisement for periods prior to 1 January 2000 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.
13. If the advertisement conforms with laws and/or regulations that conflict with the REQUIREMENTS of the GIPS standards and/or the GIPS Advertising Guidelines, FIRMS MUST disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards and/or the GIPS Advertising Guidelines.

IV. VERIFICATION

VERIFICATION is intended to provide a FIRM and its existing clients and PROSPECTIVE CLIENTS additional confidence in the FIRM'S claim of compliance with the GIPS standards. VERIFICATION may increase the knowledge of the FIRM'S performance measurement team and improve the consistency and quality of the FIRM'S COMPLIANT PRESENTATIONS. VERIFICATION may also provide improved internal processes and procedures as well as marketing advantages to the FIRM. Verification does not ensure the accuracy of any specific COMPOSITE presentation.

The GIPS standards RECOMMEND that FIRMS be verified. VERIFICATION brings additional credibility to the claim of compliance and supports the overall guiding principles of fair representation and full disclosure of a FIRM'S investment performance.

The VERIFICATION procedures attempt to strike a balance between ensuring the quality, accuracy, and relevance of performance presentations and minimizing the cost to FIRMS.

Scope and Purpose of Verification

1. VERIFICATION MUST be performed by a qualified independent third party.
2. VERIFICATION assesses whether:
 - a. The FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis and
 - b. The FIRM'S policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.
3. A single VERIFICATION REPORT is issued with respect to the whole FIRM. VERIFICATION cannot be carried out on a COMPOSITE and, accordingly, does not provide assurance about the performance of any specific COMPOSITE. FIRMS MUST NOT state that a particular COMPOSITE has been "verified" or make any claim to that effect.
4. The initial minimum period for which VERIFICATION can be performed is one year (or from FIRM inception date through period end if less than one year) of a FIRM'S presented performance. The RECOMMENDED period over which VERIFICATION is performed is that part of the FIRM'S performance for which compliance with the GIPS standards is claimed.
5. A VERIFICATION REPORT MUST opine that:
 - a. The FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis, and
 - b. The FIRM'S policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The FIRM MUST NOT state that it has been verified unless a VERIFICATION REPORT has been issued.
6. A principal verifier may accept the work of another verifier as part of the basis for the principal verifier's opinion. A principal verifier may also choose to rely on the audit and/or internal control work of a qualified and reputable independent third party. In addition, a principal verifier may choose to rely on the other audit and/or internal control work performed

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by the VERIFICATION firm. If reliance on another party's work is planned, the scope of work, including time period covered, results of procedures performed, qualifications, competency, objectivity, and reputation of the other party, MUST be assessed by the principal verifier when making the determination as to whether to place any reliance on such work. Reliance considerations and conclusions MUST be documented by the principal verifier. The principal verifier MUST use professional skepticism when deciding whether to place reliance on work performed by another independent third party.

7. Sample PORTFOLIO Selection: Verifiers MUST subject the entire FIRM to testing when performing VERIFICATION procedures unless reliance is placed on work performed by a qualified and reputable independent third party or appropriate alternative control procedures have been performed by the verifier. Verifiers may use a sampling methodology when performing such procedures. Verifiers MUST consider the following criteria when selecting samples:
 - a. Number of COMPOSITES at the FIRM;
 - b. Number of PORTFOLIOS in each COMPOSITE;
 - c. Type of COMPOSITE;
 - d. TOTAL FIRM ASSETS;
 - e. Internal control structure at the FIRM (system of checks and balances in place);
 - f. Number of years being verified; and
 - g. Computer applications, software used in the construction and maintenance of COMPOSITES, the use of external performance measurers, and the method of calculating performance.

This list is not all-inclusive and contains only the minimum criteria that MUST be considered in the selection and evaluation of a sample. For example, one potentially useful approach would be to include in the sample a PORTFOLIO that has the largest impact on COMPOSITE performance because of its size or because of extremely good or bad performance. Missing or incomplete documents, or the presence of errors, would normally be expected to warrant selecting a larger sample or applying additional VERIFICATION procedures.

8. After performing the VERIFICATION, the verifier may conclude that the FIRM is not in compliance with the GIPS standards or that the records of the FIRM cannot support a VERIFICATION. In such situations, the verifier MUST issue a statement to the FIRM clarifying why a VERIFICATION REPORT could not be issued. A VERIFICATION REPORT MUST NOT be issued when the verifier knows that the FIRM is not in compliance with the GIPS standards or the records of the FIRM cannot support a VERIFICATION.
9. The minimum VERIFICATION procedures are described below in Section B. The VERIFICATION REPORT MUST state that the VERIFICATION has been conducted in accordance with these VERIFICATION procedures.

Required Verification Procedures

The following are the minimum procedures that verifiers **MUST** follow when conducting a **VERIFICATION**. Verifiers **MUST** complete the **VERIFICATION** in accordance with these procedures prior to issuing a **VERIFICATION REPORT** to the **FIRM**:

1. Pre-**VERIFICATION** Procedures:
 - a. Knowledge of the GIPS Standards: Verifiers **MUST** understand all the **REQUIREMENTS** and **RECOMMENDATIONS** of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.
 - b. Knowledge of Regulations: Verifiers **MUST** be knowledgeable of applicable laws and regulations regarding the calculation and presentation of performance and **MUST** consider any differences between these laws and regulations and the GIPS standards.
 - c. Knowledge of the **FIRM**: Verifiers **MUST** gain an understanding of the **FIRM**, including the corporate structure of the **FIRM** and how it operates.
 - d. Knowledge of the **FIRM**'s Policies and Procedures: Verifiers **MUST** understand the **FIRM**'s policies and procedures for establishing and maintaining compliance with all the applicable **REQUIREMENTS** and adopted **RECOMMENDATIONS** of the GIPS standards. The verifier **MUST** obtain a copy of the **FIRM**'s policies and procedures used in establishing and maintaining compliance with the GIPS standards and ensure that all applicable policies and procedures are properly included and adequately documented.
 - e. Knowledge of Valuation Basis and Performance Calculations: Verifiers **MUST** understand the policies, procedures, and methodologies used to value **PORTFOLIOS** and compute investment performance.
2. **VERIFICATION** Procedures:
 - a. Fundamentals of Compliance: Verifiers **MUST** perform sufficient procedures to determine that:
 - i. The **FIRM** is, and has been, appropriately defined;
 - ii. The **FIRM** has defined and maintained **COMPOSITES** in compliance with the GIPS standards;
 - iii. All the **FIRM**'s actual, fee-paying, discretionary **PORTFOLIOS** are included in at least one **COMPOSITE**;
 - iv. The **FIRM**'s definition of discretion has been consistently applied over time;
 - v. At all times, all **PORTFOLIOS** are included in their respective **COMPOSITES** and no **PORTFOLIOS** that belong in a particular **COMPOSITE** have been excluded;
 - vi. The **FIRM**'s policies and procedures for ensuring the existence and ownership of client assets are appropriate and have been consistently applied;
 - vii. The **COMPOSITE BENCHMARK** reflects the investment mandate, objective, or strategy of the **COMPOSITE**;
 - viii. The **FIRM**'s policies and procedures for creating and maintaining **COMPOSITES** have been consistently applied;
 - ix. The **FIRM**'s list of **COMPOSITE DESCRIPTIONS** is complete; and
 - x. **TOTAL FIRM ASSETS** are appropriately calculated and disclosed.

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- b. Determination of Discretionary Status of PORTFOLIOS: Verifiers MUST obtain a list of all PORTFOLIOS. Verifiers MUST select PORTFOLIOS from this list and perform sufficient procedures to determine that the FIRM'S classification of the PORTFOLIOS as discretionary or non-discretionary is appropriate by referring to the PORTFOLIO'S investment management agreement and/or investment guidelines and the FIRM'S policies and procedures for determining investment discretion.
- c. Allocation of PORTFOLIOS to COMPOSITES: Verifiers MUST obtain lists of all open (both new and existing) and closed PORTFOLIOS for all COMPOSITES for the periods being verified. Verifiers MUST select PORTFOLIOS from these lists and perform sufficient procedures to determine that:
 - i. The timing of inclusion in the COMPOSITE is in accordance with policies and procedures of the FIRM.
 - ii. The timing of exclusion from the COMPOSITE is in accordance with policies and procedures of the FIRM.
 - iii. The PORTFOLIO'S investment mandate, objective, or strategy, as indicated by the PORTFOLIO'S investment management agreement, investment guidelines, PORTFOLIO summary, and/or other appropriate documentation, is consistent with the COMPOSITE DEFINITION.
 - iv. PORTFOLIOS are completely and accurately included in COMPOSITES by tracing selected PORTFOLIOS from:
 - a. The PORTFOLIO'S investment management agreement and/or investment management guidelines to the COMPOSITE(S); and
 - b. The COMPOSITE(S) to the PORTFOLIO'S investment management agreement and/or investment guidelines.
 - v. PORTFOLIOS sharing the same investment mandate, objective, or strategy are included in the same COMPOSITE.
 - vi. Movements from one COMPOSITE to another are appropriate and consistent with documented changes to a PORTFOLIO'S investment mandate, objective, or strategy or the redefinition of the COMPOSITE.
- d. Data Review: For selected PORTFOLIOS, verifiers MUST perform sufficient procedures to determine that the treatment of the following items is consistent with the FIRM'S policy:
 - i. Classification of PORTFOLIO flows (e.g., receipts, disbursements, dividends, interest, fees, and taxes);
 - ii. Accounting treatment of income, interest, and dividend accruals and receipts;
 - iii. Accounting treatment of taxes, tax reclaims, and tax accruals;
 - iv. Accounting treatment of purchases, sales, and the opening and closing of other positions; and
 - v. Accounting treatment and valuation methodologies for investments, including derivatives.
- e. Performance Measurement Calculation: Recognizing that VERIFICATION does not provide assurance that specific COMPOSITE returns are correctly calculated and presented, verifiers MUST determine that the FIRM has calculated and presented performance in accordance with the FIRM'S policies and procedures. Verifiers MUST perform the following procedures:

- i. Recalculate rates of return for a sample of PORTFOLIOS, determine that an acceptable return formula as REQUIRED by the GIPS standards is used, and determine that the FIRM'S calculations are in accordance with the FIRM'S policies and procedures. The verifier MUST also determine that any fees and expenses are treated in accordance with the GIPS standards and the FIRM'S policies and procedures.
 - ii. Take a sample of COMPOSITE and BENCHMARK calculations to determine the accuracy of all required numerical data (e.g., risk measures, INTERNAL DISPERSION).
 - iii. If a custom BENCHMARK or combination of multiple BENCHMARKS is used, take a sample of the BENCHMARK data used by the FIRM to determine that the calculation methodology has been correctly applied and the data used are consistent with the BENCHMARK disclosure in the COMPLIANT PRESENTATION.
- f. COMPLIANT PRESENTATIONS: Verifiers MUST perform sufficient procedures on a sample of COMPLIANT PRESENTATIONS to determine that the presentations include all the information and disclosures REQUIRED by the GIPS standards. The information and disclosures MUST be consistent with the FIRM'S records, the FIRM'S documented policies and procedures, and the results of the verifier's procedures.
- g. Maintenance of Records: The verifier MUST maintain sufficient documentation to support all procedures performed supporting the issuance of the VERIFICATION REPORT, including all significant judgments and conclusions made by the verifier.
- h. Representation Letter: The verifier MUST obtain a representation letter from the FIRM confirming that policies and procedures used in establishing and maintaining compliance with the GIPS standards are as described in the FIRM'S policies and procedures documents and have been consistently applied throughout the periods being verified. The representation letter MUST confirm that the FIRM complies with the GIPS standards for the period being verified. The representation letter MUST also contain any other specific representations made to the verifier during the VERIFICATION.

Performance Examinations

In addition to a VERIFICATION, a FIRM may choose to have a specifically focused PERFORMANCE EXAMINATION of a particular COMPOSITE COMPLIANT PRESENTATION. However, a PERFORMANCE EXAMINATION REPORT MUST NOT be issued unless a VERIFICATION REPORT has also been issued. The PERFORMANCE EXAMINATION may be performed concurrently with the VERIFICATION.

A PERFORMANCE EXAMINATION is not REQUIRED for a FIRM to be verified. The FIRM MUST NOT state that a COMPOSITE has been examined unless the PERFORMANCE EXAMINATION REPORT has been issued for the specific COMPOSITE.

Please see the Guidance Statement on PERFORMANCE EXAMINATIONS for additional guidance.

V. GIPS GLOSSARY

ACCRUAL ACCOUNTING	The recording of financial transactions as they come into existence rather than when they are paid or settled.
ADDITIONAL INFORMATION	Information that is REQUIRED or RECOMMENDED under the GIPS standards and is not considered SUPPLEMENTAL INFORMATION .
ADMINISTRATIVE FEE	All fees other than TRADING EXPENSES and the INVESTMENT MANAGEMENT FEE . ADMINISTRATIVE FEES include CUSTODY FEES , accounting fees, auditing fees, consulting fees, legal fees, performance measurement fees, and other related fees. (See “ BUNDLED FEE ”)
ALL-IN FEE	A type of BUNDLED FEE that can include any combination of INVESTMENT MANAGEMENT FEES , TRADING EXPENSES , CUSTODY FEES , and ADMINISTRATIVE FEES . ALL-IN-FEES are client specific and typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.
BENCHMARK	A point of reference against which the COMPOSITE ’s performance and/or risk is compared.
BENCHMARK DESCRIPTION	General information regarding the investments, structure, and/or characteristics of the BENCHMARK . The description MUST include the key features of the BENCHMARK or the name of the BENCHMARK for a readily recognized index or other point of reference.
BUNDLED FEE	A fee that combines multiple fees into one total or “bundled” fee. BUNDLED FEES can include any combination of INVESTMENT MANAGEMENT FEES , TRADING EXPENSES , CUSTODY FEES , and/or ADMINISTRATIVE FEES . Two examples of BUNDLED FEES are WRAP FEES and ALL-IN-FEES .
CAPITAL EMPLOYED (real estate)	The denominator of the return calculations and is defined as the “weighted-average equity” (weighted-average capital) during the measurement period. CAPITAL EMPLOYED does not include any INCOME RETURN or CAPITAL RETURN earned during the measurement period. Beginning capital is adjusted by weighting the EXTERNAL CASH FLOWS that occurred during the period.
CAPITAL RETURN (real estate)	The change in value of the REAL ESTATE investments and cash and/or cash equivalent assets held throughout the measurement period, adjusted for all capital expenditures (subtracted) and net proceeds from sales (added). The CAPITAL RETURN is computed as a percentage of the CAPITAL EMPLOYED . Also known as “capital appreciation return” or “appreciation return.”
CARRIED INTEREST (real estate and private equity)	The profits that GENERAL PARTNERS are allocated from the profits on the investments made by the investment vehicle. Also known as “carry” or “promote.”

CARVE-OUT	A portion of a PORTFOLIO that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multiple-strategy PORTFOLIO managed to a broader mandate. For periods beginning on or after 1 January 2010, a CARVE-OUT MUST be managed separately with its own cash balance.
CLOSED-END FUND (real estate and private equity)	A type of investment vehicle where the number of investors, total COMMITTED CAPITAL , and life are fixed and not open for subscriptions and/or redemptions. CLOSED-END FUNDS have a capital call (drawdown) process in place that is controlled by the GENERAL PARTNER .
COMMITTED CAPITAL (real estate and private equity)	Pledges of capital to an investment vehicle by investors (LIMITED PARTNERS and the GENERAL PARTNER) or by the FIRM . COMMITTED CAPITAL is typically not drawn down at once but drawn down over a period of time. Also known as “commitments.”
COMPLIANT PRESENTATION	A presentation for a COMPOSITE that contains all the information REQUIRED by the GIPS standards and may also include ADDITIONAL INFORMATION or SUPPLEMENTAL INFORMATION . (See Sample COMPLIANT PRESENTATIONS in Appendix A)
COMPOSITE	An aggregation of one or more PORTFOLIOS managed according to a similar investment mandate, objective, or strategy.
COMPOSITE CREATION DATE	The date when the FIRM first groups one or more PORTFOLIOS to create a COMPOSITE . The COMPOSITE CREATION DATE is not necessarily the same as the COMPOSITE INCEPTION DATE .
COMPOSITE DEFINITION	Detailed criteria that determine the assignment of PORTFOLIOS to COMPOSITES . Criteria may include investment mandate, style or strategy, asset class, the use of derivatives, leverage and/or hedging, targeted risk metrics, investment constraints or restrictions, and/or PORTFOLIO type (e.g., segregated or pooled, taxable versus tax exempt.)
COMPOSITE DESCRIPTION	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. (See the Sample List of Composite Descriptions in Appendix C)
COMPOSITE INCEPTION DATE	The initial date of the COMPOSITE 's performance record. The COMPOSITE INCEPTION DATE is not necessarily the same as the COMPOSITE CREATION DATE .
COMPOSITE TERMINATION DATE	The date that the last PORTFOLIO exits a COMPOSITE .
CUSTODY FEE	The fees payable to the custodian for the safekeeping of PORTFOLIO assets. CUSTODY FEES are considered to be ADMINISTRATIVE FEES and typically contain an asset-based portion and a transaction-based portion. The CUSTODY FEE may also include charges for additional services, including accounting, securities lending, and/or performance measurement. Custodial fees that are charged per transaction SHOULD be included in the CUSTODY FEE and not included as part of TRADING EXPENSES .

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DIRECT INVESTMENTS (private equity)	Investments made directly in PRIVATE EQUITY investments rather than investments made in fund investment vehicles or cash and/or cash equivalents.
DISTINCT BUSINESS ENTITY	A unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices and that retains discretion over the assets it manages and that should have autonomy over the investment decision-making process. Possible criteria that can be used to determine this include: <ul style="list-style-type: none">■ being a legal entity,■ having a distinct market or client type (e.g., institutional, retail, private client, etc.), and■ using a separate and distinct investment process.
DISTRIBUTION (real estate and private equity)	Cash or stock distributed to LIMITED PARTNERS (or investors) from an investment vehicle. DISTRIBUTIONS are typically at the discretion of the GENERAL PARTNER (or the FIRM). DISTRIBUTIONS include both recallable and non-recallable DISTRIBUTIONS.
DPI (real estate and private equity)	SINCE INCEPTION DISTRIBUTIONS divided by SINCE INCEPTION PAID-IN CAPITAL. (See “REALIZATION MULTIPLE”)
EVERGREEN FUND (private equity)	An OPEN-END FUND that allows for on-going subscriptions and/or redemptions by investors.
EX-ANTE	Before the fact.
EX-POST	After the fact.
EXTERNAL CASH FLOW	Capital (cash or investments) that enters or exits a PORTFOLIO.
EXTERNAL VALUATION (real estate)	An assessment of value performed by an independent external third party who is a qualified, PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/ APPRAISER.
FAIR VALUE	The amount at which an investment could be exchanged in a current arm’s length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation MUST be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation MUST represent the FIRM’s best estimate of the MARKET VALUE. FAIR VALUE MUST include accrued income.
FEE SCHEDULE	The FIRM’s current schedule of INVESTMENT MANAGEMENT FEES OR BUNDLED FEES relevant to the particular COMPLIANT PRESENTATION.
FINAL LIQUIDATION DATE (real estate and private equity)	The date when the last PORTFOLIO in a COMPOSITE is fully distributed.
FIRM	The entity defined for compliance with the GIPS standards. (See “DISTINCT BUSINESS ENTITY”)

FUND OF FUNDS (private equity)	An investment vehicle that invests in underlying investment vehicles. PRIVATE EQUITY FUNDS OF FUNDS predominately invest in CLOSED-END FUNDS and may make opportunistic DIRECT INVESTMENTS.
GENERAL PARTNER (real estate and private equity)	A class of partner in a LIMITED PARTNERSHIP. The GENERAL PARTNER (GP) retains liability for the actions of the LIMITED PARTNERSHIP. The GENERAL PARTNER is typically the fund manager, and the LIMITED PARTNERS (LPs) are the other investors in the LIMITED PARTNERSHIP. The GENERAL PARTNER earns an INVESTMENT MANAGEMENT FEE that typically includes a percentage of the LIMITED PARTNERSHIP'S profits. (See "CARRIED INTEREST")
GROSS-OF-FEES	The return on investments reduced by any TRADING EXPENSES incurred during the period.
GROSS-OF-FEES (real estate and private equity)	The return on investments reduced by any TRANSACTION EXPENSES incurred during the period.
INCOME RETURN (real estate)	The investment income earned on all investments (including cash and cash equivalents) during the measurement period net of all non-recoverable expenditures, interest expense on debt, and property taxes. The INCOME RETURN is computed as a percentage of the CAPITAL EMPLOYED.
INTERNAL DISPERSION	A measure of the spread of the annual returns of individual PORTFOLIOS within a COMPOSITE. Measures may include, but are not limited to, high/low, range, or STANDARD DEVIATION (asset weighted or equal weighted) of PORTFOLIO returns.
INTERNAL VALUATION (real estate)	A FIRM'S best estimate of value based on the most current and accurate information available under the circumstances. INTERNAL VALUATION methodologies include applying a discounted cash flow model, using a sales comparison or replacement cost approach, or conducting a review of all significant events (both general market and asset specific) that could have a material impact on the investment.
INVESTMENT MANAGEMENT FEE	A fee payable to the FIRM for the management of a PORTFOLIO. INVESTMENT MANAGEMENT FEES are typically asset based (percentage of assets), performance based (see "PERFORMANCE-BASED FEE"), or a combination of the two but may take different forms as well. INVESTMENT MANAGEMENT FEES also include CARRIED INTEREST.
INVESTMENT MULTIPLE (TVPI) (real estate and private equity)	TOTAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL.
LARGE CASH FLOW	The level at which the FIRM determines that an EXTERNAL CASH FLOW may distort performance if the PORTFOLIO is not valued. FIRMS MUST define the amount in terms of the value of cash/asset flow or in terms of a percentage of the PORTFOLIO assets or the COMPOSITE assets.
LIMITED PARTNER (real estate and private equity)	An investor in a LIMITED PARTNERSHIP. The GENERAL PARTNER is liable for the actions of the LIMITED PARTNERSHIP, and the LIMITED PARTNERS are generally protected from legal actions and any losses beyond their COMMITTED CAPITAL.

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LIMITED PARTNERSHIP (real estate and private equity)	The legal structure used by most PRIVATE EQUITY and REAL ESTATE CLOSED-END FUNDS. LIMITED PARTNERSHIPS are usually fixed life investment vehicles. The GENERAL PARTNER manages the LIMITED PARTNERSHIP pursuant to the partnership agreement.
LINK	<ol style="list-style-type: none">1. Mathematical Linking: The method by which sub-period returns are geometrically combined to calculate the period return using the following formula: $\text{Period return} = [(1+R_1) \times (1+R_2) \dots (1+R_n)] - 1,$where R_1, R_2, \dots, R_n are the sub-period returns for sub-period 1 through n, respectively.2. Presentational Linking: To be visually connected or otherwise associated within a COMPLIANT PRESENTATION (e.g., two pieces of information are LINKED by placing them next to each other).
MARKET VALUE	The price at which investors can buy or sell an investment at a given time multiplied by the quantity held plus any accrued income.
MUST	A provision, task, or action that is mandatory or REQUIRED to be followed or performed. (See “REQUIRE/REQUIREMENT”)
MUST NOT	A task or action that is forbidden or prohibited.
NET-OF-FEES	The GROSS-OF-FEES return reduced by INVESTMENT MANAGEMENT FEES (including PERFORMANCE-BASED FEES and CARRIED INTEREST).
OPEN-END FUND (real estate and private equity)	A type of investment vehicle where the number of investors and the total COMMITTED CAPITAL is not fixed and is open for subscriptions and/or redemptions. (See “EVERGREEN FUND”)
PAID-IN CAPITAL (real estate and private equity)	Capital inflows to an investment vehicle. COMMITTED CAPITAL is typically drawn down from LIMITED PARTNERS (or investors) over a period of time through a series of capital calls, which are at the discretion of the GENERAL PARTNER OR FIRM. PAID-IN CAPITAL is equal to the amount of COMMITTED CAPITAL that has been drawn down SINCE INCEPTION. PAID-IN CAPITAL includes DISTRIBUTIONS that are subsequently recalled by the GENERAL PARTNER OR FIRM and reinvested into the investment vehicle.
PERFORMANCE-BASED FEE	A type of INVESTMENT MANAGEMENT FEE that is typically based on the performance of the PORTFOLIO on an absolute basis or relative to a BENCHMARK.
PERFORMANCE EXAMINATION	A detailed examination of a specific COMPOSITE’S COMPLIANT PRESENTATION by an independent verifier.
PERFORMANCE EXAMINATION REPORT	A PERFORMANCE EXAMINATION REPORT is issued after a PERFORMANCE EXAMINATION has been performed and opines that a particular COMPOSITE’S COMPLIANT PRESENTATION has been prepared and presented in compliance with the GIPS standards.
PERIODICITY	The length of the time period over which a variable is measured (e.g., a variable that is measured at a monthly PERIODICITY consists of observations for each month).

PIC MULTIPLE (real estate and private equity)	SINCE INCEPTION PAID-IN CAPITAL divided by cumulative COMMITTED CAPITAL.
PORTFOLIO	An individually managed group of investments. A PORTFOLIO may be an account or pooled investment vehicle.
PRIMARY FUND (private equity)	An investment vehicle that makes DIRECT INVESTMENTS rather than investing in other investment vehicles.
PRIVATE EQUITY	Investment strategies include, but are not limited to, venture capital, leveraged buyouts, consolidations, mezzanine and distressed debt investments, and a variety of hybrids, such as venture leasing and venture factoring.
PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser (real estate)	In Europe, Canada, and parts of Southeast Asia, the predominant professional designation is that of the Royal Institution of Chartered Surveyors (RICS). In the United States, the professional designation is Member [of the] Appraisal Institute (MAI). In addition, each state regulates REAL ESTATE appraisers and registers, licenses, or certifies them based on their experience and test results.
PROPRIETARY ASSETS	Investments owned by the FIRM, the FIRM's management, and/or the FIRM's parent company that are managed by the FIRM.
PROSPECTIVE CLIENT	Any person or entity that has expressed interest in one of the FIRM's COMPOSITE strategies and qualifies to invest in the COMPOSITE. Existing clients may also qualify as PROSPECTIVE CLIENTS for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as PROSPECTIVE CLIENTS if they represent investors that qualify as PROSPECTIVE CLIENTS.
PUBLIC MARKET EQUIVALENT (PME) (private equity)	The performance of a public market index expressed in terms of an internal rate of return (IRR), using the same cash flows and timing as those of the COMPOSITE over the same time period. A PME can be used as a BENCHMARK by comparing the IRR of a PRIVATE EQUITY COMPOSITE with the PME of a public market index.
REAL ESTATE	Investments in: <ul style="list-style-type: none"> ■ wholly owned or partially owned properties; ■ commingled funds, property unit trusts, and insurance company separate accounts; ■ unlisted, private placement securities issued by private REAL ESTATE investment trusts (REITs) and REAL ESTATE operating companies (REOCs); and ■ equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where some portion of return to the investor at the time of investment is related to the performance of the underlying REAL ESTATE.
REALIZATION MULTIPLE (DPI) (real estate and private equity)	SINCE INCEPTION DISTRIBUTIONS divided by SINCE INCEPTION PAID-IN CAPITAL.
RECOMMEND/RECOMMENDATION	A suggested provision, task, or action that SHOULD be followed or performed. A RECOMMENDATION is considered to be best practice but is not a REQUIREMENT. (See "SHOULD")

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REQUIRE/REQUIREMENT	A provision, task, or action that MUST be followed or performed. (See “ MUST ”)
RESIDUAL VALUE (private equity and real estate)	The remaining equity that LIMITED PARTNERS (or investors) have in an investment vehicle at the end of the performance reporting period.
RVPI (real estate and private equity)	RESIDUAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL . (See “ UNREALIZED MULTIPLE ”)
SECONDARY FUND (private equity)	An investment vehicle that buys interests in existing investment vehicles.
SETTLEMENT DATE ACCOUNTING	Recognizing the asset or liability on the date when the exchange of cash and investments is completed.
SHOULD	A provision, task, or action that is RECOMMENDED to be followed or performed and is considered to be best practice but is not REQUIRED . (See “ RECOMMEND/RECOMMENDATION ”)
SIGNIFICANT CASH FLOW	The level at which the FIRM determines that a client-directed EXTERNAL CASH FLOW may temporarily prevent the FIRM from implementing the COMPOSITE strategy. The measure of significance MUST be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of PORTFOLIO assets (based on the most recent valuation).
SINCE INCEPTION (real estate and private equity)	From the initial cash flow of a COMPOSITE .
SINCE INCEPTION INTERNAL RATE OF RETURN (SI-IRR) (real estate and private equity)	The internal rate of return (IRR) is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. The SI-IRR is a special case of the IRR that equates the present value of all cash flows (capital calls and DISTRIBUTIONS) with the period end value. The SI-IRR is always annualized except when the reporting period is less than one year, in which case the SI-IRR is not annualized.
STANDARD DEVIATION	A measure of the variability of returns. As a measure of INTERNAL DISPERSION , STANDARD DEVIATION quantifies the distribution of the returns of the individual PORTFOLIOS within the COMPOSITE . As a measure of historical risk, STANDARD DEVIATION quantifies the variability of the COMPOSITE and/or BENCHMARK returns over time. Also referred to as “external STANDARD DEVIATION .”
SUB-ADVISOR	A third-party investment manager hired by the FIRM to manage some or all of the assets for which a FIRM has investment management responsibility.
SUPPLEMENTAL INFORMATION	Any performance-related information included as part of a COMPLIANT PRESENTATION that supplements or enhances the REQUIRED and/or RECOMMENDED provisions of the GIPS standards.

TEMPORARY NEW ACCOUNT	An account for temporarily holding client-directed EXTERNAL CASH FLOWS until they are invested according to the COMPOSITE strategy or disbursed. FIRMS can use a TEMPORARY NEW ACCOUNT to remove the effect of a SIGNIFICANT CASH FLOW on a PORTFOLIO. When a SIGNIFICANT CASH FLOW occurs in a PORTFOLIO, the FIRM may direct the EXTERNAL CASH FLOW to a TEMPORARY NEW ACCOUNT according to the COMPOSITE'S SIGNIFICANT CASH FLOW policy.
TIME-WEIGHTED RATE OF RETURN	A method of calculating period-by-period returns that negates the effects of EXTERNAL CASH FLOWS.
TOTAL FIRM ASSETS	All discretionary and non-discretionary assets for which a FIRM has investment management responsibility. TOTAL FIRM ASSETS includes assets assigned to a SUB-ADVISOR provided the FIRM has discretion over the selection of the SUB-ADVISOR.
TOTAL RETURN	The rate of return that includes the realized and unrealized gains and losses plus income for the measurement period.
TOTAL RETURN (real estate)	The rate of return, including all CAPITAL RETURN and INCOME RETURN components, expressed as a percentage of the CAPITAL EMPLOYED over the measurement period.
TOTAL VALUE (real estate and private equity)	RESIDUAL VALUE plus DISTRIBUTIONS.
TRADE DATE ACCOUNTING	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 (trade date, T+1, T+2, or T+3) satisfies the TRADE DATE ACCOUNTING REQUIREMENT for purposes of the GIPS standards. (See "SETTLEMENT DATE ACCOUNTING")
TRADING EXPENSES	The actual costs of buying or selling investments. These costs typically take the form of brokerage commissions, exchange fees and/or taxes, and/or bid–offer spreads from either internal or external brokers. Custodial fees charged per transaction SHOULD be considered CUSTODY FEES and not TRADING EXPENSES.
TRANSACTION EXPENSES (real estate and private equity)	All actual legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing PORTFOLIO investments as well as TRADING EXPENSES, if any.
TVPI (real estate and private equity)	TOTAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL. (See "INVESTMENT MULTIPLE")
UNREALIZED MULTIPLE (RVPI) (real estate and private equity)	RESIDUAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL.
VERIFICATION	A process by which an independent verifier assesses whether <ol style="list-style-type: none"> 1. the FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis and 2. the FIRM'S policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

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VERIFICATION REPORT

A VERIFICATION REPORT is issued after a VERIFICATION has been performed and opines that the FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis and that the FIRM's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

VINTAGE YEAR

(real estate and private equity)

Two methods used to determine VINTAGE YEAR are:

1. the year of the investment vehicle's first drawdown or capital call from its investors; or
2. the year when the first COMMITTED CAPITAL from outside investors is closed and legally binding.

WRAP FEE

WRAP FEES are a type of BUNDLED FEE and are specific to a particular investment product. The WRAP FEE is charged by a WRAP FEE sponsor for investment management services and typically includes associated TRADING EXPENSES that cannot be separately identified. WRAP FEES can be all-inclusive, asset-based fees and may include a combination of INVESTMENT MANAGEMENT FEES, TRADING EXPENSES, CUSTODY FEES, and/or ADMINISTRATIVE FEES. A WRAP FEE PORTFOLIO is sometimes referred to as a "separately managed account" (SMA) or "managed account."

APPENDIX A: SAMPLE COMPLIANT PRESENTATIONS

SAMPLE 1 INVESTMENT FIRM BALANCED GROWTH COMPOSITE

1 January 2002 through 31 December 2011

Year	Composite Gross Return (%)	Composite Net Return (%)	Custom		Number of Portfolios	Internal Dispersion (%)	Composite Assets (\$ M)	Firm Assets (\$ M)
			Benchmark Return (%)	Composite 3-Yr St Dev (%)				
2002	-10.5	-11.4	-11.8		31	4.5	165	236
2003	16.3	15.1	13.2		34	2.0	235	346
2004	7.5	6.4	8.9		38	5.7	344	529
2005	1.8	0.8	0.3		45	2.8	445	695
2006	11.2	10.1	12.2		48	3.1	520	839
2007	6.1	5.0	7.1		49	2.8	505	1,014
2008	-21.3	-22.1	-24.9		44	2.9	475	964
2009	16.5	15.3	14.7		47	3.1	493	983
2010	10.6	9.5	13.0		51	3.5	549	1,114
2011	2.7	1.7	0.4	7.1	54	2.5	575	1,236

Sample 1 Investment Firm claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 1 Investment Firm has been independently verified for the periods 1 January 2000 through 31 December 2010. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Notes:

1. Sample 1 Investment Firm is a balanced portfolio investment manager that invests solely in U.S.-based securities. Sample 1 Investment Firm is defined as an independent investment management firm that is not affiliated with any parent organization. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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2. The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap U.S. 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 50–70%, the typical allocation is between 55–65%. The account minimum for the composite is \$5 million.
3. The custom benchmark is 60% YYY U.S. Equity Index and 40% ZZZ U.S. Aggregate Bond Index. The benchmark is rebalanced monthly.
4. Valuations are computed and performance is reported in U.S. dollars.
5. Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Composite and benchmark returns are presented net of non-reclaimable withholding taxes. Net-of-fees returns are calculated by deducting the highest fee of 0.83% from the monthly gross composite return. The management fee schedule is as follows: 1.00% on the first \$25 million; 0.60% thereafter.
6. This composite was created in February 2000. A complete list of composite descriptions is available upon request.
7. Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year.
8. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The standard deviation is not presented for 2002 through 2010 because monthly composite and benchmark returns were not available and is not required for periods prior to 2011.

SAMPLE 2 ASSET MANAGEMENT COMPANY ACTIVE WORLD EQUITY COMPOSITE

Creation Date: 1 July 2005
Reporting Currency: EUR

Year	Gross Return (%)	XYZ Wo6rld Index Return (%)	Dispersion (Range) (%)	# of Portfolios	Composite Assets (€ M)	% of Firm Assets (%)
2011	-1.9	-0.5	0.2	6	224.9	2.1
2010	16.3	13.5	0.7	8	256.7	2.0
2009	29.0	25.8	1.5	8	205.6	1.9
2008	-39.8	-36.4	1.3	7	164.1	1.5
2007	-2.8	-2.7	n/a	≤ 5	143.7	1.2
2006	9.3	7.5	n/a	≤ 5	62.8	0.4
2005*	14.2	12.6	n/a	≤ 5	16.1	< 0.1

*Returns are for the period from 1 July 2005 (inception date) through 31 December 2005.

Compliance Statement

Sample 2 Asset Management Company claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 2 Asset Management Company has not been independently verified.

Definition of the Firm

Sample 2 Asset Management Company is an independent investment management firm that was established in 1997. Sample 2 Asset Management Company manages a variety of equity, fixed-income, and balanced assets for primarily European clients.

Policies

Sample 2 Asset Management Company's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Composite Description

The Active World Equity Composite includes accounts whose objective is to exceed the XYZ World Index by 2% over a rolling three-year period. Securities are selected using the firm's proprietary analytics tool, which selects securities expected to be the top performers from within the XYZ World Index universe. Portfolios are more concentrated, typically holding approximately 100–120 securities, versus the benchmark, which reflects the performance of more than 500 holdings. Composite returns may, therefore, have a lower correlation with the benchmark than a more diversified global equity strategy.

Benchmark

The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ country-specific developed market indices. Sources of foreign exchange rates may be different between the composite and the benchmark; however, there have not been material differences to date. Benchmark returns are net of withholding taxes.

Fees

Returns are presented gross of management fees, custodial fees, and withholding taxes but net of all trading expenses.

List of Composites

A list of all composite descriptions is available upon request.

Fee Schedule

The standard fixed management fee for accounts with assets under management of up to €50 million is 0.35% per annum; 0.25% thereafter.

Minimum Account Size

The minimum portfolio size for inclusion in the composite is €1 million.

Internal Dispersion

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross-of-fees returns of those portfolios that were included in the composite for the entire year. For those years when less than six portfolios were included in the composite for the full year, no dispersion measure is presented.

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Ex-Post Standard Deviation

The three-year annualized ex-post standard deviation of the composite and benchmark as of each year end is as follows:

Year	Composite 3-Yr St Dev (%)	Benchmark 3-Yr St Dev (%)
2011	12.9	14.6
2010	13.2	14.1
2009	17.0	16.3
2008	15.6	14.2

SAMPLE 3 REAL ESTATE: OPEN-END FUNDS/SEPARATE ACCOUNTS

Real Estate Advisors Value-Added Strategy Composite Schedule of Performance Results 1 January 2002 through 31 December 2011

Year	Composite Gross-of-Fees Returns					Composite Net-of-Fees Returns	Value-Added Benchmark Returns (Open-End Funds/ Separate Accounts)			Composite Statistics at Year End					
	Income Return (%)	Capital Return (%)	Total Return (%)	Low (%)	High (%)		Total Return (%)	Income Return (%)	Capital Return (%)	Total Return (%)	# of Portfolios	Composite Assets (HKD Million)	External Appraisal % of Composite Assets	Total Firm Assets (HKD Million)	Non-Real Estate % of Composite Assets
2002	7.9	1.9	9.9	n/a	n/a	8.8	8.4	-1.6	7.1	≤ 5	3,085	25	13,919	0	
2003	8.5	2.9	11.7	5.8	20.4	10.5	8.0	1.0	9.2	6	3,294	25	14,911	0	
2004	8.2	2.6	10.9	5.5	19.2	8.3	7.5	6.7	14.4	7	3,348	44	15,144	0	
2005	6.6	11.2	18.1	9.0	31.6	16.6	6.8	12.7	19.7	7	3,728	72	19,794	0	
2006	6.1	7.9	14.2	7.1	24.9	12.5	6.2	9.9	16.3	8	4,022	46	20,482	0	
2007	5.4	8.0	13.7	6.8	23.9	11.8	5.6	9.9	15.6	7	4,348	33	24,219	0	
2008	5.2	-11.4	-6.6	-9.8	-1.6	-8.2	5.1	-11.1	-5.9	7	3,836	100	21,447	0	
2009	7.5	2.7	10.3	5.2	18.1	7.4	7.3	3.2	10.8	7	3,371	52	16,601	0	
2010	7.2	1.7	9.0	4.2	19.5	6.9	7.8	3.1	11.1	7	2,852	38	4,516	0	
2011	7.2	2.8	10.2	5.1	17.8	8.1	7.1	3.2	10.6	7	3,457	50	17,414	5	
Annualized Returns (%)															
3 Year	7.3	1.9	9.8			7.5	7.4	3.2	10.8						
5 Year	6.5	2.9	7.1			5.0	6.6	1.4	8.2						
7 Year	6.4	2.6	9.6			7.6	6.6	4.2	10.9						
10 Year	7.0	11.2	10.0			8.1	7.0	3.5	10.7						
Since Inception	7.0	7.9	10.0			8.1	7.0	3.5	10.7						

Disclosures

Compliance Statement

Sample 3 Real Estate Advisors claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 3 Real Estate Advisors has been independently verified for the periods 1 January 2006 through 31 December 2011. The verification reports are available upon request.

Verification assesses whether 1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and 2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Firm

Sample 3 Real Estate Advisors (the "Firm"), a subsidiary of Sample 3 Capital, Inc., is based in Hong Kong and manages international real estate strategies. A list of the Firm's composite descriptions is available upon request.

The Composite

The Value-Added Strategy Composite consists of all discretionary open-end funds and separate accounts managed by the Firm using a value-added investment strategy with an equal income and appreciation focus and having a minimum portfolio size of HKD 10 million. Portfolio management will invest in only Asian multi-family, office, industrial, and retail property types that require correction or mitigation of the investments' operating, financial, redevelopment, and/or management risk(s). A moderate level of leverage ranging between 30% and 40% is used. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources.

The composite was created on 1 January 2006. The returns presented for periods prior to 2006 are not in compliance with the GIPS standards. Annual internal dispersion is presented using the high and low gross total returns for those portfolios that have been in the composite for the entire year.

Description of Discretion

The Firm has responsibility for sourcing, valuing, and managing the acquisition and disposition of assets. Although some of the Firm's separate accounts require client approval for the acquisition and disposition of assets, the Firm defines such portfolios as discretionary because its recommendations are consistent with the investment strategy and such client approvals are typically perfunctory.

Valuation

Real estate assets are internally valued by the Firm quarterly. For periods prior to 1 January 2011, assets were externally appraised by an independent appraiser at least every 36 months. Beginning 1 January 2011, assets are externally appraised annually unless client agreements stipulate otherwise, in which case such assets are appraised at least every 36 months or per the client agreement if the client agreement requires external valuation more frequently than every 36 months. The percentage of composite assets valued using an external valuation is shown for each annual period. When market circumstances dictate, the Firm may increase the frequency of external appraisals. All valuations are performed as of calendar quarter-ends.

Internal property valuations are determined by applying market discount rates to future projections of gross cash flows and capitalized terminal values over the expected holding period for each asset. To the extent leverage (debt) is used, the debt is valued separately from

the real estate. Property mortgages, notes, and loans are marked to market using prevailing interest rates for comparable property loans if the terms of existing loans preclude the immediate repayment of such loans. Due to the nature of real estate investments, valuations are based upon subjective unobservable inputs.

Basis of Accounting

All funds in the composite report their assets and liabilities on a fair value basis using International Financial Reporting Standards (IFRS).

Calculation of Performance Returns

Returns are presented in Hong Kong dollars and are net of leverage. Net-of-fee returns are net of actual investment management fees including incentive fees, which are recorded on an accrual basis. Returns include cash and cash equivalents and related interest income.

Capital expenditures, tenant improvements, and lease commissions are capitalized, included in the cost of property, and reflected in the capital return component. Income and capital returns may not equal total returns due to the compounding linking of quarterly returns. Composite returns are calculated quarterly on an asset-weighted basis using beginning-of-period values. Annual returns are calculated by linking quarterly composite returns.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Investment Management Fees

Some of the funds in the composite pay incentive fees ranging between 10% and 20% of profits in excess of a targeted SI-IRR. The standard annual investment management fee schedule for separately managed institutional accounts is as follows:

Up to HKD 30 million:	1.6%
HKD 30–50 million:	1.3%
Over HKD 50 million:	1.0%

Benchmark

The benchmark is the Value-Added Open-End Fund/Separate Account Index (the “Benchmark”). The Benchmark returns have been taken from published sources. The Benchmark is leveraged, includes various real estate property types, and excludes cash, cash equivalents, and other non-property-related assets, liabilities, income, and expenses. The extent of leverage used by the Benchmark may be different from that of the portfolios in the composite. As of 31 December 2011, the Benchmark leverage was 52%.

SAMPLE 4 REAL ESTATE: CLOSED-END FUND**2006 Value-Added Strategy Closed-End Fund Composite
Schedule of Performance Results 1 April 2006 through 31 December 2011**

Year	Composite Gross TWR			Composite NET TWR	Benchmark			# of Portfolios	Composite Assets (U.S. Million)	Leverage (%)	Composite at Year-End			Non-Real Estate % of Composite Assets
	Income Return (%)	Capital Return (%)	Total Return (%)	Total Return (%)	Income Return (%)	Capital Return (%)	Total Return (%)				External Appraisal % of Composite Assets	Total Firm Assets (U.S. Million)	% of Firm Assets	
4/06–12/06	-3.2	0.8	-2.5	-4.0	4.9	2.2	7.2	1	70	40	35	2,641	20	0
2007	2.5	3.4	6.0	4.5	5.8	1.1	7.1	1	164	45	28	3,125	18	0
2008	6.2	1.9	8.2	6.7	6.9	3.8	10.9	1	215	50	100	2,754	18	0
2009	7.4	30.7	38.6	36.1	7.0	10.2	17.4	1	256	53	44	2,142	21	0
2010	6.6	-13.7	-7.3	-8.8	6.1	-8.8	-2.5	1	111	57	28	1,873	19	0
2011	5.8	-1.5	4.3	2.8	5.4	-2.6	3.0	1	112	60	85	2,247	20	15

Year	Gross SI-IRR	Net SI-IRR	Total Committed Capital	Paid-In Capital	Cumulative Distributions	TVPI	DPI	RVPI	PIC
			(U.S. Million)	(U.S. Million)	(U.S. Million)	Multiple	Multiple	Multiple	Multiple
4/06–12/06	-2.3	-3.1	250	71	0	0.99	0.00	0.99	0.28
2007	3.7	2.2	250	161	1	1.02	0.01	1.02	0.64
2008	5.8	4.2	250	226	26	1.07	0.12	0.95	0.90
2009	18.5	15.2	250	236	76	1.41	0.32	1.08	0.94
2010	11.5	9.8	250	240	201	1.30	0.84	0.46	0.96
2011	10.8	9.1	250	245	208	1.31	0.85	0.46	0.98

TVPI (investment multiple) = total value to paid-in capital

DPI (realization multiple) = cumulative distributions to paid-in capital

RVPI (unrealized multiple) = residual value to paid-in capital

PIC (PIC multiple) = paid-in capital to committed capital

Disclosures**Compliance Statement**

Sample 4 Real Estate Managers claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 4 Real Estate Managers has been independently verified for the periods 1 January 2006 through 31 December 2011. The verification reports are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Firm

Sample 4 Real Estate Managers (the "Firm") is a registered investment adviser under the Investment Advisers Act of 1940. A list of the Firm's composite descriptions is available upon request.

The Composite

The 2006 Value-Added Strategy Closed-End Fund Composite includes a single closed-end commingled fund managed by the Firm using a value-added investment strategy with a focus

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on both income and appreciation. Portfolio management intends to invest in properties located in major markets within the United States with higher operational risk than traditional property types. The target level of leverage is 50% with a maximum allowable level of 60%. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed. The composite was created on 1 January 2006. The composite vintage year is 2006, which was determined based on the fund's first capital call in April 2006.

Description of Discretion

The Firm has complete discretion for all investment activities within the fund.

Valuation

Real estate investments are internally valued by the Firm quarterly. For periods prior to 1 January 2011, investments were externally appraised by an independent appraiser at least every 36 months. Beginning 1 January 2011, assets are externally appraised annually. The percentage of composite assets valued using an external valuation is shown for each annual period. When market circumstances dictate, the Firm may increase the frequency of external appraisals. All valuations are performed as of calendar quarter-ends. Internal investment valuations are determined by applying market discount rates to future projections of net cash flows (gross real estate cash flows less debt service) and capitalized terminal values over the expected holding period for each asset. Due to the nature of real estate investments, valuations are based upon subjective unobservable inputs.

Basis of Accounting

All assets and liabilities are reported on a fair value basis using U.S. Generally Accepted Accounting Principles for non-operating companies.

Calculation of Performance Returns and Metrics

Returns are presented in U.S. dollars and are net of leverage. Net-of-fee returns are net of actual investment management fees, including incentive fees, which are recorded on an accrual basis.

Capital expenditures, tenant improvements, and lease commissions are capitalized, included in the cost of property, and reflected in the capital return component. Income and capital returns may not equal total returns due to the compounding linking of quarterly returns. Composite time-weighted returns are calculated quarterly on an asset-weighted basis using beginning-of-period values. Annual returns are calculated by linking quarterly composite returns.

SI-IRRs are calculated using quarterly cash flows through 2010 and daily cash flows starting in 2011.

Policies for valuing portfolios, calculating performance, and preparing presentations are available upon request.

Investment Management Fees

The fund pays an incentive fee of 15% of profits if the SI-IRR exceeds a preferred return to investors of 11%. The incentive fee is calculated annually. The standard annual investment management fee schedule for separately managed institutional accounts is as follows:

Up to \$100 million:	1.50%
Over \$100 million:	1.25%

Benchmark

The benchmark is the Value-Added Closed-End Fund Index (the “Benchmark”). The Benchmark is a time-weighted return index and returns have been taken from published sources. The Benchmark is leveraged and includes various real estate investment and property types, cash and other non-property-related assets, liabilities, income, and expenses. The extent of leverage used by the Benchmark may be different from that of the fund in the composite. As of 31 December 2011, the Benchmark leverage was 60%. There is no SI-IRR benchmark available for the 2006 vintage year.

SAMPLE 5 PRIVATE EQUITY: FUND OF FUNDS BY INVESTMENT STRATEGY

ABC Fund of Funds Manager, LLC
2006 Buyout Strategy Fund of Funds Composite
Results Reported as of Calendar Year End

Year End	# of Portfolios	Gross-of-Fees SI-IRR (%)	Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)	Composite Assets (\$ Mil)	Composite % of Firm Assets
2006*	8	26.9	26.4	17.2	2,336	80.8
2007	10	18.5	17.8	10.2	2,512	83.6
2008	11	18.7	18.1	11.0	3,227	84.2
2009	13	19.6	18.9	11.5	4,518	84.8
2010	13	20.7	20.1	11.8	6,330	85.2
2011	13	21.9	21.3	11.8	9,269	86.0
2012	14	22.2	21.7	12.3	12,286	86.4
2013	14	15.1	14.4	9.6	12,346	87.7

*Partial year from 15 April 2006 (inception) through 31 December 2006.

Year End	Paid-In Capital (\$ Mil)	Cumulative Committed Capital (\$ Mil)	Since Inception Distributions	Investment Multiple (TVPI)	Realization Multiple (DPI)	Unrealized Multiple (RVPI)	PIC Multiple (PIC)
2006	1,556	3,177	1,205	1.5	0.8	0.7	0.48
2007	1,908	3,675	1,341	1.3	0.7	0.6	0.51
2008	2,371	5,166	1,623	1.4	0.7	0.7	0.45
2009	3,254	6,401	2,186	1.4	0.7	0.7	0.50
2010	4,400	8,370	2,950	1.4	0.7	0.8	0.51
2011	6,303	11,344	4,138	1.5	0.7	0.8	0.54
2012	8,167	13,713	6,513	1.5	0.8	0.7	0.69
2013	9,651	15,290	7,091	1.3	0.7	0.5	0.71

2 The GIPS Standards

The GIPS Standards

Aggregate Performance of Underlying Investments by Vintage Year Results Reported as of 31 December 2013

Vintage Year	Gross-of-Fees	
	Annualized SI-IRR (%)	Benchmark SI-IRR (%)
2006	22.3	2.5
2007	13.4	1.9
2008	26.0	7.1
2009	18.1	3.9
2010	0.7	1.0
2011	-16.2	-7.5
2012	-25.6	-19.9
2013	-49.9	-40.3

Vintage Year	Paid-In Capital (\$ Mil)	Cumulative Committed Capital (\$ Mil)	Since Inception Distributions (\$ Mil)	Investment Multiple (TVPI)	Realization Multiple (DPI)	Unrealized Multiple (RVPI)	PIC Multiple (PIC)
2006	731	724	939	3.0	1.3	1.7	1.0
2007	710	234	294	1.8	0.4	1.3	3.0
2008	1,475	1,220	1,442	2.0	1.0	1.0	1.2
2009	1,640	1,048	1,156	1.9	0.7	1.2	1.6
2010	1,896	3,695	1,124	1.9	0.6	1.4	0.5
2011	1,984	4,518	1,100	2.1	0.6	1.5	0.4
2012	680	1,998	938	2.2	1.4	0.8	0.3
2013	535	1,853	100	1.1	0.2	0.9	0.3

TVPI (investment multiple) = total value to paid-in capital

DPI (realization multiple) = cumulative distributions to paid-in capital

RVPI (unrealized multiple) = residual value to paid-in capital

PIC (PIC multiple) = paid-in capital to committed capital

Compliance Statement

ABC Fund of Funds Manager, LLC, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. ABC Fund of Funds Manager, LLC, has been independently verified for the periods 15 April 2006 through 31 December 2012.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. The verification report is available upon request.

The Firm

ABC Fund of Funds Manager, LLC, is an independent private equity investment firm with offices in New York, London, and Tokyo. The firm's list of composite descriptions, as well as information regarding the firm's policies for valuing investments, calculating performance, and preparing compliant presentations, are available upon request.

The Composite

The 2006 Buyout Strategy Fund of Funds Composite includes primary and secondary partnership investments with strategies focused on leveraged and growth-oriented buyouts primarily in the United States. Managers of partnerships are expected to focus on reducing costs, preparing companies for downturn, and providing operational improvement rather than financial engineering. Investments may be in small, medium, and large buyout partnerships, aiming to make selective commitments diversifying across stages, industries, and vintage years. Secondary deals take advantage of distressed primary partnership sales providing access to an increased mix of assets. The underlying funds are leveraged 100–300%. Private equity investments are illiquid and, therefore, if investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed. The composite was created on 31 December 2006. The vintage year is 2006 and was determined by the initial subscription date of the fund of funds.

Valuation

The firm uses valuations reported by the general partner of the investment partnerships. Given the nature of the investments, all valuations are determined using both subjective observable and subjective unobservable inputs.

Calculation of Performance Returns

The fund's SI-IRR calculation uses daily cash flows. All cash flows and values used to calculate returns are in, or have been converted to, U.S. dollars. Gross returns are net of all underlying investment partnership expenses, management fees, and carried interest but gross of ABC Fund of Funds Manager's management fees. Net returns are net of all underlying partnership fees and expenses, including ABC Fund of Funds Manager's management fees.

Investment Management Fee

ABC Fund of Funds Manager's management fee varies based on the size of the commitment and structure of the program. The management fee is 100 basis points, based on the total commitment to a fund of funds, plus a 10% carry on total gains. Net returns are calculated using actual management fees of the fund of funds and underlying funds, including performance fees.

Benchmark

The benchmark is derived from private equity dollar-weighted IRRs, and the calculation is based on the overall market return for buyout fund of funds as determined by benchmark provider GHI. Individual vintage year benchmarks are the median SI-IRR for the applicable vintage years, at 31 December 2013.

2 The GIPS Standards

SAMPLE 6 PRIVATE EQUITY: FUND OF FUNDS BY VINTAGE YEAR

Investments 2002 Fund of Funds Composite Results Reported as of Calendar Year End

Calendar Year	Gross-of-Fees SI-IRR (%)	Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)	Composite Assets (\$ Mil)	Total Firm Assets (\$ Mil)	# of Portfolios
2002*	2.5	-5.5	8.5	2.6	250	≤ 5
2003	-4.2	-12.3	-3.8	4.7	300	≤ 5
2004	12.5	6.5	14.4	7.5	350	≤ 5
2005	45.8	40.8	42.7	24.2	400	≤ 5
2006	35.6	31.5	30.2	21.6	450	≤ 5
2007	22.2	19.3	13.5	14.7	500	≤ 5
2008	17.4	15.5	8.1	11.8	550	≤ 5
2009	17.3	15.3	7.5	11.0	600	≤ 5
2010	16.5	14.8	8.0	9.3	650	≤ 5
2011	15.9	13.5	8.5	8.1	700	≤ 5
2012	16.8	14.0	10.3	6.5	750	≤ 5

*Returns are for the period from 1 May 2002 (inception date) through 31 December 2002.

Calendar Year	Cumulative Committed Capital (\$ Mil)	Paid-In Capital (\$ Mil)	Cumulative Distributions (\$ Mil)	DPI	RVPI	TVPI	PIC
2002	20	3	0	0.00	1.04	1.04	0.15
2003	20	5	0	0.00	0.93	0.93	0.25
2004	20	8	2	0.22	0.94	1.16	0.40
2005	20	15	4	0.23	1.62	1.85	0.75
2006	20	17	12	0.71	1.25	1.96	0.85
2007	20	18	16	0.89	0.82	1.71	0.90
2008	20	19	17	0.89	0.62	1.51	0.95
2009	20	19	19	0.99	0.57	1.56	0.96
2010	20	20	23	1.18	0.47	1.65	0.98
2011	20	20	25	1.25	0.41	1.66	1.00
2012	20	20	29	1.45	0.33	1.78	1.00

Underlying Partnership Investments by Strategy
Results Reported as of 31 December 2012

Investment Strategy	SI-IRR Gross- of-Fees (%)	Benchmark Return (%)	Committed Capital (\$ Mil)	Paid-In Capital (\$ Mil)	Cumulative Distributions (\$ Mil)	Assets (\$ Mil)	DPI Multiple	RVPI Multiple	TVPI Multiple	PIC Multiple
Venture Capital	65.3	32.6	8.0	8.0	16.0	2.0	2.0	0.3	2.3	1.0
Buyout	11.3	10.2	12.0	12.0	13.0	4.5	1.1	0.4	1.5	1.0

Disclosures

Sample 6 Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 6 Investments has not been independently verified.

Sample 6 Investments is an independent private equity manager of fund of funds strategies with offices in Zurich, Menlo Park, New York, and Hong Kong. The composite was created in May 2002 and includes one closed-end fund that invests in buyout and venture capital funds. The fund of funds has an 8–10 year investment time horizon, but it may be longer based on the life of the underlying funds, which may be extended due to changes in investment and/or exit opportunities. As more fully described in the fund's offering memorandum, primary risks include industry and geographic concentration depending on investment opportunities, and liquidity risks due to the nature of the fund's investments.

The composite's vintage year is 2002, which was determined using the date of the initial capital call of the fund of funds. Returns are presented in U.S. dollars.

The 2002 Fund of Funds Composite complies with PQR's valuation guidelines, which are consistent with the GIPS Valuation Principles. Valuations are normally based on valuations provided by the manager of the underlying investments' partnerships. Because fund investments are not publicly traded, all investments are considered to be valued using subjective unobservable inputs.

All returns for the 2002 Fund of Funds Composite reflect the deduction of administrative expenses (legal, auditing, etc.) of the closed-end fund. Gross returns do not reflect the deduction of Sample 6 Investments' management fees. Net returns reflect the deduction of actual management fees and accrued carried interest, if any.

The fund's SI-IRR calculation incorporates daily cash flows. Sample 6 Investments' annual management fee is 1% on the total committed capital.

The Vendor ABC Private Equity Fund of Funds Index (vintage year 2002) is used as the benchmark.

A complete list of the firm's composite descriptions is available upon request, as are policies for valuing portfolios, calculating performance, and preparing compliant presentations.

2 The GIPS Standards

SAMPLE 7 PRIVATE EQUITY: PRIMARY FUND VEHICLE

Private Equity Capital Management
2001 Venture Capital Composite
Results Reported as of 31 December

Year End	Paid-In Capital (AUD Mil)	Since Inception Distributions (AUD Mil)	Cumulative Committed Capital (AUD Mil)	Composite Assets (AUD Mil)	% of Firm Assets
2001*	40.3	0.0	175.0	38.5	64.2
2002	82.3	1.0	175.0	78.8	52.5
2003	129.5	29.9	175.0	105.0	58.3
2004	143.5	42.3	175.0	120.8	41.6
2005	157.5	97.0	175.0	119.0	37.8
2006	166.2	129.3	175.0	112.0	31.1
2007	171.5	184.7	175.0	98.0	28.0
2008	182.5	184.7	175.0	78.8	21.0
2009	182.5	184.7	175.0	49.0	11.9
2010	182.5	184.7	175.0	31.5	7.5
2011	182.5	205.8	175.0	5.2	1.1

*Returns are for the period from 3 February 2001 (inception date) through 31 December 2001.

Year End	TVPI	DPI	RVPI	PIC	Composite Gross-of-Fees SI-IRR (%)	Composite Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)
2001	0.96	0.00	0.96	0.23	-7.5	-9.5	-12.5
2002	0.97	0.01	0.96	0.47	0.3	-1.6	-3.5
2003	1.04	0.23	0.81	0.74	4.1	2.3	1.2
2004	1.14	0.29	0.84	0.82	8.2	6.4	7.4
2005	1.37	0.62	0.76	0.90	11.0	9.3	8.2
2006	1.45	0.78	0.67	0.95	13.0	10.1	9.7
2007	1.65	1.08	0.57	0.98	18.1	12.3	11.4
2008	1.44	1.01	0.43	1.04	16.9	10.4	10.1
2009	1.28	1.01	0.27	1.04	14.9	8.7	7.2
2010	1.18	1.01	0.17	1.04	14.0	7.7	6.8
2011	1.16	1.13	0.03	1.04	11.2	6.2	5.5

TVPI = Total Value to Since Inception Paid-In Capital

DPI = Since Inception Distributions to Since Inception Paid-In Capital

PIC = Since Inception Paid-In Capital to Cumulative Committed Capital

RVPI = Residual Value to Since Inception Paid-In Capital

Disclosures

Compliance Statement

Private Equity Capital Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Private Equity Capital Management has been independently verified for the periods 3 February 2001 through 31 December 2010.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The 2001 Venture Capital Composite has been examined for the periods 1 January 2005 through 31 December 2010. The verification and performance examination reports are available upon request.

Firm & Composite

Private Equity Capital Management ("PECM") is an independent private equity investment firm with offices in New York, London, and Sydney. The 2001 Venture Capital Composite includes one fund, whose objective is to seek long-term capital appreciation by acquiring minority interests in early-stage technology companies. The fund invests in technology companies in Europe, Asia Pacific, and emerging markets. European venture investments are more concentrated than in the other regions and are focused in a few high-quality companies. Exit opportunities include IPOs, trade sales, and secondary sales. Opportunities in China and India will be targeted for investment, and an allocation to Chinese high-tech will be at least 10% of the invested capital over the life of the fund. International venture capital investments are generally illiquid and are subject to currency risk. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed. The 2001 Venture Capital Composite was created in 2001. The vintage year of the composite is 2001 and was determined by the year of the first drawdown. The firm's list of composite descriptions and the firm's policies for calculating performance and preparing compliant presentation are available upon request.

Input Data & Calculation

The 2001 Venture Capital Composite complies with the LMN Venture Capital Association's valuation guidelines as well as the GIPS Valuation Principles. Valuations are prepared by PECM's valuation committee and reviewed by an independent advisory board. All investments within the composite are valued using either a most recent transaction or an earnings multiple. Policies for valuing investments are available upon request. Due to the nature of private equity investments, all investments are valued using subjective unobservable inputs.

The SI-IRR calculation incorporates monthly cash flows for periods prior to 31 December 2009 and daily cash flows thereafter. Performance is expressed in Australian dollars (AUD).

Gross returns are net of transaction expenses and all administrative expenses. Net returns are net of transaction expenses, administrative expenses, management fees, and carried interest. The standard fee schedule currently in effect is as follows:

The manager will receive an annual management fee equal to 2% of capital commitments. The manager's participation in profits (carried interest) begins after the limited partners have been provided an 8% preferred return. The manager collects 20% of the distributed profits from that point forward. Subsequently, if the amount of cumulative carried interest exceeds 20% of the net cumulative gains, the manager will repay the excess amount to the fund for distribution to the limited partners.

2 The GIPS Standards

The GIPS Standards

There is only one fund in the composite for all periods; therefore, the internal dispersion of portfolio returns is not applicable.

Benchmark

The benchmark return is derived from private equity dollar-weighted IRRs, and the calculation is based on the overall market return for international venture capital funds as published by Benchmark Provider GHI. Vintage year benchmarks are median returns for the applicable vintage year, as of each year end.

SAMPLE 8 INVESTMENTS LARGE-CAP SMA COMPOSITE

1 January 2001 through 31 December 2010							
Year	Net Return (%)	XYZ Index Return (%)	Internal Dispersion (%)	As of 31 December			
				Number of Portfolios	Composite Assets (\$ Millions)	Firm Assets (\$ Millions)	% of SMA Portfolios
2010	8.4	10.2	0.7	1,834	2,125	18,222	100
2009	21.1	21.1	1.1	1,730	2,130	17,635	100
2008	-39.7	-39.8	1.0	1,631	2,141	19,246	100
2007	1.4	6.2	1.2	1,532	2,127	14,819	100
2006	11.4	10.5	0.9	1,428	2,116	12,362	100
2005	1.0	4.3	0.8	68	1,115	12,051	0
2004	6.8	4.9	1.0	52	1,110	13,419	0
2003	23.9	27.0	1.1	46	990	10,612	0
2002	-24.4	-19.1	0.9	38	975	9,422	0
2001	-17.7	-12.8	0.8	41	870	8,632	0

Notes:

- Sample 8 Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 8 Investments has been independently verified for the period from 1 April 1996 through 31 December 2009. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Large Cap SMA Composite has been examined for the period from 1 January 2006 through 31 December 2009. The verification and performance examination reports are available upon request.
- Sample 8 Investments is an independent investment adviser registered under the Investment Advisers Act of 1940, was founded in March 1996, and manages global large-cap equity, fixed-income, and balanced strategies.
- Beginning 1 January 2006, the composite includes only wrap fee (SMA) portfolios benchmarked to the XYZ Index. Performance results prior to 2006 are based on the Large-Cap Institutional Composite returns.
- The Large-Cap SMA Composite is composed of portfolios invested in U.S. equities which have a market capitalization greater than \$5 billion.

5. The composite was created in February 2006. A list of composite descriptions is available upon request.
6. All returns are expressed in U.S. dollars. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
7. The XYZ Index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested and includes the reinvestment of income. The returns for the index do not include any trading costs, management fees, or other costs. Index returns have been taken from published sources.
8. "Pure" gross returns, presented below as supplemental information, from 2006 through 2010 do not reflect the deduction of any trading costs, fees, or expenses and are presented for comparison purposes only. "Pure" gross returns prior to 2006 reflect the deduction of trading costs. The SMA fee includes all charges for trading costs, portfolio management, custody, and other administrative fees. Net returns are calculated by subtracting the highest applicable SMA fee (2.50% on an annual basis, or 0.21% monthly) on a monthly basis from the "pure" gross composite monthly return. The standard fee schedule in effect is as follows: 2.50% on total assets.
9. The dispersion is measured by the equal-weighted standard deviation of annual returns of those portfolios that are included in the composite for the full year.
10. At 31 December 2010, the three-year annualized ex-post standard deviation of the composite and the benchmark are 12.3% and 13.2%, respectively.
11. Past performance is not an indicator of future results.

Supplemental Information			
Year	"Pure" Gross Return* (%)	Net Return (%) Assuming 3% SMA Fees	Net Return (%) Assuming 2% SMA Fees
2010	11.1	7.9	9.0
2009	24.0	20.5	21.7
2008	-38.0	-40.1	-39.4
2007	4.0	0.9	2.0
2006	14.1	10.8	11.9
2005	3.5	0.5	1.5
2004	9.5	6.3	7.4
2003	26.9	23.3	24.5
2002	-22.3	-24.8	-23.9
2001	-15.5	-18.1	-17.2

* "Pure" gross-of-fees returns do not reflect the deduction of any expenses, including trading costs. "Pure" gross-of-fees returns are supplemental to net returns.

APPENDIX B: SAMPLE ADVERTISEMENTS

1. SAMPLE ADVERTISEMENT WITHOUT PERFORMANCE

Generic Asset Management

Generic Asset Management is the institutional asset management division of Generic Inc. and is a registered investment advisory firm specializing in qualitative growth-oriented investment management.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write to Generic Asset Management, 123 Main Street, Returnsville 12345, or jpaul@genericassetmanagement.com.

2. SAMPLE ADVERTISEMENT INCLUDING ONE-, THREE-, AND FIVE-YEAR ANNUALIZED RETURNS

Generic Asset Management: Global Equity Growth Composite

	Ending 31 Mar 2012		
	1-Year	3-Year Annualized	5-Year Annualized
Global Equity Growth Composite	-0.3%	13.7%	0.1%
XYZ World Index	-0.5%	13.8%	-0.6%

Note: Returns are shown in U.S. dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write Generic Asset Management, One Plain Street, Returnsville 12345, or jpaul@genericassetmanagement.com.

3. SAMPLE ADVERTISEMENT INCLUDING PERIOD-TO-DATE AND ONE-, THREE-, AND FIVE-YEAR ANNUALIZED RETURNS

Generic Asset Management: Global Equity Growth Composite				
	Ending 31 Mar 2012	Ending 31 Dec 2011		
	Period to Date (3 months)	1-Year	3-Year Annualized	5-Year Annualized
Global Equity Growth Composite	-3.84%	1.3%	15.0%	-1.2%
XYZ World Index	-4.94%	1.5%	14.1%	-0.7%

Note: Returns are shown in U.S. dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write Generic Asset Management, One Plain Street, Returnsville 12345, or jpaul@genericassetmanagement.com.

4. SAMPLE ADVERTISEMENT INCLUDING FIVE YEARS OF ANNUAL RETURNS

Generic Asset Management: Global Equity Growth Composite						
	Period to Date (3 months to 31 Mar 2012)	Annual Returns Periods Ended 31 December				
		2011	2010	2009	2008	2007
Global Equity Growth Composite	-3.84%	1.3%	13.0%	33.0%	-40.6%	9.6%
XYZ World Index	-4.94%	1.5%	11.8%	30.8%	-40.3%	9.6%

Note: Returns are shown in U.S. dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative, growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®).

To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write to Generic Asset Management, 123 Main Street, Returnsville 12345, or jpaul@genericasset-managment.com.

APPENDIX C: SAMPLE LIST OF COMPOSITE DESCRIPTIONS

1. Unconstrained Activist U.K. Equity Composite

The Unconstrained Activist U.K. Equity Composite includes all institutional portfolios invested in both listed and unlisted U.K. equities that pursue an activist investment policy; there is no restriction on the market capitalization of companies held. Portfolios within this composite are highly concentrated, holding approximately 15 securities, so returns may have lower correlation with the benchmark than a fully diversified strategy. In times of increased market volatility, the composite characteristics may change significantly and stock liquidity could be reduced. Due to their more concentrated nature, portfolios will tend to have more stock-specific risk than a more diversified strategy. Portfolios can use both exchange-traded and OTC derivative contracts for efficient portfolio management, which may expose the strategy to counterparty risk. The benchmark is the FTSE All Share® Index.

2. 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+).

3. U.K. Liquidity Plus Composite

The U.K. 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 U.K. 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, the three-month LIBOR rate. The U.K. 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.

4. Socially Responsible Investment (SRI) Composite

The Socially Responsible Investment Composite includes all segregated institutional and pooled portfolios that invest in global equity securities issued by companies that make a positive contribution to society and the environment through sustainable and socially responsible practices. The strategy aims to provide long-term capital appreciation together with a growing income stream through investment in a portfolio of core equity holdings diversified by economic sector, industry group, and geographic business concentration. All foreign currency exposures are fully hedged back to U.S. dollars.

The SRI process tends to screen out certain companies and sectors, which may result in a more concentrated strategy than a fully diversified strategy. Changes in legislation, scientific thinking, national and supra-national policies, and behaviors could significantly affect the stocks of companies held within the strategy. The benchmark is the Morningstar Ethical/SRI Global GIF Sector peer group.

2 The GIPS Standards

5. 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 employed. The benchmark is the Barclays Capital Global Aggregate Bond Index.

6. 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 U.S. 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 ReturnSM.

7. Large Cap Equity Growth Composite

The Large Cap Equity Growth Composite includes all institutional portfolios that invest in large capitalization U.S. stocks that are considered to have growth in earnings prospects that is 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%.

8. Balanced Growth Composite

The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap U.S. 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%.

9. Currency Overlay Composite

The Currency Overlay Composite includes all institutional and retail portfolios invested in a broad range of foreign-currency-denominated deposits or instruments, such as forward contracts, futures, or foreign exchange derivatives. The principal investment objective is alpha generation through currency appreciation and/or risk mitigation from adverse movements in exchange rates where the original currency exposure stems from a global or international

portfolio. Hedging strategies may range from passive to fully active. Currency-related investing carries inherent risks due to changes in macroeconomic policy, which can be amplified in the case of emerging markets, where political regime shifts and changes in the control of capital may be more prevalent. In volatile periods, liquidity and correlations between currencies may change expected returns drastically. Foreign exchange forwards and derivatives traded over the counter have counterparty default risk.

10. Asian Market Neutral Composite

The Asian Market Neutral Composite includes a single hedge fund with a market neutral strategy that invests in publically traded Asian equities with a market capitalization greater than \$500 million. The strategy uses a risk controlled quantitative screening and optimization process that invests at least 85% of the net asset value in long equity positions and at least 85% of the net asset value in short equity positions. The long portion of the strategy will overweight those securities that have been quantitatively identified as potentially exhibiting superior and sustainable earnings growth compared with the market; conversely, the short portion of the strategy will consist of securities that have been identified as having inferior growth prospects or that may also be adversely affected by either specific events or by momentum considerations. The principal objective of the strategy is to outperform the return on three-month U.S. Treasury Bills through active trading of long and short equity positions.

The Asian Market Neutral strategy seeks to dollar balance exposures between long and short positions so that broad market movements are neutralized. In certain market conditions, the investment process behind the strategy can give rise to unmatched country, sector, industry, market capitalization, and/or style bias exposures in the portfolio. The active trading strategy will involve significantly greater stock turnover when compared with passive strategies.

11. 2001 Venture Capital Composite

The 2001 Venture Capital Composite includes one fund, whose objective is to seek long-term capital appreciation by acquiring minority interests in early-stage technology companies. The fund invests in technology companies in Europe, Asia Pacific, and emerging markets. European venture investments are more concentrated than in the other regions and are focused in a few high-quality companies. Exit opportunities include IPOs, trade sales, and secondary sales. Opportunities in China and India will be targeted for investment, and an allocation to Chinese high-tech will be at least 10% of the invested capital over the life of the fund. International venture capital investments are generally illiquid and are subject to currency risk. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed.

12. 2006 Buyout Strategy Fund of Funds Composite

The 2006 Buyout Strategy Fund of Funds Composite includes primary and secondary partnership investments with strategies focused on leveraged and growth-oriented buyouts primarily in the United States. Managers of partnerships are expected to focus on reducing costs, preparing companies for downturn, and providing operational improvement rather than financial engineering. Investments may be in small, medium, and large buyout partnerships, aiming to make selective commitments diversifying across stages, industries, and vintage years. Secondary deals take advantage of distressed primary partnership sales providing access to an increased mix of assets. The underlying funds are leveraged 100–300%. Private equity investments are illiquid and, therefore, if investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed.

13. Value-Added Strategy Non-Closed-End Real Estate Composite

The Value-Added Strategy Composite consists of all discretionary open-end funds and separate accounts managed by the Firm using a value-added investment strategy with an equal income and appreciation focus and having a minimum portfolio size of \$10 million. Portfolio management will invest in multi-family, office, industrial, and retail property types only within Asia that require correction or mitigation of the investments' operating, financial, redevelopment, and/or management risk(s). A moderate level of leverage ranging between 30% and 40% is used. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources.

14. Value-Added Strategy Closed-End Real Estate Composite

The Value-Added Strategy Composite includes a single closed-end commingled fund managed by the Firm using a value-added investment strategy with a focus on both income and appreciation. Portfolio management intends to invest in properties located in major markets within the United States with higher operational risk than traditional property types. The target level of leverage is 50% with a maximum allowable level of 60%. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed.

15. U.S. Core Equity Composite (Terminated Composites)

The U.S. Core Equity Composite includes all institutional portfolios and pooled funds managed to a GARP (growth at a reasonable price) strategy through investment in a high-quality, focused portfolio of domestic, large-capitalization stocks that are expected to generate returns above the S&P 500[®] Index over a market cycle. Sample Asset Management Firm uses a quantitative screening process together with fundamental research and then overlays macroeconomic factors and economic sector exposures to construct portfolios. The benchmark is the S&P 500 Index. Quantitative-driven investment screening relies on historical stock correlations, which can be adversely affected during periods of severe market volatility. The composite terminated in March 2009.

Detailed composite definitions are available upon request.

3 EXPLANATION OF THE PROVISIONS OF THE GIPS STANDARDS

3-0

3-0 FUNDAMENTALS OF COMPLIANCE

Fundamentals of Compliance—Requirements

Provision O.A.1

FIRMS MUST comply with all the REQUIREMENTS of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.

Discussion

The GIPS standards are ethical standards for investment performance presentation to ensure fair representation and full disclosure of a firm's performance. Firms must comply with all the requirements of the GIPS standards, including the provisions of the GIPS standards as well as any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*. Firms must review all of the provisions and other requirements of the GIPS standards to determine the applicability of each of the requirements.

Firms must also create policies and procedures to monitor and identify changes to all of the updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee.

The GIPS standards must be applied with the objectives of full disclosure and fair representation of investment performance. Meeting the objectives of full disclosure and fair representation will likely require more than compliance with the minimum requirements of the GIPS standards. If a firm applies the GIPS standards in a performance 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. To fully explain the performance included in a compliant presentation, firms are encouraged to present all relevant additional information and supplemental information in addition to the required disclosure and presentation items.

Editor's note: Words appearing in small capital letters are defined in the GIPS Glossary in Chapter 2, Section 5, which serves as a reference and provides authoritative definitions of key words and terms in the GIPS standards.

Provision 0.A.2

FIRMS MUST comply with all applicable laws and regulations regarding the calculation and presentation of performance.

Discussion

The GIPS standards provide an ethical framework for the calculation and presentation of the investment performance history of a firm. Firms must comply with all applicable laws and regulations regarding the calculation and presentation of performance in the country or countries in which they are domiciled as well as those countries in which they do business. Firms must create policies and procedures to ensure that they adhere to all applicable laws and regulations regarding the calculation and presentation of performance. Firms must also have policies and procedures to identify and monitor changes and additions to laws and regulations regarding the calculation and presentation of performance.

Compliance with applicable laws and regulations does not necessarily result in compliance with the GIPS standards. Firms claiming compliance must comply with the GIPS standards and all applicable laws and regulations, unless there is a conflict. In the rare cases where laws and regulations conflict with the GIPS standards, firms are required to comply with the laws and regulations and disclose the manner in which the laws and/or regulations conflict with the GIPS standards.

Provision 0.A.3

FIRMS MUST NOT present performance or performance-related information that is false or misleading.

Discussion

The underlying principles of the GIPS standards, fair representation and full disclosure, help to ensure that prospective clients and existing clients are not given performance or performance-related information that is incomplete, inaccurate, biased, or fraudulent. Firms must not present any performance or performance-related information that is known to be inaccurate or may mislead prospective or existing clients. This concept applies to all performance or performance-related materials on a firm-wide basis and is not limited to those materials that reference the GIPS standards. For example, the following items are misleading and unrepresentative; therefore, firms are prohibited from presenting this information (unless specifically requested by a prospective or current client in a one-on-one presentation):

1. Model, hypothetical, back-tested, or simulated results linked to actual performance results;
2. Non-portable performance from a prior firm linked to current ongoing results;
3. Comparing performance to an inappropriate benchmark; and
4. Selectively presenting (i.e., cherry-picking) performance periods.

This is not an exhaustive list and is only provided to show examples of misleading information.

Additionally, even with the tightest of controls, there are occasions when a firm might discover that performance or performance-related information contains a material error. While the Guidance Statement on Error Correction only addresses how firms should handle errors related to compliant presentations, firms should consider this guidance when establishing policies and procedures related to addressing errors in other marketing materials.

Firms must establish policies and procedures to ensure that performance and performance-related information does not include false or misleading information.

Q&A

1. *The GIPS standards state that firms must not present performance or performance-related information that is false or misleading. Does this requirement apply only to information that is included in compliant presentations?*

No. A firm that claims compliance with the GIPS standards has an ethical obligation to present investment performance that is based on the fundamental principles of fair representation and full disclosure. This applies to performance and performance-related materials on a firm-wide basis and is not limited to those materials that reference the GIPS standards.

2. *We discovered a material error in composite performance that was included in our compliant presentation. The GIPS standards state that a firm must not present performance or performance-related information that is false or misleading. Have we violated the GIPS standards by presenting false information? Should we stop claiming GIPS compliance until the compliant presentation is corrected and distributed as necessary?*

The fundamental principles of the GIPS standards are fair representation and full disclosure. A firm must not knowingly present false or misleading information. Even with the tightest of controls, errors may occur in a compliant presentation. The firm must promptly correct the error in accordance with the firm's documented error correction policy. Firms that follow the Guidance Statement on Error Correction may continue to claim compliance with the GIPS standards. However, if a material error occurs, the firm must determine whether it is appropriate to continue to claim compliance. Firms must also consider any regulatory requirements that may apply in this situation.

Provision 0.A.4

The GIPS standards **MUST** be applied on a **FIRM**-wide basis.

Discussion

The GIPS standards provide an ethical framework for the calculation and presentation of the investment performance history of a firm. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries for determining total firm assets. Only firms or organizations that manage actual assets may claim compliance with the GIPS standards. This includes plan sponsors, foundations, endowments, and similar entities that manage discretionary assets either internally and/or via third-party sub-advisors.

3 Explanation of the Provisions of the GIPS Standards

A firm must comply with all the requirements of the GIPS standards to claim compliance. Compliance cannot be met on a composite or product basis but can only be met on a firm-wide basis. As the first step in complying with the GIPS standards, the firm must be defined fairly and appropriately. Compliance with the GIPS standards relies on a clear and consistent definition of the firm. The definition of the firm delineates the universe of “all” portfolios that must be included in total firm assets. Once the definition of the firm is clearly established, all actual, fee-paying, discretionary portfolios that have been part of the defined firm at any time during the period for which the firm claims compliance must be placed in composites. Compliant presentations, which contain the required disclosure and presentation items (including the claim of compliance), are then created and distributed to prospective clients. The GIPS standards require that the definition of the firm be disclosed in compliant presentations.

For firms that choose to have a verification performed, the verification procedures require that verifiers perform sufficient procedures to determine that the firm is, and has been, appropriately defined.

Q&A

1. *Our firm definition includes both equity and fixed income products. Can we present only our equity products (strategies) in compliance with the GIPS standards?*

No. The claim of compliance is a firm-wide claim disclosed in compliant presentations and, if the firm chooses, in advertisements. The firm described above has been defined to include both equity and fixed income products. As such, the firm must make the claim of compliance in all compliant presentations; in this case, the firm must create composites for all equity and fixed income composites. Firms must also be able to create a compliant presentation for all composites within the defined firm. Additionally, the firm must ensure it has adhered to all of the requirements of the GIPS standards prior to making the claim of compliance.

2. *Our firm is a pension plan sponsor, responsible for managing assets of our organization's pension plan. We have discretionary authority to manage the assets. For those asset classes for which we do not have in-house expertise, we hire third-party managers as sub-advisors for those assets. May we claim compliance with the GIPS standards?*

Yes. An organization that manages actual assets may claim compliance with the GIPS standards. This includes plan sponsors, foundations, endowments, and similar entities that manage discretionary assets either internally and/or via third-party sub-advisors. The use of a sub-advisor does not impact the ability of a firm to claim compliance with the GIPS standards, provided the firm has discretion over the selection of the sub-advisor. For periods beginning on or after January 1, 2006, a firm must disclose the use of a sub-advisor and the periods for which a sub-advisor was used. To claim compliance, the organization must adhere to all the requirements of the GIPS standards, including any updates, Guidance Statements (including the Guidance Statement on Definition of the Firm), interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.

Provision 0.A.5

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.

3-0**Discussion**

Policies and procedures are essential to implementing adequate business controls at all stages of the investment performance process—from data input to presentation material—to ensure the validity of the claim of compliance. A firm must document all of the policies and procedures it follows for meeting the requirements of the GIPS standards, as well as any recommendations the firm has chosen to adopt. Policies and procedures can be documented in either hard copy or electronic format. There is no requirement to create and document policies and procedures to comply with provisions or other requirements of the GIPS standards that do not apply to the firm. However, firms must actively make a determination about the applicability of all the provisions or other requirements of the GIPS standards and document their policies and procedures accordingly.

Once a firm establishes its policies, those policies must be consistently applied. Policies and procedures should be reviewed on a regular basis to determine if they should be changed or improved, but it is not expected that they will change frequently. A firm must not change a policy retroactively solely to increase performance or to present the firm in a better light. Furthermore, retroactive changes to policies and procedures should be avoided.

Firms must create and document policies and procedures to ensure that the firm's composites and total firm assets properly reflect only actual assets managed by the firm. Firms must also consider any laws and regulations with regard to ensuring the existence and ownership of client assets.

Q&A

1. *The GIPS standards require firms to 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 to apply them consistently. What qualifies as a procedure that will ensure the existence and ownership of client assets?*

Only actual, discretionary assets managed by the firm may be included in composites. Performance that is based on model or hypothetical portfolios must not be included in composites. A firm's policies and procedures might include obtaining custodian statements, broker statements, and trade confirmations and performing timely reconciliations between the firm's records and the custodian's and broker's records. Certain investment types (e.g., limited partnership interests, derivatives, real estate, and private equity) may require alternative documentation to establish the ownership and existence of client assets, as custody and broker records may not exist.

3 Explanation of the Provisions of the GIPS Standards

3-0

Provision 0.A.6

If the FIRM does not meet all the REQUIREMENTS of the GIPS standards, the FIRM MUST NOT represent or state that it is “in compliance with the Global Investment Performance Standards except for...” or make any other statements that may indicate partial compliance with the GIPS standards.

Discussion

When the firm makes the claim of compliance, it is indicating that all of the applicable requirements of the GIPS standards have been met on a firm-wide basis. Either a firm meets all of the applicable requirements of the GIPS standards and may claim compliance, or a firm does not meet all of the applicable requirements of the GIPS standards and must not claim compliance with the GIPS standards.

Provision 0.A.7

Statements referring to the calculation methodology as being “in accordance,” “in compliance,” or “consistent” with the Global Investment Performance Standards, or similar statements, are prohibited.

Discussion

Compliance can only be achieved by a firm when it has met all the applicable requirements of the GIPS standards on a firm-wide basis. Compliance with the GIPS standards involves more than just the use of a calculation methodology. To avoid any confusion, references to the GIPS standards must not be used in the context of reporting performance or performance presentations when the firm is not in compliance with the GIPS standards.

Consultant questionnaires often require investment management firms to fill in monthly or quarterly performance data. The questionnaires then ask the manager to indicate whether or not the data presented has been prepared in accordance with the GIPS standards. Questions regarding whether returns “are prepared” in compliance with the GIPS standards demonstrate a misunderstanding of the meaning of compliance. However, a firm that claims compliance with the GIPS standards may state that the returns “are prepared in compliance with the GIPS standards” if all of the following conditions are met:

- The performance information used to complete the questionnaire is consistent with the information used to prepare the respective composite’s compliant presentation;

- If applicable, the performance information used to complete the questionnaire is more current than the information currently included in the respective composite's compliant presentation but will be used in the future to update the respective composite's compliant presentation; and
- If applicable, the performance information used to complete the questionnaire is older than the information currently included in the respective composite's compliant presentation but could be used to report the composite's performance for periods prior to those currently included in the compliant presentation.

Software vendors must not claim compliance with the GIPS standards or state that their system complies with the GIPS standards. They may state that their system calculates performance that satisfies the portfolio and composite calculation requirements of the GIPS standards but must not state that using the software system automatically makes a firm compliant with the GIPS standards.

Provision 0.A.8

Statements referring to the performance of a single, existing client PORTFOLIO as being “calculated in accordance with the Global Investment Performance Standards” are prohibited, except when a GIPS-compliant FIRM reports the performance of an individual client's PORTFOLIO to that client.

Discussion

The GIPS standards do not specifically address how a firm must report performance of an individual client's portfolio to its existing clients. The GIPS standards provide an ethical framework for the calculation and presentation of the investment performance history of a firm, allowing both prospective and existing clients the best opportunity to fairly evaluate the past performance of the firm's composites.

If a firm that claims compliance with the GIPS standards decides to report the performance of an existing client's portfolio to that client, the firm may note on the existing client's performance report that the return was calculated in accordance with the Global Investment Performance Standards (GIPS) if the statement is true.

Provision 0.A.9

FIRMS MUST make every reasonable effort to provide a COMPLIANT PRESENTATION to all PROSPECTIVE CLIENTS. FIRMS MUST NOT choose to whom they present a COMPLIANT PRESENTATION. As long as a PROSPECTIVE CLIENT has received a COMPLIANT PRESENTATION within the previous 12 months, the FIRM has met this REQUIREMENT.

Discussion

Firms claiming compliance with the GIPS standards must make every reasonable effort to provide all prospective clients with a compliant presentation. The firm must not choose to which prospective clients it presents a compliant presentation.

3 Explanation of the Provisions of the GIPS Standards

3-0

A compliant presentation is defined as a presentation for a composite that contains all the information required by the GIPS standards and may also include additional information and supplemental information. A prospective client is defined as any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. Existing clients may also qualify as prospective clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties (e.g., consultants and consultant databases) are included as prospective clients if they represent investors that qualify as prospective clients.

Firms must establish policies and procedures for determining when an interested party becomes a prospective client. An interested party becomes a prospective client when two tests are met. First, the interested party must have expressed interest in a specific composite strategy or strategies. Second, the firm must have determined that the interested party qualifies to invest in the respective composite strategy. For example, assume a firm is meeting with an interested party to introduce the firm to the interested party. At this initial meeting, the firm provides information about itself in an attempt to attract the interested party to the firm. At this point, the two tests to qualify as a prospective client have not been met; therefore, the interested party is not yet a prospective client, and the firm is not obligated to provide a compliant presentation. Once the interested party expresses interest in a specific composite strategy and the firm determines that the interested party qualifies to invest in the composite strategy, the interested party then becomes a prospective client. At that point, the firm must make every reasonable effort to provide the prospective client with the appropriate compliant presentation(s).

At times, a prospective client may ask the firm about a composite strategy that the firm does not yet manage. For example, assume a firm manages one equity and one fixed income composite and has been meeting with a prospective client who originally was interested in (and qualified to invest in) the equity composite only. The prospective client learns that the firm also manages fixed income portfolios and inquires about a balanced strategy that blends the equity and fixed income strategies. If the firm does not have an appropriate composite to present to the 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 the firm currently manages and must make the list of composite descriptions available to the prospective client. This list must include all of the firm's composites, including composites that have terminated within the past five years.

Some prospective clients remain prospective clients for extended periods of time. Once a firm has provided a compliant presentation to a prospective client, the firm must provide an updated compliant presentation at least once every 12 months if the prospective client is still a prospective client. If a firm provides performance information to an investment consultant or a database, these entities qualify as prospective clients and they must receive the appropriate compliant presentation(s). They must also receive an updated compliant presentation at least once every 12 months.

A firm should establish policies and procedures for tracking which compliant presentation(s) were provided to which prospective clients and when. Doing so will allow a firm to know who must receive a corrected compliant presentation in case the firm subsequently determines a previously distributed compliant presentation includes a material error. Such procedures will also allow a firm to determine when ongoing prospective clients must receive an updated compliant presentation.

It is the firm's obligation to provide a compliant presentation to prospective clients. Posting a compliant presentation on the firm's website and directing the prospective client to obtain the compliant presentation from the website would require the prospective client to initiate the retrieval of information rather than the firm disseminating the information and as such would not satisfy this requirement. However, the firm may provide the compliant presentation electronically (e.g., as an attachment to an e-mail or on a CD or flash drive provided to the prospective client).

Firms are not limited to providing only GIPS-compliant information to prospective clients or interested parties. Firms may present other performance or performance-related information as long as it is not false or misleading. Firms are also not prohibited from providing any information the prospective client specifically requests in a one-on-one presentation.

Q&A

1. *Our firm has a new strategy that we want to market. The composite's performance started in May 2011, and our marketing people are meeting with a prospective client in September 2011. At the time of this meeting, the composite has four months of history. We prepare compliant presentations with annual returns as of 31 December. Are we required to prepare a compliant presentation for this new composite? How do we meet the requirement to make every reasonable effort to provide a compliant presentation to all prospective clients?*

All data required to be included in a compliant presentation, as listed in Section 5.A.1 of the GIPS standards, must be presented as of each annual period end. In this case, the composite does not yet have performance through 31 December; therefore, the firm is not required to prepare a compliant presentation. If a request is made for a compliant presentation for a new composite that does not yet have an initial annual period of performance, the performance for the partial period must be made available. If the prospective client for this strategy is still a prospective client after the compliant presentation is prepared with performance through 31 December, the firm must provide this compliant presentation to the prospective client.

2. *There are often times when clients that are invested in one strategy of our firm will become interested in one of our other investment strategies. Are the existing clients now considered prospective clients with respect to these other investment strategies in which they have expressed interest?*

Existing clients are considered prospective clients for any strategy that is different from their current investment mandate, if the existing client has expressed interest in the composite strategy and the existing client qualifies to invest in the composite. As such, the existing clients must be given the appropriate composite's compliant presentation. This will help ensure that they have the information necessary to evaluate the new investment strategy and make an informed decision.

3. *The GIPS standards state that as long as a prospective client has received a compliant presentation within the previous 12 months, the firm has met the GIPS requirement to provide a compliant presentation to all prospective clients. Does this mean that we have 12 months after an initial meeting with a prospective client to provide them with a compliant presentation?*

No. A compliant presentation must be provided to all prospective clients when they are initially identified as prospective clients. If after 12 months, the prospective client is still considered a prospective client, then the firm must provide them with a current compliant presentation. It is important to note that databases and consultants are also considered prospective clients under the GIPS standards. If a firm provides performance information to an investment consultant and other third parties (e.g., consultant databases) or a database, these entities qualify as prospective clients and they must initially receive a compliant presentation and must receive an updated compliant presentation at least once every 12 months.

3 Explanation of the Provisions of the GIPS Standards

4. *Firms must make every reasonable effort to provide a compliant presentation to all prospective clients. We maintain all of our compliant presentations on our website. Instead of providing the appropriate client presentation in our pitch books, can we instead direct the prospective client to obtain the compliant presentation on our website?*

No. A firm must take action to ensure that each prospective client receives a compliant presentation. A firm should establish policies and procedures for tracking which compliant presentation(s) were provided to which prospective clients and when. Once a firm has provided a compliant presentation to a prospective client, the firm must provide an updated compliant presentation at least once every 12 months.

It is the firm's obligation to provide a compliant presentation to prospective clients. Posting a compliant presentation on the firm's website and directing the prospective client to obtain the compliant presentation from the website would require the prospective client to initiate the retrieval of information versus the firm disseminating the information and as such would not satisfy this requirement. However, the firm may provide the compliant presentation electronically. The firm may include the compliant presentation as an attachment to an e-mail or on a CD or flash drive provided to the prospective client.

Provision O.A.10

FIRMS MUST provide a complete list of COMPOSITE DESCRIPTIONS to any PROSPECTIVE CLIENT that makes such a request. FIRMS MUST include terminated COMPOSITES on the FIRM'S list of COMPOSITE DESCRIPTIONS for at least five years after the COMPOSITE TERMINATION DATE.

Discussion

Firms must disclose in their compliant presentations the availability of a list of composite descriptions, which must include all of the firm's composites. The list of composite descriptions must be made available to prospective clients and provided upon request. While firms are required to provide a list of composite descriptions to any prospective client that makes such a request, they are encouraged to provide this information to anyone else who makes the request.

The list of composite descriptions must include all of the firm's composite descriptions. The composite description, which must also be disclosed in each compliant presentation, 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 enough information to allow a prospective client to understand the key characteristics of the composite's investment mandate, objective, or strategy. Simply stating that the composite includes all portfolios invested in the composite strategy is not sufficient.

One objective of the GIPS standards is to ensure the fair representation of a firm's investment performance track record. This includes not only currently managed strategies, but also those that the firm previously managed. Firms must include terminated composites on the firm's list of composite descriptions for at least five years after the composite termination date. If requested by a prospective client, a firm must provide a compliant presentation for a terminated composite on the list of composite descriptions.

A sample list of composite descriptions is provided in Appendix C of the 2010 edition of the GIPS standards.

Provision 0.A.11

FIRMS MUST provide a COMPLIANT PRESENTATION for any COMPOSITE listed on the FIRM'S list of COMPOSITE DESCRIPTIONS to any PROSPECTIVE CLIENT that makes such a request.

3-0**Discussion**

If requested, a firm must provide a compliant presentation for any composite, including terminated composites, on the list of composite descriptions.

A prospective client is defined as any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. Existing clients may also qualify as prospective clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as prospective clients if they represent investors that qualify as prospective clients. It is up to the firm to determine policies and procedures for determining who is considered to be a prospective client. While firms are required to provide this information to any prospective client that makes such a request, they are encouraged to provide this information to anyone else who makes the request.

Several sample compliant presentations are provided in Appendix A and a sample list of composite descriptions is provided in Appendix C of the 2010 edition of the GIPS standards.

Provision 0.A.12

FIRMS MUST be defined as an investment firm, subsidiary, or division held out to clients or PROSPECTIVE CLIENTS as a DISTINCT BUSINESS ENTITY.

Discussion

It is the firm's responsibility to ensure that the definition of the firm is fair and appropriate. The GIPS standards recommend that the firm adopt the broadest, most meaningful definition of the firm. The scope of this definition should include all geographic (country, regional, etc.) offices operating under the same brand name, regardless of the actual name of the individual investment management company.

The firm's definition will reflect the specific circumstances at each firm and must reflect how it is held out to clients or prospective clients as a distinct business entity. A distinct business entity is a unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices and that retains discretion over the assets it manages and should have autonomy over the investment decision-making process.

Possible criteria that can be used to determine this include, but are not limited to, the following:

- being a legal entity,
- having a distinct market or client type (e.g., institutional, retail, private client), and
- using a separate and distinct investment process.

3 Explanation of the Provisions of the GIPS Standards

In some cases, due to corporate restructuring and merger and acquisition activities, the changes within the firm may be so significant that it is held out to the public as a new firm. The new firm must determine if there is a continuation from the prior firm or if the restructuring is so substantial that it is essentially a new firm.

Firms must consider the Guidance Statement on the Definition of the Firm and the Guidance Statement on Portability for additional requirements and recommendations regarding the definition of the firm.

3-0

Q&A

1. *Previously, our firm was a department within a larger organization. Recently, the department was able to complete a buy-out, and we are now an independent investment advisor. What must the firm do in order to continue the claim of compliance?*

A firm's definition reflects how it holds itself out to the public. As the department was previously within the larger organization, if the department claimed compliance as a separate firm without the parent organization being included in that firm definition, there may not need to be any changes. The department may have been and may continue to be a distinct business entity held out to the public as such. It may be necessary for the department to disclose the buy-out as a significant event because firms must disclose any significant events that would help prospective clients interpret the compliant presentation.

However, if the department and parent organization were historically combined in the same firm definition for purposes of claiming compliance, the definition of the firm has changed with the buy-out and the claim of compliance with the GIPS standards must be reevaluated.

Provision O.A.13

For periods beginning on or after 1 January 2011, TOTAL FIRM ASSETS MUST be the aggregate of the FAIR VALUE of all discretionary and non-discretionary assets managed by the FIRM. This includes both fee-paying and non-fee-paying PORTFOLIOS.

Discussion

For periods beginning on or after 1 January 2011, firms must value portfolios in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II of the 2010 edition of the GIPS standards. Total firm assets must reflect the fair value of all portfolios within the firm definition. For periods prior to 1 January 2011, total firm assets must be the aggregate of the market value of all discretionary and non-discretionary assets under management within the defined firm. In all cases, this includes both fee-paying and non-fee-paying assets.

Total firm assets

- include assets for which the firm has either conditional or unconditional authority to trade the assets;
- include fee-paying assets (where a fee is payable to the firm for the ongoing management of a portfolio's assets) and non-fee-paying assets (where no fee is payable to the firm for the ongoing management of a portfolio's assets);

- include assets managed outside the firm (e.g., by sub-advisors) for which the firm has asset allocation (assignment) authority (i.e., the firm has discretion over the selection of the sub-advisor);
- beginning 1 January 2011, are equal to the fair value of all discretionary and non-discretionary assets managed by the firm (for periods prior to 1 January 2011, are equal to the market value of all discretionary and non-discretionary assets managed by the firm);
- exclude assets within advisory-only relationships; and
- include cash and cash equivalents (substitutes).

Assets that are advisory-only, where the firm has no control as to whether investment recommendations are accepted or the firm does not have trading authority over the assets, must not be included in total firm assets.

Firms are prohibited from double-counting assets when calculating total firm assets. For firms that include portfolios in more than one composite or that manage portfolios that invest in the firm's pooled funds (e.g., portfolios that invest in the firm's short-term money market fund), care must be taken to ensure assets are not counted more than once.

Q&A

1. *Firm A has the following assets under management. Under the GIPS standards, which of these assets are to be included in "total firm assets"?*

Asset	Included in Total Firm Assets?	Reason
Discretionary assets in all asset classes: Firm has unconditional trading authority to implement its strategy	Yes	Firm controls investment decisions.
Non-discretionary assets in all asset classes: Firm has conditional trading authority; strategy implementation restricted	Yes	Firm has limited control of investment decisions.
Assets within advisory-only client relationships	No	Firm has no control of implementation of investment decisions and no trading authority for the assets.
Real estate assets	Yes	Assets for which the real estate provisions are applicable.
Private equity assets	Yes	Assets for which the private equity provisions are applicable.
Assets directed to a sub-advisor by the firm	Yes	Firm retains discretion over sub-advisor selection and has investment management responsibility.
Assets directed to a sub-advisor by client	No	Firm does not retain discretion over sub-advisor selection and does not have investment management responsibility.
Non-fee-paying assets	Yes	Firm controls investment decisions.

3 Explanation of the Provisions of the GIPS Standards

2. *We do not include non-fee-paying portfolios in our composites. Do we have to include non-fee-paying portfolios in total firm assets?*

Yes. Both fee-paying and non-fee-paying portfolios must be included in total firm assets.

3. *Firm XYZ has one Eurozone fixed income composite that contains the following three portfolios:*

Portfolio 1 a fund that is invested in Eurozone bonds with net assets of €20 million,

Portfolio 2 a second fund that is invested in Eurozone bonds of several countries of the Eurozone with net assets of €30 million, and

Portfolio 3 a private portfolio invested entirely in the two funds already mentioned. Net assets of this portfolio are €10 million.

These three portfolios are the only portfolios within Firm XYZ.

- *What is the correct number of portfolios in the Eurozone fixed income composite?*
- *What is the correct amount of composite assets in the Eurozone fixed income composite?*
- *What is the correct amount of total firm assets in Firm XYZ?*

The question is that of eliminating the double counting of assets. Is it correct to present the Eurozone fixed income composite asset level as €60 million, and total firm assets as €60 million, or would that be misleading?

The GIPS standards are based on the principles of fair representation and full disclosure. Double-counting assets does not fairly represent total firm assets and is prohibited. The Eurozone fixed income composite described above would have three portfolios in the composite, with composite assets of €50 million (€20 million + €30 million = €50 million or €20 million + €30 million + €10 million – €10 million = €50 million). Presenting composite assets of €60 million—thus including €10 million from Portfolio 3, which is invested entirely in Portfolio 1 and Portfolio 2—is misleading, and those assets would also be considered double-counted. The correct amount of total firm assets for Firm XYZ is also €50 million because the only composite in Firm XYZ is the Eurozone fixed income composite and the portfolios above are the only portfolios within the firm.

Provision 0.A.14

TOTAL FIRM ASSETS MUST include assets assigned to a SUB-ADVISOR provided the FIRM has discretion over the selection of the SUB-ADVISOR.

Discussion

Some firms utilize a sub-advisor to manage part or all of a particular strategy. For example, if a firm specializes in managing equities, it might hire a sub-advisor to manage the fixed income portion of its balanced portfolios.

If a firm has discretion over the selection of the sub-advisor (i.e., can hire and/or fire), the firm must claim the sub-advisor's performance as part of its performance history and include the assets in total firm assets. Because the sub-advisor has discretion over the actual investment of the assets and the firm has discretion over the selection of the sub-advisor, both the firm and the sub-advisor are able to claim the performance of the assets as their own. The firm is able to claim

this performance because the sub-advised portion of the portfolio is essentially viewed as an asset (similar to purchasing a mutual fund within the portfolio) and the firm must be held responsible for its decision to utilize a sub-advisor. The firm can only include the sub-advisor's performance record relevant to those assets assigned by the firm. If a firm does not have discretion over sub-advisor selection, it must not include the sub-advisor's performance in its performance history and must not include the assets in total firm assets or composite assets.

Firms must disclose the use of sub-advisors for periods beginning on or after 1 January 2006.

Provision O.A.15

Changes in a FIRM's organization MUST NOT lead to alteration of historical COMPOSITE performance.

Discussion

Once the boundaries for the firm definition have been determined, the historical composite performance remains part of the firm's history. Changes in legal status, investment style, or personnel are not valid reasons for redefining the firm, unless the changes are such that the firm is held out to clients or prospective clients in a significantly different way. A simple name change is not sufficient reason to redefine the firm and restart the performance record. Please refer to the Guidance Statement on Performance Record Portability for related guidance.

Firms are permitted to be redefined if the changes within the firm are so significant that it is held out to clients or potential clients as a new firm. The new firm must determine if there is a continuation from the prior firm or if the restructuring is so substantial that it is essentially a new firm. In some cases, a firm definition may change without the firm losing its performance history.

Provision O.A.16

When the FIRM jointly markets with other firms, the FIRM claiming compliance with the GIPS standards MUST be sure that it is clearly defined and separate relative to other firms being marketed, and that it is clear which FIRM is claiming compliance.

Discussion

The term "firm" is used in two different ways in Provision O.A.16. "FIRM" is used to indicate a GIPS-compliant firm as defined in the GIPS Glossary, while "firm" is used to indicate an entity that does not claim compliance with the GIPS standards. A firm that claims compliance with the GIPS standards (i.e., "FIRM" in Provision O.A.16) may jointly market with another entity that does not comply with the GIPS standards (i.e., "firm" in Provision O.A.16). In order to avoid confusion when jointly marketing with other entities, a GIPS-compliant firm must be sure that it is clearly defined relative to the other entity being marketed so that it is clear which entity is claiming compliance.

Fundamentals of Compliance—Recommendations

3-0

Provision 0.B.1

FIRMS SHOULD comply with the RECOMMENDATIONS of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which will be made available on the GIPS website (www.gipsstandards.org) as well as in the *GIPS Handbook*.

Discussion

The GIPS standards must be applied with the objectives of full disclosure and fair representation of investment performance. Meeting the objectives of full disclosure and fair representation may mean a firm must follow the recommendations in addition to the requirements of the GIPS standards. If a firm chooses to adopt any recommendations, the firm's policies and procedures must reflect how that recommendation is applied. To fully explain the performance included in a compliant presentation, firms are encouraged to present all relevant additional information and supplemental information in addition to the required disclosure and presentation items.

Provision 0.B.2

FIRMS SHOULD be verified.

Discussion

Verification is intended to provide a firm and its existing clients and prospective clients additional confidence in the firm's claim of compliance with the GIPS standards. Verification may increase the knowledge of the firm's performance measurement team and improve the consistency and quality of the firm's compliant presentations. Verification may also provide improved internal processes and procedures as well as marketing advantages to the firm. However, verification does not ensure the accuracy of any specific composite presentation. While verification brings additional credibility to the claim of compliance, it does not guarantee that a firm's claim of compliance with the GIPS standards is valid.

The verification procedures attempt to strike a balance between ensuring the quality, accuracy, and relevance of performance presentations and minimizing the cost to firms.

Verification assesses whether

- a. the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and
- b. the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

Provision O.B.3

FIRMS SHOULD adopt the broadest, most meaningful definition of the FIRM. The scope of this definition SHOULD include all geographical (country, regional, etc.) offices operating under the same brand name regardless of the actual name of the individual investment management company.

Discussion

It is important that firms remember the overarching principles of fair representation and full disclosure when defining the firm. While there are specific requirements that must be met related to defining the firm, firms must also consider the spirit of the GIPS standards. Firms are recommended to define the firm as broadly as possible, encompassing all of the relevant locations, departments, and functional areas so that the prospective client is given enough information about the investment strategies being managed and the firm as a whole. Factors to consider when defining the firm include, but are not limited to, the following:

- All offices operating under the same brand name (e.g., XYZ Asset Management).
- Other names resulting from mergers, acquisitions, and/or trading under a different name for branding purposes.
- Financial service holding companies defined as one global firm with multiple brands, several legal entities, multiple offices, investment teams, and investment strategies.
- An investment management firm with one brand but multiple strategies and investment teams.
- All offices trading under a globally recognizable trading name with regional/country specific additions (e.g., XYZ Asset Management Asia).
- Investment management firms in most countries must register with one or more governmental agencies or regulators. The GIPS standards recognize a regulatory registration as a possible definition of a firm for purposes of compliance, but also require firms to consider the manner in which they are holding themselves out to the public when determining the firm definition.

Provision O.B.4

FIRMS SHOULD provide to each existing client, on an annual basis, a COMPLIANT PRESENTATION of the COMPOSITE in which the client's PORTFOLIO is included.

Discussion

It may be helpful for a client to know how the client's own portfolio performed relative to other portfolios that are managed according to the same investment objective, mandate, or strategy. In addition to composite performance, compliant presentations include important disclosures and presentation items that a firm may not always provide existing clients as a regular part of client reporting.

3-1 INPUT DATA

Input Data—Requirements

3-1

Provision 1.A.1

All data and information necessary to support all items included in a COMPLIANT PRESENTATION MUST be captured and maintained.

Discussion

A fundamental principle of the GIPS standards is the need for firms to be able to ensure the validity of their claim of compliance. This requirement reflects that principle. It is of particular importance for existing clients, prospective clients, verifiers, and regulators to have assurance that all items included in the compliant presentation are supported by the appropriate records. Firms must maintain records to be able to recalculate their performance history as well as substantiate all other information, including supplemental information, included in compliant presentations for all periods shown. This requirement applies regardless of the time period for which performance is presented in the compliant presentation (e.g., 5 years, 10 years, since inception). This requirement is consistent with the regulatory requirements of many countries.

Although most firms are looking for a very precise list of the minimum supporting documents that must be maintained to support all parts of the compliant presentation, including the ability to recalculate the firm's performance history, there is not a single list of records that will suffice in all situations. Each firm must determine for itself which records must be maintained. The Guidance Statement on Recordkeeping Requirements includes lists of records that firms should consider maintaining to meet this requirement.

The firm must have policies and procedures for capturing and maintaining all data and information necessary to support all items included in its compliant presentations. Above all else, a firm must comply with all applicable laws and regulations regarding the calculation and presentation of performance, including any recordkeeping requirements.

Q&A

1. *Firm A claims compliance with the GIPS standards. It maintains hard copies of the records supporting compliance for three years and discards all records older than three years in an effort to save office space. The performance reported on all of its compliant presentations shows five years of history. Is the firm in compliance with the GIPS standards?*

No. A firm must capture and maintain all data and information necessary to support all items included in a compliant presentation. Because Firm A presents five years of performance history, it must maintain the records to support the firm's five-year history and all other data and information in the firm's compliant presentations. Because the GIPS

standards require firms to present an additional year of performance each year, building up to a minimum of 10 years of GIPS compliant history, the firm must continue to maintain the records to support the firm's eventual 10-year performance history.

2. *Are recordkeeping requirements different for compliant and non-compliant performance within a compliant presentation?*

No. Firms must capture and maintain all data and information necessary to support both non-compliant and compliant performance presented in compliant presentations. For periods prior to 1 January 2000 (or for periods prior to 1 January 2006 for Real Estate, Private Equity, and Wrap Fee/SMA assets), a firm may present non-compliant performance in a compliant presentation, provided the firm has the necessary supporting documentation and discloses the periods of non-compliance.

3. *I have a composite that I don't use for advertising or marketing purposes. Must I keep the records for the portfolios in this composite as well as the records for the composite itself, even if I don't market the composite's performance?*

Yes. A firm must capture and maintain all data and information (i.e., records) necessary to support all items included in compliant presentations. This includes all of the firm's composites, whether marketed or not. All composites, whether marketed or not, must be listed on the firm's list of composite descriptions. The firm must be prepared to provide a compliant presentation to any prospective client that makes such a request for all composites on the list of composite descriptions. The compliant presentation should be available within a reasonable time frame, if not immediately available.

4. *Certain types of records (e.g., thermal printed faxes) have a limited life, and in many cases, such documents are more than 10 years old. What happens if these records begin to disintegrate and are no longer readable? Will we meet the recordkeeping requirements if we no longer have these records?*

Original hard copy documents are not required to be maintained. Firms can rely on electronic scans of paper documents in order to satisfy the recordkeeping requirements. However, records stored in a system that is not operable will not satisfy the requirements of the GIPS standards to capture and maintain all data and information necessary to support all items included in a firm's compliant presentations.

5. *We present performance attribution as supplemental information within our compliant presentation for our Growth and Income Composite. Must we keep the data and information to support this supplemental information?*

Yes. Firms are required to capture and maintain all data and information necessary to support all items included in the firm's compliant presentations, which would include supplemental information. Supplemental information is defined as any performance-related information included as a part of a compliant presentation that supplements or enhances the required and/or recommended provisions of the GIPS standards. Firms must also comply with any regulatory requirements related to recordkeeping.

6. *Our firm has had a catastrophic event that has caused a loss of all records. How will this affect our firm's ability to claim compliance with the GIPS standards?*

If a firm has had a catastrophic event that is beyond the control of the firm (e.g., fire, flood, terrorist attack), the firm has options depending on the situation.

If the firm has never claimed compliance with the GIPS standards, it must attempt to recreate the records using third-party information (e.g., custodian records). If the firm is able to recreate the necessary records and is able to satisfy all of the requirements of the

3 Explanation of the Provisions of the GIPS Standards

GIPS standards, it may claim compliance with the GIPS standards. If the firm is unable to recreate the necessary records, but is otherwise able to meet all of the requirements of the GIPS standards, the firm must wait until it has the minimum five years of history before claiming compliance.

If the firm has claimed compliance with the GIPS standards prior to the catastrophic event, it must attempt to recreate the records using third-party information (e.g., custodian records, verifier records). In this instance, if the firm is unable to recreate the records necessary to meet all of the requirements of the GIPS standards, the firm may continue claiming compliance; however, the firm must disclose the catastrophic event that caused the loss of all of the firm's records.

It is expected that all firms will implement disaster recovery plans to mitigate the loss of records for any reason, whether it is a catastrophic event beyond the control of the firm or a situation within the control of the firm. All firms are reminded that they must follow all applicable laws and regulations.

Provision 1.A.2

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.

Discussion

Beginning 1 January 2011, portfolio valuations must be based on fair value. For periods prior to 1 January 2011, portfolio valuations must be based on market values (not cost basis or book values). The shift to a broader fair value requirement has implications for all firms claiming compliance with the GIPS standards. For liquid investments in active markets, the change from market value to fair value will typically not result in a change to the valuation process.

Beginning 1 January 2011, firms must value portfolios in accordance with the GIPS Valuation Principles and the following definition of fair value:

Fair value is defined as the amount at which an investment could be exchanged in a current arm's length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation must be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation must represent the firm's best estimate of the market value. Fair value must include accrued income.

When determining fair value, firms must use the objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available. However, markets are not always liquid and investment prices are not always objective and/or observable. For illiquid or hard to value investments, or for investments where no observable market value or market price is available, additional steps are necessary. A firm's valuation policies and procedures must address situations where the market prices may be available for similar but not identical investments, inputs to valuations are subjective rather than objective, and/or markets are inactive instead of active.

There is a recommended valuation hierarchy in Section C of the GIPS Valuation Principles. Firms must disclose if the composite's valuation hierarchy materially differs from the recommended valuation hierarchy.

For periods prior to 1 January 2011, the GIPS standards require the use of market value, which is defined as the current price at which investors buy or sell securities at a given time, in order to best identify the fair economic value of the firm's portfolios.

Although a firm may use external third parties to value investments, the firm still retains responsibility for compliance with the GIPS standards, which includes the GIPS Valuation Principles.

The GIPS Valuation Principles also include additional requirements and recommendations for the valuation of Real Estate and Private Equity assets.

Provision 1.A.3

FIRMS MUST value PORTFOLIOS in accordance with the COMPOSITE-specific valuation policy. PORTFOLIOS MUST be valued:

- a. For periods beginning on or after 1 January 2001, at least monthly.
- b. For periods beginning on or after 1 January 2010, on the date of all LARGE CASH FLOWS. FIRMS MUST define LARGE CASH FLOW for each COMPOSITE to determine when PORTFOLIOS in that COMPOSITE MUST be valued.
- c. No more frequently than required by the valuation policy.

Discussion

In order to improve the accuracy of time-weighted performance calculations, the GIPS standards have gradually increased the minimum required frequency of portfolio valuation from quarterly, to monthly, to the date of all large cash flows. A large cash flow, which is to be defined by the firm for each composite, is the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued at the time of the cash flow. Firms must define the amount in terms of the value of the cash/asset flow or in terms of a percentage of portfolio assets or the composite assets. Firms must also determine if a large cash flow is a single external cash flow or an aggregate of a number of external cash flows within a stated period of time.

In addition, a firm must not value a portfolio "opportunistically" and must follow the composite-specific valuation policy consistently. For example, assume the valuation policy is to value portfolios for large cash flows, which are defined in the composite-specific valuation policy as a single external cash flow equal to or greater than 5% of the beginning-of-month value of the portfolio. For any single external cash flow that is less than 5% of the beginning-of-month value of the portfolio, the firm must not value the portfolio. For any single external cash flow that is equal to or greater than 5% of the beginning-of-month value of the portfolio, the firm must value the portfolio. The firm must apply the composite-specific valuation policy consistently and not "cherry-pick" when to value portfolios.

A large cash flow should not be confused with the concept of a significant cash flow. The GIPS standards define a significant cash flow as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy, thereby causing the portfolio to no longer be representative of the composite strategy. Portfolios that experience a significant cash flow are temporarily removed from the composite, whereas portfolios that experience a large cash flow remain in the composite.

3 Explanation of the Provisions of the GIPS Standards

Real Estate and Private Equity assets have additional valuation requirements that must be followed. Please see the GIPS Valuation Principles in Chapter II of the GIPS standards.

Q&A

3-1

1. *Firm A has been in existence since 1995. The firm has calculated its performance using quarterly valuations of portfolios. In January 2002, the firm seeks to show history since its inception that meets the requirements of the GIPS standards. Does it have to recreate its performance history because it does not meet the monthly valuation requirement?*

Assuming it has satisfied all the other requirements, it can show its history from 1995 through 2000 using its original performance calculations for its portfolios valued on a quarterly basis. However, to claim compliance with the GIPS standards, the firm is required to use monthly valuations for periods beginning on or after 1 January 2001. Therefore, to claim compliance, Firm A must value its portfolios on at least a monthly basis and recalculate the performance for all periods beginning on or after 1 January 2001.

2. *The 2010 edition of the GIPS standards requires a firm to value portfolios in accordance with the composite-specific valuation policy. We manage both pooled funds, which are valued daily, and non-pooled (segregated) portfolios, which are valued monthly and for cash flows above 5%. We include both types of portfolios in the same composite. May we have a different policy for the frequency of valuing pooled funds versus non-pooled portfolios that are included in the same composite?*

Yes. The firm must establish a composite-specific valuation policy, but that policy may differentiate valuation frequency for different types of portfolios in the composite. The firm must apply the composite-specific valuation policy consistently based on the valuation frequency for the type of portfolio.

3. *What factors should we consider when determining what is a large cash flow?*

A large cash flow is the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. The firm must determine in advance (i.e., on an *ex-ante* basis) what is considered to be a large cash flow on a composite-specific basis. Firms must define the amount in terms of the value of cash/asset flow or in terms of a percentage of the portfolio assets or the composite assets. The determination of the large cash flow level may be influenced by a variety of factors, such as the nature of the strategy, historical and expected volatility of the strategy, and the targeted cash level of the strategy.

4. *We understand that portfolios must be valued on the date of all large cash flows for periods beginning on or after 1 January 2010. We are worried about our ability to meet this requirement. Can we define our large cash flow level using a high threshold to reduce or potentially eliminate the number of instances when we need to value portfolios?*

No. A firm must not establish a high cash flow level solely for the purpose of reducing the number of instances when portfolios must be valued due to large cash flows. The GIPS standards define a large cash flow as the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. The large cash flow level chosen by the firm on a composite-specific basis must represent the firm's estimate as to the level of external cash flow that would potentially distort the accuracy of a portfolio's performance calculation if the portfolio is not valued at the time of the external cash flow.

5. *For periods beginning on or after 1 January 2010, firms must define the level of large cash flows for each composite used to determine when portfolios in that composite must be valued. Can we use the same large cash flow level for all our composites?*

Yes, but only if it is appropriate for each composite. The large cash flow level must represent the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. It may be possible that all of a firm's composites have the same level of large cash flows; however, the appropriate level must be determined for each composite. Firms must define the large cash flow level for each composite in terms of the value of the cash/asset flow or in terms of a percentage of portfolio assets or composite assets. Although it is possible for all of a firm's composites to have the same large cash flow level, a firm must not simply establish this level on a firm-wide basis without considering whether the level is appropriate for each composite.

6. *We are in the process of establishing our significant cash flow and large cash flow levels for each composite. We understand that establishing a significant cash flow policy is optional, whereas for periods beginning on or after 1 January 2010, firms must define the level of large cash flow for each composite to determine when portfolios in a composite must be valued. Can the levels used to define large cash flows and significant cash flows be the same? If not, does the level established for significant cash flows need to be greater than the level used for large cash flows?*

The GIPS standards define a large cash flow as the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. Firms must define large cash flow levels for each composite to determine when portfolios in that composite must be valued. Portfolios that experience a large cash flow remain in the composite (unless it is also a significant cash flow, as defined). The determination of the large cash flow level may be influenced by a variety of factors, such as the nature of the strategy, historical and expected volatility of the strategy, and the targeted cash level of the strategy.

The GIPS standards define a significant cash flow as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy, thereby causing the portfolio to no longer be representative of the composite strategy. Firms that choose to adopt a significant cash flow policy for certain composites must define the significant cash flow level on a composite-specific basis. Portfolios that subsequently experience a significant cash flow are then temporarily removed from the composite. The determination of the significant cash flow level may be influenced by a variety of factors, such as market liquidity and the trading capabilities of the investment manager.

It is not expected that the level used to define large cash flows and significant cash flows will be the same. It is expected that the level used to define large cash flows will be less than the level established for significant cash flows because the cash flow amount that would cause a portfolio to be distorted and thus need to be valued typically does not rise to the level that disrupts the implementation of the investment strategy.

7. *Can we choose to adopt a significant cash flow policy in which we remove portfolios from our composite in order to avoid valuing portfolios due to large cash flows?*

No. A firm must not adopt a significant cash flow policy solely for the purpose of reducing or eliminating the number of instances where portfolios must be valued due to large cash flows. The GIPS standards define a significant cash flow as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the

3 Explanation of the Provisions of the GIPS Standards

firm from implementing the composite strategy. The significant cash flow level chosen by the firm on a composite-specific basis must represent the firm's estimate as to the level of external cash flows that would potentially disrupt the implementation of the investment strategy. Significant cash flow and large cash flow levels must be established independently.

8. *The GIPS standards state that for periods beginning 1 January 2010, firms must value portfolios on the date of all large external cash flows. We presently assume all cash flows take place as of the beginning of the day, and so the revaluation is done at the close of the business day prior to the large external cash flow. Does this mean our policy is no longer acceptable and we must revalue the portfolios with large external cash flows on the exact date of the cash flow for periods beginning 1 January 2010?*

No. The change in the provision noted above would not require you to change your current policy for periods beginning 1 January 2010. The intent of the provision is to require firms to revalue portfolios at the time of all large external cash flows, and so revaluing portfolios as of the close of the business day prior to the large external cash flow will continue to be acceptable if cash flows are assumed to take place at the beginning of the day.

Provision 1.A.4

For periods beginning on or after 1 January 2010, FIRMS MUST value PORTFOLIOS as of the calendar month end or the last business day of the month.

Discussion

Consistency in monthly portfolio valuation dates will result in improved comparability of data for all compliant presentations. When calculating and presenting composite returns, valuing the portfolios included in the composite at different end dates does not allow for the comparability of information. Therefore, to facilitate comparability, as of 1 January 2010, performance must be calculated through calendar month-end or on the last business day of the month.

Q&A

1. *Our firm values portfolios as of the last Friday of the month. Can this methodology be used for all periods?*

No. For periods beginning on or after 1 January 2010, firms must value portfolios as of the calendar month-end or the last business day of the month. For periods prior to 1 January 2010, firms may value portfolios as of the last Friday of the month, with appropriate disclosure.

Provision 1.A.5

For periods beginning on or after 1 January 2005, FIRMS MUST use TRADE DATE ACCOUNTING.

Discussion

For the purpose of complying with the GIPS standards, trade-date accounting is defined as recognizing the asset or liability on the date of 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 (trade date, T+1, T+2, or T+3) satisfies the trade date accounting requirement for the purposes of the GIPS standards. Settlement-date accounting is defined as recognizing the asset or liability on the date when the exchange of cash and investments is completed. For purchases, when using settlement-date accounting, any movement in value between the trade date or booking date and the settlement date will not have an impact on performance until settlement date; whereas for trade-date accounting, the change in value will be reflected for each valuation between trade date and settlement date. Performance comparisons between portfolios and/or composites that use settlement-date accounting and those that use trade-date accounting may not be valid. The same problem occurs when comparing settlement-date portfolios and composites with their benchmarks.

The principle behind requiring trade-date accounting is to ensure there is not a significant lag between trade execution and reflecting the trade in the performance of a portfolio. For the purposes of compliance with the GIPS standards, portfolios are considered to satisfy the trade-date accounting requirement provided that transactions are recorded and recognized consistently and within normal market practice—typically, a period between trade date and up to three days after trade date (T+3). Firms must not use settlement-date accounting for periods beginning on or after 1 January 2005.

Q&A

1. *Some mutual funds function on a T+1 schedule. Therefore, if a bond is purchased on January 31, it is not included in the net asset value (NAV) calculation for January 31. It is included in the NAV calculation February 1. Does the requirement for trade-date accounting mean that firms managing mutual funds must account for the funds in their own portfolio management software systems in order to base performance on trade-date net assets as opposed to NAVs (T+1) in order to remain compliant with the GIPS standards?*

A fund recognizing the bond purchase in the portfolio at trade date + 1 day (T+1) will satisfy the requirements of the GIPS standards. For the purposes of compliance with the GIPS standards, portfolios are considered to satisfy the trade-date accounting requirement provided that transactions are recorded and recognized consistently and within normal market practice—typically, a period between trade date (T) and up to three days after trade date (T+3).

2. *When should we record an incoming external cash flow to a portfolio: on the date we are notified the cash is incoming or the date that we actually receive the funds? In our situation, we are notified of incoming funds in order to allow us to place trades so that the incoming funds are fully invested when the cash contribution is actually received into the portfolio. We use a trade-date accounting methodology for all securities; however, we do not reflect external cash flows in the portfolio until the cash is physically received (i.e., settlement date). Is this an acceptable methodology to use for reporting performance when there is an external cash flow to the portfolio?*

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. By definition, the trade-date accounting convention applies only to investment transactions (i.e., purchases and sales of securities). Accounting for an investment transaction on the trade date ensures

3 Explanation of the Provisions of the GIPS Standards

that the security is reflected in the performance calculation on the date when the ownership and economic risks and rewards are transferred. Therefore, external cash flows are typically booked on the date when they are actually received or distributed.

If trading on the pre-announced external cash inflow before it is received into the portfolio, the portfolio will become leveraged during the period between the trade date and the date when the cash inflow is physically received. In order to “cover” this additional exposure and eliminate the leverage effect, some firms may choose to apply the trade-date and settlement-date principles to pre-arranged cash flows by booking the cash flow with a trade date that reflects the date the firm may trade in advance of the cash inflow and a settlement date that reflects the date when the cash is received. If the firm chooses to match the trade date of pre-announced external cash flows to the trade date of trades related to those cash flows, it should establish this as its policy and treat all pre-announced cash flows consistently.

3-1

Provision 1.A.6

ACCRUAL ACCOUNTING MUST be used for fixed income securities and all other investments that earn interest income. The value of fixed income securities MUST include accrued income.

Discussion

Accrual accounting allows the recording of financial transactions as they come into existence rather than when they are paid or settled. When determining the valuation for a security that pays interest income, firms must include the income that would have been received at the end of the performance period had the security actually paid interest income earned during the performance period.

Accrued interest income must be included in the beginning and ending portfolio values when performance is calculated. Interest should be accrued for a security in the portfolio using whatever method is customary and appropriate for that security.

Some instruments already include accrued income as part of the security’s market prices. If income for these instruments is being accrued as part of the income recognition process, steps should be taken to ensure that the income is not double counted.

Accrued income for cash and cash equivalents can be more difficult to calculate. Unlike bonds with a known coupon rate, there may not be a published interest rate for some short-term securities, such as overnight deposits. Firms must develop a methodology for accounting for short-term interest earnings and consistently apply the method selected. Firms could consider using the last actual known interest rate to accrue income for the most recent period. When the actual rate becomes known, an adjustment can then be made to allocate the actual income earned to the proper period. In this way, there is no systematic under-estimation or over-estimation of income and income is also properly assigned to the period when earned. Cash-basis accounting (recording the income for short-term cash/cash equivalents as it is actually received) will tend to lag the suggested accrual method by recognizing income a month after it was earned; however, either method is acceptable and the method chosen must be used consistently.

Q&A

1. *Firm B seeks to have all of its clients' funds 100% invested at all times. However, because of the nature of cash flows in the buying and selling of assets, cash may be held in the accounts for a short period. The firm holds this cash in a money market account. How should Firm B account for the income generated by the assets in the money market account when calculating investment performance?*

Both the value of and interest earned on the money market account must be included in the portfolio's rate of return calculation. The firm has two options. Because the money market fund is clearly a cash substitute in this case, Firm B could recognize interest income on a cash basis. Firm B could also choose to recognize interest income on an accrual basis. Because there is no published interest rate for money market funds on which to accurately accrue the income, Firm B may use the last actual interest rate from the money market fund to accrue income for the current period, and when the actual rate for the current period becomes known, it can adjust returns to allocate the actual income earned to the proper period. Once Firm B chooses an accounting method, it must be applied consistently to ensure continuity and consistency of results.

2. *How should a firm claiming compliance with the GIPS standards treat bonds in default when calculating their performance results?*

If a bond goes into default, a firm must recognize the loss when it occurred. The historical performance figures must not be recalculated. The accrual of interest must be included in the calculation method up until the point of the bond's default. At that point, the calculation method would reflect the loss of accrued interest by adjusting the amount of accrued interest to zero.

When and if the bond comes out of default and there is a reasonable expectation that the bond will commence paying interest, including back interest, the firm must begin accruing for such interest payments. The firm must not allocate such payments over periods when they were originally due but not paid.

Provision 1.A.7

For periods beginning on or after 1 January 2006, COMPOSITES MUST have consistent beginning and ending annual valuation dates. Unless the COMPOSITE is reported on a non-calendar fiscal year, the beginning and ending valuation dates MUST be at calendar year end or on the last business day of the year.

Discussion

Consistency in the annual beginning and ending composite valuation dates will result in improved comparability of data. Within a compliant presentation, the annual reporting periods must be consistent and the portfolios in the composite must have consistent beginning and ending valuation dates corresponding to the reporting period.

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Q&A

1. *Our firm reports performance in compliance with the GIPS standards for years ending 30 June for our High-Yield composite; all the other composites are reported at 31 December. Must we report annual returns as of 31 December for all of the firm's composites?*

No. The firm is not required to change the year-end valuation and reporting date from 30 June to 31 December for the High-Yield composite. Each composite at the firm may have different year-end valuation dates; however, the year-end valuation dates must correspond to the reporting dates for the composite. Within each compliant presentation, the annual periods must be consistent. For example, a firm that reports a composite's performance annually as of 30 June must consistently report data for years ending 30 June for the High-Yield composite. The firm may decide in the future to create a compliant presentation for the High-Yield composite based on a 31 December valuation and reporting date; however, the firm may not mix 30 June and 31 December valuation and reporting dates in the same compliant presentation.

3-1

Input Data—Recommendations

Provision 1.B.1

FIRMS SHOULD value PORTFOLIOS on the date of all EXTERNAL CASH FLOWS.

Discussion

In order to improve the accuracy of time-weighted performance calculations, the GIPS standards have gradually increased the minimum required frequency of portfolio valuation from quarterly, to monthly, to the date of all large cash flows for periods beginning on or after 1 January 2010. However, best practice is to value portfolios on the date of all external cash flows. Firms are encouraged to create a policy to value portfolios on the date of all external cash flows as part of the composite-specific valuation policy where possible.

Provision 1.B.2

Valuations SHOULD be obtained from a qualified independent third party.

Discussion

The quality of valuations used as inputs to calculate performance has a significant impact on the accuracy of portfolio and composite returns; therefore, it is important that the valuations used are accurate. It is recommended that firms obtain valuations from an independent source because a third party can provide the most objective investment valuations. In most instances, obtaining valuations from an independent third party is considered to be a best practice. A firm claiming

compliance with the GIPS standards is responsible for its claim of compliance and must ensure that the valuations obtained from a third party can be used to satisfy the requirements of the GIPS standards.

Provision 1.B.3

ACCRUAL ACCOUNTING SHOULD be used for dividends (as of the ex-dividend date).

3-1

Discussion

Accrual accounting determines the correct economic value of the portfolio assets and allows the recording of financial transactions as they come into existence rather than when they are paid or settled. It is recommended that dividends be recognized when earned (accrual basis) versus when paid (cash basis).

Provision 1.B.4

FIRMS SHOULD ACCRUE INVESTMENT MANAGEMENT FEES.

Discussion

Investment management fees are the fees payable to the investment management firm for the ongoing management of a portfolio. They are typically asset based (based on a percentage of assets), performance based (based on the performance of the portfolio on an absolute basis or relative to a benchmark), or a combination of the two but may take different forms as well. Investment management fees also include carried interest.

The net-of-fees return is defined as the gross-of-fees return reduced by investment management fees (including performance-based fees and carried interest). Accrual accounting allows the recording of financial transactions as they come into existence rather when they are paid or settled. In order to reflect the most accurate net-of-fees return, investment management fees should be accrued when possible. Net-of-fees returns can be skewed if investment management fees are used in the calculation of net-of-fees returns as they are paid.

The GIPS standards do not require a specific calculation methodology for accounting for investment management fees when calculating performance net-of-fees. The firm must develop a calculation methodology that generates performance that is not misleading, presents performance fairly, and is applied consistently.

Q&A

1. *A firm manages both pooled funds and separate client accounts and charges investment management fees for its services to both. Clients may hold pooled funds as part of their separate account investments and, in this case, are being charged double for investment management services at both the pooled fund and separate account level. To eliminate the double charging of fees, the firm deposits on a monthly basis a “fee rebate” to client accounts holding the pooled funds. How should this “fee rebate” be treated in performance calculations?*

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If a firm reduces its investment management fee charged to clients, the recommended method is to waive the appropriate portion of the investment management fee so that there is neither a withdrawal nor deposit of cash (i.e., payment or refund of fees). The net-of-fees return must be reduced by the fee minus the rebate. The net-of-fees return will be higher than if it were calculated using the full fees charged at both the pooled fund and separate account levels. The gross-of-fees return must be calculated as if the investment management fee were not charged and the rebate not given. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to trading expenses.

3-1

2. *We want to report the net-of-fees returns of a composite. Should we state the actual net-of-fees returns for all portfolios, which would reflect the deduction of the actual fee paid by each portfolio, or can we use a model fee?*

The net-of-fees return is defined as the gross-of-fees return reduced by the investment management fee (including performance-based fees and carried interest). Firms are permitted to use either the actual investment management fee incurred by each portfolio in the composite or the highest investment management fee appropriate to a prospective client to reduce the gross-of-fees return to calculate the net-of-fees return.

3-2 CALCULATION METHODOLOGY

Calculation Methodology—Requirements

Provision 2.A.1

TOTAL RETURNS MUST be used.

3-2

Discussion

Total return, which is measured over a specified period, has two components: the appreciation or depreciation (capital change) of the assets in the portfolio over the specified period and the income earned on the assets in the portfolio over the specified period. When calculating the performance of the portfolios within a composite, the GIPS standards require firms to use a total rate of return.

Provision 2.A.2

FIRMS MUST calculate TIME-WEIGHTED RATES OF RETURN that adjust for EXTERNAL CASH FLOWS. Both periodic and sub-period returns MUST be geometrically LINKED. EXTERNAL CASH FLOWS MUST be treated according to the FIRM'S COMPOSITE-specific policy. At a minimum:

- a. For periods beginning on or after 1 January 2001, FIRMS MUST calculate PORTFOLIO returns at least monthly.
- b. For periods beginning on or after 1 January 2005, FIRMS MUST calculate PORTFOLIO returns that adjust for daily-weighted EXTERNAL CASH FLOWS.

Discussion

When calculating the performance of the portfolios within a composite, firms must use a time-weighted rate of return, or an appropriate approximation, that adjusts for external cash flows. When calculating the time-weighted rate of return, interim (sub-period) returns must be geometrically linked to calculate periodic returns. There are separate calculation requirements for private equity and real estate portfolios. Firms should refer to these provisions and related guidance.

Calculation methods that include adjustments to remove the effects of external cash flows from the performance return are called time-weighted rate-of-return (TWRR) methods. The GIPS standards require a time-weighted rate of return because external cash flows are generally client driven. By removing the effects of external cash flows, a time-weighted rate of return best reflects the firm's ability to manage the portfolio according to a specified investment mandate, objective, or strategy, allowing prospective clients the best opportunity to fairly evaluate the past performance of the firm and to facilitate comparison between investment management firms.

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The most accurate method for calculating a TWRR for individual portfolio performance is to determine the value of the portfolio at the time of each external cash flow, calculate a rate of return for the sub-periods (each period between the cash flows) according to the following formula, and geometrically link the sub-period returns to calculate the portfolio return for the period. An external cash flow is capital (cash or investments) that enters or exits a portfolio. Dividend and interest income payments, for example, are not considered external cash flows. Dividends and interest income payments are cash flows that impact total return; they are not considered external cash flows for which an adjustment must be made in the time-weighted calculation.

The formula for calculating the time-weighted portfolio return when there are no external cash flows is

$$r_i = \frac{V_i^E - V_i^B}{V_i^B},$$

where

r_i = the return for period i in which there are no external cash flows

V_i^E = the ending value of the portfolio for period i

V_i^B = the beginning value of the portfolio for period i

This formula represents the growth (or decline) in the value of a portfolio, including both capital appreciation (or capital depreciation) and income, as a proportion of the beginning value with no external cash flows over a period. The numerator in the formula reflects the income earned and the change in the portfolio's value over the period, which has been earned by the capital available to be invested. The denominator in the formula reflects the capital available to be invested to earn the change in value calculated in the numerator.

This formula calculates total return in the absence of external cash flows. Because most portfolios do experience external cash flows, which can often be unpredictable, the formula must be adjusted so that external cash flows do not skew the portfolio return. Adjustments must, therefore, be made to account for external cash flows. Valuing and subsequently calculating performance for a portfolio at the time of each external cash flow removes the effects of external cash flows on the portfolio return.

The Guidance Statement on the Treatment of Significant Cash Flows offers additional guidance for addressing external cash flows that are so significant that the implementation of the investment strategy of the portfolio is disrupted. Firms could consider adopting a significant cash flow policy in their policies and procedures.

Time-weighted total return calculation methods that adjust for external cash flows in the portfolio using the mid-point or mid-period methods, such as the Original Dietz method, are acceptable for calculation periods prior to 1 January 2005. Because the philosophy of the GIPS standards is to present performance that is as accurate as practically possible, the GIPS standards have transitioned to more precise calculation methodologies. Therefore, firms must use time-weighted total return calculations that adjust for *daily-weighted* external cash flows for calculation periods beginning on or after 1 January 2005 at the latest; firms may use this methodology for calculation periods prior to this date. For periods beginning on or after 1 January 2010, firms must value portfolios on the date of all large cash flows, in addition to calendar month-end or the last business day of the month; firms may use this methodology for calculation periods prior to this date. Performance is then calculated for sub-periods. The sub-period returns are then geometrically linked to calculate

the total period total return. Each of these methodologies is described below. Once a calculation methodology is selected for a portfolio, it must be used consistently until the firm transitions to a more accurate methodology.

TWRR that adjusts for external cash flows (using mid-point or mid-period adjustment) (*allowable for periods prior to 1 January 2005*) Various methods approximating a TWRR are acceptable. The purpose of these methods is to produce as accurate an estimate as possible in circumstances where valuations at the time of external cash flows are not available. One example of an acceptable method is the Original Dietz method. This method estimates when external cash flows are received into or withdrawn from a portfolio by assuming that all external cash flows occur at the mid-point of the period, thus half-weighting the net total external flow for the period when calculating the period's average capital invested (denominator):

$$r_t^{OD} = \frac{V_t^E - V_t^B - \sum_{i=1}^I CF_{i,t}}{V_t^B + \sum_{i=1}^I (CF_{i,t} \times 0.5)},$$

where

r_t^{OD} = the Original Dietz return for the portfolio for period t

V_t^E = the ending value of the portfolio for period t

V_t^B = the beginning value of the portfolio for period t

i = the number of external cash flows (1, 2, 3, . . . I) in period t

$CF_{i,t}$ = the value of cash flow i in period t (*contributions to the portfolio are positive flows and withdrawals or distributions are negative flows*)

TWRR that adjusts for day-weighted external cash flows (*allowable for any calculation period; required for periods beginning on or after 1 January 2005*) Calculation methods approximating TWRR using a day-weighted adjustment for external cash flows that occur during the calculation period are required for periods beginning on or after 1 January 2005. The denominator in this calculation reflects the weighting of external cash flows for the days they have been in the portfolio and available for investment during the period. Examples of acceptable day-weighted methods are the Modified Dietz and Internal Rate of Return (IRR) methods. These methods are also estimates of the true TWRR because they weight each external cash flow in the denominator by the days it is held in the portfolio.

Modified Dietz Method. The Modified Dietz method improves upon the Original Dietz method, which assumes that all external cash flows occur during the mid-point of the period. In an attempt to determine a more accurate return, the Modified Dietz method weights each external cash flow in the denominator by the amount of time it is held in the portfolio. The formula for estimating the time-weighted rate of return using the Modified Dietz method is

$$r_t^{MD} = \frac{V_t^E - V_t^B - \sum_{i=1}^I CF_{i,t}}{V_t^B + \sum_{i=1}^I (CF_{i,t} \times w_{i,t})},$$

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where

r_t^{MD} = the Modified Dietz return for the portfolio for period t

V_t^E = the ending value of the portfolio for period t

V_t^B = the beginning value of the portfolio for period t

i = the number of external cash flows (1, 2, 3 . . . I) in period t

$CF_{i,t}$ = the value of cash flow i in period t

$w_{i,t}$ = the weight of cash flow i in period t (assuming the cash flow occurred at the end of the day), as calculated according to the following formula:

$$w_{i,t} = \frac{D_t - D_{i,t}}{D_t},$$

where

$w_{i,t}$ = the weight of cash flow i in period t , assuming the cash flow occurred at the end of the day

D_t = the total number of calendar days in period t

$D_{i,t}$ = the number of calendar days from the beginning of period t to cash flow i

Other formulas in addition to the Modified Dietz method for calculating approximate time-weighted rates of return are also permitted.

The numerator is based on the assumption that the external cash flows occur at the end of the day. If external cash flows were assumed to occur at the beginning of the day, the numerator would be $[(D_t - D_{i,t}) + 1]$. A firm may choose to use a beginning-of-day or end-of-day external cash flow assumption or some combination of the two. The key is to establish a policy and treat external cash flows consistently.

The chief advantage of the Modified Dietz method is that it does not require portfolio valuation on the date of each external cash flow. Its chief disadvantage is that it provides a less accurate estimate of the true time-weighted rate of return than when the portfolio is valued at the time of each external cash flow. The estimate suffers most when a combination of the following conditions exists: (1) one or more large external cash flows occur; (2) external cash flows occur during periods of high market volatility—that is, the portfolio's returns are significantly non-linear.

Internal Rate of Return (IRR) Method. The IRR, which is a money-weighted return, is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows.

The IRR is that value of R that satisfies the following equation:

$$V_E = \sum_{i=0}^n CF_i(1 + R)^{W_i},$$

where V_E and W_i are the same as for the Modified Dietz method.

The external cash flows, CF_p , are also the same as with the Modified Dietz method with one important exception: The value at the beginning of the period is also treated as an external cash flow—that is, $V_B = CF_0$.

The IRR is obtained by selecting values for R and solving the equation until the result equals V_E . For example, if three external cash flows (including the value at the beginning of the period) have occurred, the computational formula will have three terms:

$$VE = CF_0(1 + R)^{W_0} + CF_1(1 + R)^{W_1} + CF_2(1 + R)^{W_2}.$$

The first term deals with the first external cash flow, CF_0 , which is the value of the portfolio at the beginning of the period; W_i is the proportion of the period when the external cash flow CF_i was held in the portfolio. Because CF_0 is in for the whole period, $W_0 = 1$. The larger the value of CF_i in the term, the more it will contribute to the total, but the smaller the exponent (i.e., the value of W_i), the less the term will contribute to the sum. The usual effect is that the first term, with a large CF_0 and W_0 equal to 1, will contribute far more than the other terms.

The advantages and disadvantages of the IRR method are the same as those of the Modified Dietz method. The IRR method has the additional disadvantage of requiring an iterative process solution and is thus less desirable than the Modified Dietz method when manual calculation is required. It is also possible to have multiple answers if there are both positive and negative external cash flows.

3-2

TWRR that values portfolios at the time of large cash flows (*allowable for any calculation period; required for periods beginning on or after 1 January 2010*) In order to calculate a more accurate time-weighted return, a large cash flow must be defined by each firm for each composite to determine when the portfolios in that composite are to be valued for performance calculations. A large cash flow is the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued at the time of the external cash flow. Firms must define the amount, for each composite, in terms of (1) the value of the cash/asset flow, or in terms of a percentage of the portfolio assets or the composite assets, and (2) whether it is a single flow or an aggregate of a number of flows within a stated period of time.

The actual valuation of the portfolio's investments and calculation of return each time there is a large cash flow will result in a more accurate TWRR calculation than using either the mid-point or day-weighted methods, but is less accurate than a "true" TWRR calculation methodology, which requires valuation and return calculation with every external cash flow.

The returns calculated for each sub-period are then geometrically linked according to the following formula:

$$r_t^{TWR} = [(1 + r_1) \times (1 + r_2) \times \dots \times (1 + r_I)] - 1,$$

where r_t^{TWR} is the time-weighted return for period t and period t consists of I sub-periods.

The chief advantage of this method is that it calculates a better estimate than the mid-point or day-weighting methods. The major disadvantage is that it requires precise valuation of the portfolio each time there is a large cash flow. In practice, this means that firms must have the ability to value portfolios on a daily basis. If all investments are not accurately priced for each sub-period valuation, errors generated in the return calculation may be greater than the errors caused by using the mid-point or day-weighting approximation methods. In such cases, it is important to be able to correct for errors, such as missed security splits, mispricings, and improperly booked transactions, because day-to-day compounding will not correct for them automatically if there are external cash flows.

Because a time-weighted rate of return using *actual* valuations at the time of large cash flows is required for periods beginning on or after 1 January 2010, firms using less accurate approximation methods must change their calculation methods for periods beginning on or after 1 January 2010.

Geometric Linking If monthly composite returns are calculated, the monthly returns are linked geometrically using this formula:

$$r_{QT} = [(1 + r_{MO1}) \times (1 + r_{MO2}) \times (1 + r_{MO3})] - 1,$$

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where r_{QT} is the composite quarterly return and r_{MO1} , r_{MO2} , and r_{MO3} are the composite returns for Months 1, 2, and 3, respectively.

Similarly, to compute the annual rate of return for composite returns calculated quarterly, the formula to use is

$$r_{YR} = \left[(1 + r_{QT1}) \times (1 + r_{QT2}) \times (1 + r_{QT3}) \times (1 + r_{QT4}) \right] - 1,$$

where r_{QT1} , r_{QT2} , r_{QT3} , and r_{QT4} are composite returns for Quarters 1, 2, 3, and 4, respectively.

Alternatively, firms could geometrically link the 12 monthly returns to calculate the annual return.

Q&A

3-2

1. *Does the firm violate the GIPS standards by reporting money-weighted rates of return to an existing client for their portfolio?*

No. The GIPS standards do not address client reporting, and therefore, the GIPS standards would not be violated if the firm reported money-weighted rates of return to an existing client for their portfolio. The GIPS standards are primarily based on the concept of presenting the firm's composite performance to a prospective client rather than presenting individual portfolio returns to an existing client. Money-weighted returns may add further value in understanding the impact to the client of the timing of external cash flows but are less useful for comparing one firm/manager to another and are, therefore, only required in the GIPS standards for private equity portfolios and closed-end real estate funds where the investment firm controls the cash flows. The IRR (or money-weighted return) represents the performance of the specific client's portfolio holdings (i.e., influenced by the client's timing and amount of cash flows) and measures the performance of the portfolio rather than the performance of the investment manager.

2. *Given the following information, calculate the rates of return for this portfolio for January, February, March, and the first quarter of 1998 by using the Dietz and Modified Dietz methods and by valuing for large cash flows > 5%. Assume cash flows occur at the end of the day.*

Date	Value (€)	External Cash Flow (€)	Value Post External Cash Flow (€)
12/31/97	200,000		
1/31/98	208,000		
2/16/98	217,000	+40,000	257,000
2/28/98	263,000		
3/22/98	270,000	-30,000	240,000
3/31/98	245,000		

Solution: Dietz

January

$$R_{Jan} = \frac{(208,000 - 200,000)}{200,000} = 4.00\%.$$

February

$$R_{Feb} = \frac{(263,000 - 208,000 - 40,000)}{[208,000 + (0.5 \times 40,000)]} = 6.58\%.$$

March

$$R_{Mar} = \frac{[245,000 - 263,000 - (-30,000)]}{[263,000 + (0.5 \times (-30,000))]} = 4.84\%.$$

Quarter 1

$$R_{QT1} = [(1 + 0.0400) \times (1 + 0.0658) \times (1 + 0.0484)] - 1 = 16.21\%.$$

3-2

Solution: Modified Dietz

January

$$R_{Jan} = \frac{(208,000 - 200,000)}{200,000} = 4.00\%.$$

February

$$W = \frac{(28 - 16)}{28} = 0.43.$$

$$R_{Feb} = \frac{(263,000 - 208,000 - 40,000)}{[208,000 + (40,000 \times 0.43)]} = 6.66\%.$$

March

$$W = \frac{(31 - 22)}{31} = 0.29.$$

$$R_{Mar} = \frac{[245,000 - 263,000 - (-30,000)]}{[263,000 + (-30,000 \times 0.29)]} = 4.72\%.$$

Quarter 1

$$R_{QT1} = [(1 + 0.0400) \times (1 + 0.0666) \times (1 + 0.0472)] - 1 = 16.16\%.$$

Solution: Valuation and Calculation at Time of Large Cash Flows

January

$$R_{Jan} = \frac{(208,000 - 200,000)}{200,000} = 4.00\%.$$

February

$$R_{Feb1-15} = \frac{(217,000 - 208,000)}{(208,000)} = 4.33\%.$$

$$R_{Feb16-28} = \frac{(263,000 - 257,000)}{(257,000)} = 2.33\%.$$

$$R_{Feb1-28} = [(1 + 0.0433) \times (1 + 0.0233)] - 1 = 6.76\%.$$

3 Explanation of the Provisions of the GIPS Standards

March

$$R_{Mar1-21} = \frac{(270,000 - 263,000)}{(263,000)} = 2.66\%.$$

$$R_{Mar22-31} = \frac{(245,000 - 240,000)}{(240,000)} = 2.08\%.$$

$$R_{Mar1-31} = [(1 + 0.0266) \times (1 + 0.0208)] - 1 = 4.80\%.$$

Quarter 1

$$R_{QT1} = [(1 + 0.0400) \times (1 + 0.0676) \times (1 + 0.0480)] - 1 = 16.36\%.$$

3-2

3. *Should securities lending income be included in the investment firm's performance?*

The GIPS standards provide comparability of the performance of investment managers by utilizing composites, which are based on investment strategy. Typically, securities lending is not an active part of the portfolio strategy. Therefore, unless the securities lending is a part of the strategy defined by and at the discretion of the investment manager, for purposes of reporting performance for the GIPS standards, securities lending income should be treated like an external cash flow and subtracted from performance results in order to get an accurate representation of the investment manager's ability to implement the intended strategy of the portfolio. Firms should disclose how securities lending income is treated.

4. *We manage certain portfolios, including pooled vehicles, which may participate in securities lending. We have recognized income related to securities lending in the portfolio performance. Due to bankruptcies and other market events, we did not receive back securities that had been loaned and instead received the pledged collateral. The value of the collateral received is less than the value of the securities loaned, resulting in a negative impact to performance. Can we exclude this negative impact from the portfolio's return calculation? Alternatively, can we exclude the portfolio from the composite?*

The firm cannot exclude the impact of the securities lending collateral shortfall if it had previously determined that it would include the income associated with securities lending. Firms must not exclude the portfolio from the respective composite due to the loss on securities lending collateral.

5. *We manage certain portfolios that participate in securities lending, but securities lending is not part of the strategy. The securities lending arrangement is between our client and the client's custodian. We do not recognize income related to securities lending in the portfolio's performance. Due to bankruptcies and other market events, the portfolio did not receive back the securities that had been loaned and instead received the pledged collateral. The value of the collateral received is less than the value of the securities loaned, resulting in a negative impact to performance. Can we exclude this negative impact from the portfolio's return calculation?*

Yes. In cases where the securities lending decision was made by the client, securities lending is not part of the intended strategy, and the firm has not included securities lending income in the performance of the portfolio, any impact caused by the securities lending transactions, including a shortfall in related pledged collateral, may be excluded from the performance of the portfolio.

Provision 2.A.3

Returns from cash and cash equivalents held in PORTFOLIOS MUST be included in all return calculations.

3-2

Discussion

Returns earned on cash and cash equivalents held in portfolios must be combined with the returns of other assets in the portfolio to calculate the portfolio's return. The investment manager's asset allocation decisions, including allocation to cash, are a component of the implementation of an investment strategy and thus part of the portfolio's return.

If the manager does not control the actual investment of cash (e.g., cash is always invested in a custodial money market fund or invested separately by the client) but does control the amount of the portfolio that is allocated to cash, then the cash assets must be included in the manager's total assets and the performance of cash must be included in the portfolio performance. The fact that the investment of cash is technically not under the manager's control will not generally affect the portfolio's returns as much as the allocation of assets to cash, which is under the manager's control.

Q&A

1. *Firm A manages the portfolios of several clients and has full investment discretion over their assets. At the end of each day, the excess cash in each portfolio is swept into the custodian's money market fund. Because Firm A does not manage the money market fund, it does not include the cash portion of the portfolio in its total return performance calculation. Is this practice in compliance with the GIPS standards?*

No. Even if Firm A does not control the cash investment, it does control the amount of portfolio assets that are held in cash equivalents. Because Firm A chose to have portfolio assets "invested" in cash, Firm A is responsible for the return the cash assets earn and it must be included in the total return of the portfolio.

2. *In most instances, our clients select the cash vehicle into which excess cash is swept each evening. We recognize the income on this cash vehicle in the portfolio return. The client-selected cash vehicle recently "broke" the \$1.00 NAV. As the client selected the cash vehicle, we wish to exclude the impact of the change in NAV from the portfolio return. May we do so?*

No. You must include the impact of the change in NAV on this cash vehicle in the portfolio return and composite return. Even if the firm does not control the cash vehicle used, it does control the amount of portfolio assets that are held in cash and cash equivalents. Because the firm chose to have portfolio assets "invested" in cash and cash equivalents, the firm is responsible for the performance of this investment and the change in NAV must be included in the total return of the portfolio. Additionally, the firm must continue to include the portfolio in the respective composite.

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Provision 2.A.4

All returns **MUST** be calculated after the deduction of the actual **TRADING EXPENSES** incurred during the period. **FIRMS MUST NOT** use estimated **TRADING EXPENSES**.

Discussion

Trading expenses are defined as the actual costs of buying or selling investments. These costs typically take the form of brokerage commissions, exchange fees and/or taxes, and/or bid–offer spreads from either internal or external brokers. Custodial fees charged per transaction should be considered custody fees and not trading expenses. For purposes of the GIPS standards, firms must reduce both gross-of-fees and net-of-fees returns by the trading expenses incurred in the purchase or sale of investments. These trading expenses must be included when calculating performance because these are costs that must be paid in order to implement the investment strategy. Estimated trading expenses are not permitted.

3-2

Provision 2.A.5

If the actual **TRADING EXPENSES** cannot be identified and segregated from a **BUNDLED FEE**:

- a. When calculating **GROSS-OF-FEES** returns, returns **MUST** be reduced by the entire **BUNDLED FEE** or the portion of the **BUNDLED FEE** that includes the **TRADING EXPENSES**. **FIRMS MUST NOT** use estimated **TRADING EXPENSES**.
- b. When calculating **NET-OF-FEES** returns, returns **MUST** be reduced by the entire **BUNDLED FEE** or the portion of the **BUNDLED FEE** that includes the **TRADING EXPENSES** and the **INVESTMENT MANAGEMENT FEE**. **FIRMS MUST NOT** use estimated **TRADING EXPENSES**.

Discussion

A bundled fee portfolio is a portfolio with a fee structure that combines multiple fees into one total or “bundled” fee. Bundled fees can include any combination of investment management fees, trading expenses, custody fees, and/or administrative fees. Performance must reflect (be reduced by) the trading expenses incurred by the portfolio during the measurement period.

The GIPS standards define a gross-of-fees return as the return on investments reduced by any trading expenses incurred during the period. To meet the requirements of the GIPS standards when calculating a bundled fee portfolio’s gross-of-fees return, if the firm can identify the portion of the bundled fee that includes the trading expenses, that is the only portion of the bundled fee that must be reflected in the performance calculation. If the firm is unable to determine the portion of the bundled fee that includes the trading expenses, the entire bundled fee must be reflected (i.e., reduce performance) when calculating the bundled fee portfolio’s gross-of-fees return.

The GIPS standards define a net-of-fees return as the gross-of-fees return reduced by investment management fees, which includes performance-based fees and carried interest. To meet the requirements of the GIPS standards when calculating a bundled fee portfolio’s net-of-fees return, if the firm can identify the portion of the bundled fee that includes investment management fees, that is the only portion of the bundled fee that must be reflected in the performance calculation. If

the firm is unable to determine the portion of the bundled fee that includes trading expenses and investment management fees, the entire bundled fee must be reflected (i.e., reduce performance) when calculating the bundled fee portfolio's net-of-fees return.

Provision 2.A.6

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.

3-2

Discussion

A composite is defined as an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The objective in calculating the composite's return is to use a method that will conceptually produce the same value as if the assets of all the individual portfolios in the composite were aggregated and a return was calculated as if the composite were one portfolio. The composite return must be the asset-weighted average of the performance of all the portfolios in the composite.

The GIPS standards are based on the principle of asset-weighted composite returns. For example, if a composite contains two portfolios, one of which is 10 times the size of the other, the rate of return for the larger portfolio should have more impact on the composite return than the rate of return for the smaller portfolio. The asset-weighted return method accomplishes this by weighting each portfolio's contribution to the composite rate of return by its beginning value (as a percentage of the composite's beginning value).

The GIPS standards require asset weighting of the portfolio returns within a composite using beginning-of-period values or beginning-of-period values plus weighted external cash flows or by aggregating portfolio assets and external cash flows to calculate performance as a single master portfolio.

The *Beginning Assets Weighting* method for calculating composite returns, R_t , uses the formula

$$R_t = \frac{\sum_{k=1}^K (V_{k,t}^B \times r_{k,t})}{\sum_{k=1}^K V_{k,t}^B},$$

where

R_t = the beginning assets weighted return for the composite for period t

k = the number of portfolios (1, 2, 3, . . . , K) in the composite at the beginning of period t

$V_{k,t}^B$ = the beginning value of portfolio k for period t

$r_{k,t}$ = the return of portfolio k for period t

The Beginning Assets Weighting method can also be expressed as

$$R_t = \sum_{k=1}^K \left(\frac{V_{k,t}^B}{\sum_{k=1}^K V_{k,t}^B} \times r_{k,t} \right) = \sum_{k=1}^K w_{k,t}^B r_{k,t},$$

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where $w_{k,t}^B$ is the weight of the value of portfolio k as a fraction of total composite asset value based on beginning asset values for period t and can be calculated according to the following formula:

$$w_{k,t}^B = \frac{V_{k,t}^B}{\sum_{k=1}^K V_{k,t}^B}$$

The *Beginning Assets Plus Weighted Cash Flow* method represents a refinement to the Beginning Assets Weighting method. Consider the case in which one of two portfolios in a composite doubles in value as the result of a contribution on the third day of a performance period. Under the Beginning Assets Weighting method, this portfolio will be weighted in the composite based solely on its beginning value (i.e., not including the contribution). The Beginning Assets Plus Weighted Cash Flow method resolves this problem by including the effect of external cash flows in the calculation. Assuming that external cash flows occur at the end of the day, the weighting factor for each cash flow is calculated using the same methodology as in the Modified Dietz method as follows:

$$w_{i,k,t} = \frac{D_t - D_{i,k,t}}{D_t},$$

where

$w_{i,k,t}$ = the weight of cash flow i in portfolio k in period t , assuming the cash flow occurred at the end of the day

D_t = the total number of calendar days in period t

$D_{i,k,t}$ = the number of calendar days from the beginning of period t to cash flow i in portfolio k

The numerator is based on the assumption that the external cash flows occur at the end of the day. If external cash flows were assumed to occur at the beginning of the day, the numerator would be $[(D_t - D_{i,t}) + 1]$. A firm may choose to use a beginning-of-day or end-of-day external cash flow assumption or some combination of the two. The key is to establish a policy and treat external cash flows consistently.

The Beginning Assets Plus Weighted Cash Flow composite return can be calculated as follows:

$$R_t = \frac{\sum_{k=1}^K \left\{ V_{k,t}^B + \sum_{i=1}^{I_k} (CF_{i,k,t} \times w_{i,k,t}) \right\} \times r_{k,t}}{\sum_{k=1}^K \left[V_{k,t}^B + \sum_{i=1}^{I_k} (CF_{i,k,t} \times w_{i,k,t}) \right]}$$

where

R_t = the beginning assets plus weighted cash flow composite return for period t

$V_{k,t}^B$ = the beginning value of portfolio k for period t

i_k = the number of cash flows (1, 2, 3, . . . , I_k) in portfolio k

$CF_{i,k,t}$ = the i th cash flow in portfolio k for period t

$w_{i,k,t}$ = the weight of cash flow i in portfolio k for period t

$r_{k,t}$ = the return for portfolio k for period t

The Beginning Assets Plus Weighted Cash Flow composite return method can also be expressed by the following formula:

$$R_t = \sum_{k=1}^K \left(\frac{V_{k,t}}{\sum_{k=1}^K V_{k,t}} \times r_{k,t} \right),$$

where

R_t = the beginning assets plus weighted cash flow composite return for period t

$r_{k,t}$ = the return for portfolio k for period t

$V_{k,t}$ = the beginning value plus weighted cash flows of portfolio k for period t as calculated according to the following formula:

$$V_{k,t} = V_{k,t}^B + \sum_{i=1}^{I_k} (CF_{i,k,t} \times w_{i,k,t}),$$

where

$V_{k,t}$ = the value of portfolio k 's beginning assets plus weighted cash flows for period t

$V_{k,t}^B$ = the beginning value of portfolio k for period t

i_k = the number of cash flows (1, 2, 3, . . . , I_k) in portfolio k

$CF_{i,k,t}$ = the i th cash flow in portfolio k for period t

$w_{i,k,t}$ = the weight of cash flow i in portfolio k for period t

The *Aggregate Return* method combines all the composite assets and external cash flows before any calculations occur to calculate returns as if the composite were one portfolio. The method is also acceptable as an asset-weighted approach. Unlike the Beginning Assets Weighting method or the Beginning Assets Plus Weighted Cash Flow method, portfolio returns are not used in the Aggregate Return method. Instead, this method combines all the composite assets and external cash flows before any calculations occur to calculate returns as if the composite were one portfolio.

Q&A

1. *Can you demonstrate how to calculate the composite return using the Beginning Assets Weighting method, the Beginning Assets Plus Weighted Cash Flow method, and the Aggregate Return method, assuming that cash flows occur at the end of the day, based on the following data?*

Portfolio 1

Date	Value (\$)	External Cash Flow (\$)	Value Post External Cash Flow (\$)
12/31/99	100,000		
1/10/00	103,000	20,000	123,000
1/22/00	130,000		
1/31/00	133,000		
Monthly Return = 11.37%.			

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Portfolio 2

Date	Value (\$)	External Cash Flow (\$)	Value Post External Cash Flow (\$)
12/31/99	500,000		
1/10/00	512,000		
1/22/00	530,000	-70,000	460,000
1/31/00	470,000		

Monthly Return = 8.30%.

3-2

Composite Return

Beginning Assets Weighting method:

$$R_{BMV} = \frac{(100,000 \times 0.1137) + (500,000 \times 0.0830)}{(100,000 + 500,000)} = 8.81\%$$

Beginning Assets Plus Weighted External Cash Flow method:

$$W_{PORT2} = \frac{(31 - 22)}{31} = 0.29.$$

$$W_{PORT1} = \frac{(31 - 10)}{31} = 0.68.$$

$$R_{BMV+CF} = \frac{\{[100,000 + (20,000 \times 0.68)] \times 0.1137\} + \{[500,000 + (-70,000 \times 0.29)] \times 0.0830\}}{\{[100,000 + (20,000 \times 0.68)] + [500,000 + (-70,000 \times 0.29)]\}} = 8.89\%$$

Aggregate Return method (using Modified Dietz method):

$$W_{Port1} = \frac{(31 - 10)}{31} = 0.68.$$

$$W_{Port2} = \frac{(31 - 22)}{31} = 0.29.$$

$$R_{January} = \frac{[(133,000 + 470,000) - (100,000 + 500,000) - (20,000 - 70,000)]}{[100,000 + 500,000 + (20,000 \times 0.68) + (-70,000 \times 0.29)]} = 8.93\%$$

2. We calculate portfolio and composite returns monthly. When calculating monthly composite returns, how do we reflect the performance of new portfolios that begin during the month and that were not managed for the entire month? Does your answer change if we use the aggregate method to calculate composite returns?

Portfolio	Period Managed In Strategy	Include/Exclude
1	1 May 2011–31 May 2011	Include
2	1 May 2011–31 May 2011	Include
3	14 May 2011–31 May 2011	Exclude
4	1 May 2011–31 May 2011	Include
5	1 May 2011–31 May 2011	Include
6	1 May 2011–31 May 2011	Include
7	1 May 2011–20 May 2011	Exclude
8	19 May 2011–31 May 2011	Exclude

When calculating composite returns for a specific period, only portfolios that are included in the composite for the entire performance measurement period are included in the calculation. In this situation, when calculating monthly composite returns, only those portfolios that are managed on a discretionary basis for the full month are included in the composite return calculation. Portfolios that begin during the month, close during the month, or are otherwise determined to not qualify for inclusion in the composite for the full month must not be included in the composite return calculation. The method used to calculate monthly composite returns does not have any impact on the population of portfolios that are included in the composite return calculation.

For example, assume Firm A maintains a Small Cap Value Composite. For the month of May 2011, Firm A manages 8 portfolios in this strategy at any point in time during the month. Only those portfolios managed for the full month, from 1 May 2011 through 31 May 2011, are included in the composite calculation. In this example, Portfolio 3 is not included in the composite calculation as it began on 14 May 2011 and does not have a full month of performance. The same is true for Portfolio 8. It also does not have a full month of performance; therefore, it is not included in the May 2011 composite calculation. Portfolio 7, which terminated on 20 May 2011, is not included in the calculation because it too does not have a full month of performance. Because the composite return is calculated monthly, only the five portfolios that have a full month of performance, from 1 May 2011 through 31 May 2011, are included in the composite return calculation for the month of May 2011.

When calculating a monthly composite return and the performance measurement period is defined as a month, a firm must not include in the composite calculation portfolios that were not managed for the full month and, therefore, do not have a full month of performance. If a firm wishes to include in composite returns portfolios that do not have a full month of performance, the firm must calculate composite returns more frequently than monthly, e.g., daily. Assuming a firm calculates composite returns daily, the firm would include in the daily composite return calculation only those portfolios that were managed for the full day. Firms must consistently follow their policies and procedures for calculating composite returns.

3. *We use the aggregate method to calculate monthly composite returns. We calculate portfolio returns monthly and only value a portfolio during the month if it experiences a large cash flow that is greater than 5% of its beginning-of-month value. We use the same large cash flow level for the composite. If any cash flow is greater than 5% of the composite's beginning-of-month value, we value all of the portfolios in the composite. For one month, we calculated a composite return that was lower than the return of any portfolio in the composite. Does this mean that the aggregate method is not accurate and should not be used?*

The aggregate method is an accurate method for calculating composite returns. This method calculates the composite return using the sum of the portfolio-level information for those portfolios included in the composite for the full period. The situation described in the question, where the composite return is outside the range of portfolio-level returns for a given period, can occur if the policies used to calculate portfolio-level returns do not flow through to the aggregate composite-level return calculation policies. What is meant by “flowing through” to the composite is as follows: if any portfolio is valued during the month due to a large cash flow, the entire composite would also be valued and the sub-period return calculated for both the portfolio and the composite. However, in this situation, the large cash flow policies have been established such that only those

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portfolios in the composite that experience a large cash flow during the month are valued at the time of the large cash flow while the portfolios that did not experience a large cash flow are not valued during the month. To prevent this situation from occurring, the firm should consider establishing a policy where all portfolios in the composite are valued if any portfolio in the composite is valued during the month due to large cash flows. Once a firm has established large cash flow policies for a composite, the firm must apply the large cash flow policies consistently.

3-2

Provision 2.A.7

COMPOSITE returns MUST be calculated:

- a. For periods beginning on or after 1 January 2006, by asset weighting the individual PORTFOLIO returns at least quarterly.
- b. For periods beginning on or after 1 January 2010, by asset weighting the individual PORTFOLIO returns at least monthly.

Discussion

The more frequently composite returns are calculated, the more accurate the results will be. Quarterly composite calculations are permitted for periods prior to 1 January 2010; subsequently, composite returns must be calculated at least monthly.

The composite population must be consistent for the entire performance measurement period (e.g., for the entire month if the composite is calculated using monthly portfolio returns).

Calculation Methodology—Recommendations

Provision 2.B.1

Returns SHOULD be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes SHOULD be accrued.

Discussion

Global investing requires recognition of the tax consequences of investing in different countries. The GIPS standards recommend that performance be reported net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Some countries allow certain types of foreign investors to reclaim a portion of the foreign withholding taxes that are paid when transactions or payments occur. These reclaimable foreign withholding taxes may be credited back to the investor at a later date. It is recommended that reclaimable foreign withholding taxes be accrued.

Provision 2.B.2

For periods prior to 1 January 2010, FIRMS SHOULD calculate COMPOSITE returns by asset weighting the individual PORTFOLIO returns at least monthly.

Discussion

The more frequently composite returns are calculated, the more accurate the results will be.

3-3 COMPOSITE CONSTRUCTION

Composite Construction—Requirements

Provision 3.A.1

All actual, fee-paying, discretionary PORTFOLIOS MUST be included in at least one COMPOSITE. Although non-fee-paying discretionary PORTFOLIOS may be included in a COMPOSITE (with appropriate disclosure), non-discretionary PORTFOLIOS MUST NOT be included in a FIRM'S COMPOSITES.

3-3

Discussion

A portfolio is an individually managed group of investments, which may be an account or pooled investment vehicle. The portfolio is generally managed on behalf of a client for a defined strategy. An actual portfolio is a portfolio invested in real (tangible) assets and is differentiated from a hypothetical, simulated, or back-tested portfolio or an advisory-only (model) portfolio.

A fee-paying portfolio incurs investment management fees, which are fees paid to the firm for the management of the portfolio. These investment management fees are typically asset based (a percentage of assets), performance based (based on performance of the portfolio on an absolute basis or relative to a benchmark), or a combination of the two, but may take different forms as well. Non-fee-paying discretionary portfolios may be included in the firm's composites. If a firm chooses to include non-fee-paying discretionary portfolios in a specific composite, all non-fee-paying portfolios meeting the definition of that composite must be included. Firms must present, as of the end of each annual period, the percentage of composite assets represented by non-fee-paying portfolios. If the firm chooses to include non-fee-paying discretionary portfolios in one or more of its composites, the firm is not required to include all non-fee-paying discretionary portfolios in composites. Examples of non-fee-paying portfolios are portfolios consisting of the firm's own pension plan assets or portfolios managed for friends or employees that are not charged investment management fees. If a firm temporarily waives the investment management fee for a portfolio that is normally charged a fee, the portfolio is still considered a fee-paying portfolio (with a fee of zero for that period) and must be included in the appropriate composite.

If the firm includes non-fee-paying discretionary portfolios in its composites, they are subject to the same rules as fee-paying portfolios (e.g., the firm must not move the non-fee-paying portfolio into and out of a composite without documented changes in client guidelines or unless the redefinition of the composite make it appropriate).

Discretion is the ability of the firm to implement its intended strategy. If documented client-imposed restrictions significantly hinder the firm from fully implementing its intended strategy, the firm may determine that the portfolio is non-discretionary. There are degrees of discretion, and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy.

Non-discretionary portfolios must not be included in a firm's composites. Some firms, however, may group some or all of the firm's non-discretionary portfolios together to simplify portfolio administration. For purposes of complying with the GIPS standards, this is *not* a composite and must not be included on the firm's list of composite descriptions. Firms make the ultimate decision as to whether or not portfolio restrictions render a portfolio non-discretionary. Firms must document the reasons for classifying each portfolio as non-discretionary.

Discretion should be defined at the firm level but may be defined at the composite level or by asset class if appropriate. Once the definition of discretion has been determined, it must be applied consistently.

It is the firm's responsibility to ensure that all of its actual, fee-paying, discretionary portfolios are included in at least one composite. Accordingly, firms must review each of their portfolios (both discretionary and non-discretionary) on a regular basis to determine whether any portfolios must be re-classified.

Firms must include a portfolio in more than one composite if it satisfies the definition of each composite, and each composite must contain all portfolios that meet the composite's definition.

Q&A

1. *Firm B manages several portfolios according to a particular strategy; however, the firm does not ever plan to market the strategy. Do these portfolios have to be included in a composite?*

Yes. These portfolios must be included in a composite if the portfolios are actual, fee-paying, discretionary portfolios. It is important to remember that the GIPS standards do not differentiate between "marketed" and "non-marketed" composites.

The requirement for firms to include all actual, fee-paying, discretionary portfolios in at least one composite ensures that a firm presents a complete picture of its performance record. Without this requirement, there is a potential for firms to exclude poorly performing portfolios from composites. Because the intent of the GIPS standards is to accurately and fairly represent firm performance, all actual, fee-paying, discretionary portfolios must be included in at least one of the firm's composites. Firms must maintain a list of composite descriptions, which must include all composites, whether marketed or not, and must disclose that the list is available upon request.

If client-imposed restrictions on these portfolios do not allow the implementation of the firm's strategy, the firm could either classify these portfolios (and all other portfolios with the same restriction) as non-discretionary or could choose to classify them as discretionary and create a composite for portfolios with the defined restrictions. Firms should, where possible and appropriate, consider classifying portfolios with defined restrictions as discretionary and grouping them with portfolios with similar restrictions in a composite.

2. *Firm C manages a portfolio that recently had new investment restrictions placed on it by the client, rendering it non-discretionary. Should the firm retroactively remove that portfolio from its composite?*

No. The firm must not retroactively remove that portfolio from its composite. Firm C has the responsibility for creating its own definition of discretion and applying this definition consistently over time to all portfolios. A portfolio that changes from discretionary to non-discretionary status due to a new client-imposed restriction must be removed from a composite on a prospective basis only.

3 Explanation of the Provisions of the GIPS Standards

3. *Firm F seeks to establish a record for managing aggressive growth portfolios but does not yet manage client funds to that style. To create a performance history to show potential clients, the firm uses its own capital to create a portfolio that is managed to an aggressive growth style and does not charge a management fee for this portfolio. Can the firm present this performance in a new aggressive growth composite and remain in compliance with the GIPS standards?*

Yes. Firm F may create an aggressive growth composite consisting only of the firm's seed capital. The firm must show in the compliant presentation the percentage of composite assets that are non-fee-paying as of each annual period end, which in this case equals 100%. The composite performance record would begin with the inception of the one portfolio and, therefore, would not have any prior history. As the firm acquires portfolios that are managed to this strategy, the new portfolios' performance will be included in the composite as soon as they meet the composite inclusion criteria the firm establishes for the composite. Firms should disclose if a composite contains proprietary assets.

4. *Is there a minimum number of portfolios, a minimum percentage of a firm's portfolios, and/or a minimum amount of money that must comprise a legitimate composite?*

No. There is not a minimum number of portfolios, a minimum percentage of a firm's portfolios, and/or a minimum amount of money that must comprise a composite. All actual, fee-paying, discretionary portfolios must be included in at least one composite; composites must be defined according to investment mandate, objective, or strategy.

5. *Can a firm include a single portfolio in more than one of the firm's composites?*

Yes. The GIPS standards require firms to include all actual, discretionary, fee-paying portfolios in at least one of the firm's composites. If the portfolio meets the defined criteria for inclusion in more than one composite, the firm must include the portfolio in all of the firm's appropriate composites. For example, a firm may have a large-cap composite and a large-cap growth composite. If the firm manages a portfolio that meets the criteria for inclusion in the large-cap composite as well as the large-cap growth composite, the firm must include the portfolio in both composites. When calculating total firm assets, firms are prohibited from double-counting assets. An asset must be counted only once, even if it is included in more than one composite.

6. *How do we determine what is considered a non-fee-paying portfolio?*

If a portfolio pays no investment management fee, it is considered a non-fee-paying portfolio. Some firms may manage portfolios that have a minimal investment management fee that is meant to cover operating or transaction costs. If a portfolio has a very small investment management fee that is not representative of an investment management fee a portfolio would typically pay, the firm should consider such a portfolio as a non-fee-paying portfolio.

7. *How should incubator fund performance be presented under the GIPS standards?*

Incubator funds typically are portfolios set up with firm assets to initiate a new style of asset management. As such, they are typically non-fee-paying portfolios. The GIPS standards only require fee-paying portfolios to be included in the firm's composites. However, the GIPS standards permit firms to include non-fee-paying portfolios in their composites. If non-fee-paying portfolios are included in one of the firm's composites, the GIPS standards require that the firm present the percentage of the composite assets represented by the non-fee-paying portfolios as of the end of each annual period.

Provision 3.A.2

COMPOSITES MUST include only actual assets managed by the FIRM.

Discussion

Simulated, back-tested, or model performance must not be included in any composites because it does not represent actual assets managed by the firm.

Similarly, firms must not blend the history of two existing composites to create historical performance for a “hybrid” or model composite (e.g., combine the results of an equity composite and a fixed income composite to form a hypothetical balanced composite) and present it as performance in compliance with the requirements of the GIPS standards. Even though the asset class returns are based on actual assets managed by the firm, the arbitrary method of combining them historically is subject to manipulation and does not represent real-time, actual asset allocation decisions.

Firms may present simulated or model (which also includes hypothetical or back-tested) results clearly labeled as supplemental information. Firms must not link performance of simulated or model portfolios with actual performance. Please refer to the Guidance Statement on the Use of Supplemental Information for additional information.

Q&A

1. *Firm A wants to offer a new investment management style. To demonstrate its capability to manage assets according to the new balanced strategy, Firm A creates a new balanced composite and produces three years of performance history using hypothetical assets and a back-tested asset allocation strategy. Can Firm A present this hypothetical composite history as a composite in a compliant presentation?*

No. Hypothetical and back-tested composite returns do not satisfy the requirements of the GIPS standards. Composite returns must only contain actual portfolios managed by the firm and must not include hypothetical or back-tested results. Firms may present hypothetical or back-tested results clearly labeled as supplemental information.

2. *Will a model portfolio, developed by an advisor who does not have discretion to invest assets in accordance with the model, qualify for a composite?*

No. A model portfolio must not be included in total firm assets or composite assets. Model or advisory-only portfolios are not actual, fee-paying, discretionary portfolios and must not be included in composites.

Provision 3.A.3

FIRMS MUST NOT LINK performance of simulated or model PORTFOLIOS with actual performance.

3 Explanation of the Provisions of the GIPS Standards

Discussion

Firms may present performance of simulated or model (which also includes hypothetical or back-tested) portfolios, but this performance must not be linked to the performance of a composite that includes actual portfolios. If performance of simulated or model portfolios is included in a compliant presentation, it must be clearly labeled as supplemental information. Please refer to the Guidance Statement on the Use of Supplemental Information for additional information.

Q&A

1. *Our firm had a composite that lost all of its constituent portfolios for one quarter. May we continue our track record without interruption by using the benchmark return as a simulated return for the missing quarter of performance?*

No. Firms must not link simulated performance to actual performance earned by the firm and represent the history as that of the firm. Composite returns must represent performance of only actual discretionary portfolios managed by the firm.

2. *Are there any limits to what can be shown as supplemental information?*

Yes. The definition and guiding principles of the Guidance Statement on the Use of Supplemental Information are very specific about the types of information that can and cannot be shown as part of a compliant presentation. When in doubt, firms should always turn their focus to the first guiding principle of the Guidance Statement, which is also the fundamental objective of the GIPS standards: to ensure fair representation and full disclosure of performance.

Specifically, firms that claim compliance with the GIPS standards must not present performance or performance-related information that is false or misleading. For example, the following two items are misleading and unrepresentative; therefore, compliant firms are prohibited from presenting this information (unless specifically requested from the firm by a prospective or existing client in a one-on-one presentation):

- Model, hypothetical, back-tested, or simulated results linked to actual performance results.
- Non-portable performance from a prior firm linked to current ongoing performance results.

This is not an exhaustive list and is only provided to show examples of potentially misleading information.

Provision 3.A.4

COMPOSITES MUST be defined according to investment mandate, objective, or strategy. COMPOSITES MUST include all PORTFOLIOS that meet the COMPOSITE DEFINITION. Any changes to a COMPOSITE DEFINITION MUST NOT be applied retroactively. The COMPOSITE DEFINITION MUST be made available upon request.

Discussion

A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. Creating meaningful composites is critical to fair presentation, consistency, and comparability of results over time and among firms. The important concept is that all portfolios in the defined firm are accounted for appropriately in composites. Firms make the ultimate decision as to which portfolios belong in each composite.

Composite definitions, the detailed criteria that determine the assignment of portfolios to composites, must be documented in the firm's policies and procedures. In addition, when requested, the composite definition must be made available.

Defining and constructing composites is one of the first steps in implementing the GIPS standards. Composites are the primary vehicle for presenting performance to a prospective client. The GIPS standards require that firms include *all* actual, discretionary, fee-paying portfolios in at least one composite that is defined according to a particular investment mandate, objective, or strategy. In this way, firms cannot “cherry-pick” their best performing portfolios to present to prospective clients.

The manager must determine what definition of the composite is most appropriate: either a broad, “inclusive” definition of the composite, with a potential for a wide internal dispersion of portfolio returns, or a more limited, narrower, “exclusive” definition, with a potential for a smaller internal dispersion of portfolio returns. This choice will be revealed through the required presentation of the composite assets and either the composite assets as a percentage of total firm assets or the amount of total firm assets at the end of each annual period.

The GIPS standards encourage firms to develop objective criteria for defining composites. The following are guiding principles that firms must consider when defining composites:

- Composites must be defined according to investment mandate, objective, or strategy. Composites should enable clients and prospective clients to compare the performance of one firm with another. The firm should also consider the definition and construction of similar products found within the competitive universe. Composites must be representative of the firm's products and be consistent with the firm's marketing strategy.
- Firms must apply the criteria for defining composites consistently (e.g., the firm may not select only certain, specific portfolios (i.e., “cherry-picking”) that meet the composite definition but must include all portfolios that satisfy the criteria for inclusion).
- Firms are not permitted to include portfolios with materially dissimilar investment mandates, objectives, or strategies in the same composite. The performance of such a composite is meaningless. In the case where there are many portfolios with unique, defining investment characteristics, it may be necessary for the firm to create numerous single-portfolio composites.
- Portfolios must not be switched from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes switching appropriate. The historical performance of the portfolio must remain with the original composite.

Composite Definition Criteria In addition to the guiding principles above, firms may choose to define their composites according to relevant criteria and must document the definition of each composite, including any criteria or constraints. It is constructive to consider a hierarchical structure of criteria for composite definition that promotes primary and secondary strategy characteristics. It is also important to understand the defining characteristics commonly found in the marketplace

3 Explanation of the Provisions of the GIPS Standards

for investment products. Comparability of similar strategies or products is a fundamental objective of the GIPS standards, and it benefits current and prospective clients when firms define composites similarly, using clear and unambiguous terminology.

Suggested Hierarchy for Composite Definition The following suggested hierarchy may be helpful as firms consider how to define composites. Firms are not required to define their composites according to each level of the hierarchy.

Investment Mandate Composites based on the summary of strategy or product description.

Example: Large-cap global equities

Asset Class Composites based on a broad asset class are the most basic and should be representative of the firm's products. Firms may further define asset classes by country or region.

Examples: Equity, fixed income, balanced, real estate, venture capital, U.S. fixed income, European equities

Style or Strategy Firms may further define a composite based on the style or strategy in order to provide investors with additional insight and allow for increased comparability.

Examples: Growth, value, active, indexed, asset class sector (e.g., telecommunications)

Benchmark Firms may define composites on the basis of the portfolios' benchmark or index provided the benchmark reflects the investment objective or strategy and there are no other composites with the same characteristics. This is often the case if the benchmark also defines the investment universe.

Examples: Swiss Market Index, S&P 500 Index, Barclays Capital Aggregate Index

Risk/Return Characteristics Portfolios with different risk characteristics (e.g., targeted tracking error, beta, volatility, and information ratio) and return objectives may be grouped together into different composites.

Example: A Japanese equity composite with a targeted excess return of 1% and targeted tracking error of 2% would be in a separate composite from a Japanese equity composite with a targeted excess return of 3% and targeted maximum volatility of 6%.

Constraints/Guidelines In addition to the fundamental criteria above, firms may choose to further define their composites based on relevant client constraints or guidelines. The following are examples of constraints or guidelines that could result in materially different strategies and, therefore, justify separate composites.

Extent of the Use of Derivatives, Hedging, and/or Leverage In general, portfolios that use derivatives, leverage, and/or hedging have a unique investment strategy from those portfolios that do not utilize these techniques or instruments. Accordingly, firms must consider whether portfolios that use leverage, derivatives, and/or hedging should be included in separate composites from portfolios that are restricted from using such instruments or strategies.

Treatment of Taxes The firm should define separate composites for portfolios with specific tax treatments if the treatment of taxes hinders the firm's ability to implement a specific investment strategy as compared with similar portfolios without specific tax treatments. For example, the different

tax situations of corporate or insurance clients and private clients may require different investment strategies in terms of emphasizing growth versus yield or dividend versus interest income. If so, firms are required to define separate composites appropriate to the different strategies.

Type of Client (e.g., pension fund, private client, endowment) Client type alone must not be used as the primary criterion for defining a composite. In some cases, the client type determines the investment strategy because of characteristics that are unique to the client type. If portfolios of different client types have materially different investment strategies and/or styles that are specific to the type of client, the firm must create separate composites representing each of the different strategies.

Instruments Used (e.g., invest only in pooled vehicles [mutual funds] versus individual securities) If portfolios use specific instruments, the firm may define separate composites.

Size of Portfolios Differences in portfolio size may result in meaningful, material differences in investment strategy and justify the creation of separate composites. For example, an index strategy may be implemented via sampling (i.e., holding a sample of the index securities) for smaller portfolios, while the strategy may be implemented via a full replication of the index for larger portfolios. In this case, the strategy is actually different based on the size of portfolio.

Client Characteristics (e.g., cash flow needs, risk tolerances) Firms may create composites based on multiple client characteristics. For example, a firm may choose to create a composite composed of growth equity, taxable clients that allow leverage and have a targeted tracking error of 4%.

Portfolio Types (e.g., segregated [separate] portfolios, pooled portfolios [mutual funds]) Pooled funds, including mutual funds and unit trusts, may be treated as separate composites or combined with other portfolios into one or more composites of the same strategy, style, or objective.

Base Currency Base currency must *not* be a criterion used for composite definition unless it is specific to the investment strategy.

Additional Considerations

Multiple Asset Class Portfolios Multi-asset or balanced portfolios are portfolios that consist of more than one asset class. Composites should be constructed according to strategic ranges of asset mixes provided in the client investment guidelines, not according to the tactical percentage of assets invested in the different asset classes. Portfolios with varying, but similar strategic asset allocations can be grouped together if they collectively have the same strategy or style. Firms often have discretion to tactically alter the asset allocation in an effort to add value. Portfolios must not be moved into or out of composites due to changes in the tactical asset allocation. Only in the case of client-documented strategic asset allocation changes can portfolios be moved into different composites.

If the firm has discretion over changes from one asset class to another, the total return of the entire portfolio must be used in compiling the performance of that portfolio. If the firm does not have discretion over the asset mix, the segments of the various asset classes, with their respective cash positions, could be included in composites of like assets.

Inception Date In general, firms are not permitted to create composites based solely on inception date. However, in very specific situations, it may be appropriate to group portfolios into composites according to inception date (e.g., private equity composites, after-tax composites, municipal bond composites).

Firms with Multiple Offices, Branches, or Investment Divisions Firms are only permitted to define different composites for offices, branches, or investment divisions of a firm if the portfolios are managed according to investment mandates, objectives, or strategies that are unique to each particular office, branch, or division. Thus, it is the investment mandate, objective, or strategy that determines

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the composite, not the location or group. Composite definition cannot span multiple firms. For additional guidance regarding how the firm can be defined, please refer to the Guidance Statement on Definition of the Firm.

Internal Dispersion of Portfolio Returns within a Composite While internal dispersion is one measure to determine how consistently the firm has implemented its strategy across the portfolios in the composite, it can only be measured on an *ex-post* basis and, therefore, must not be used as a criterion to define a composite. An internal dispersion figure may serve as a good indicator of whether the criteria for composite definition are suitable and whether or not to redefine the composite. There is no general rule for a maximum amount of composite internal dispersion. The firm should contemplate the definition of a broad, “inclusive” composite with a wide internal dispersion of portfolio returns versus a narrow, “exclusive” composite with a more narrow internal dispersion measure.

Treatment of Fees Different types of investment management fees should not be used as criteria for composite definition.

Once a firm has established composite definitions, all actual, fee-paying, discretionary portfolios must be assigned to at least one appropriate composite. If a portfolio meets more than one composite definition, the portfolio must be included in each of the relevant composites.

Q&A

1. *Firm E has a number of fee-paying client portfolios managed to a particular investment strategy. Firm E also manages assets following this same strategy for clients who do not pay investment management fees and wants to include these portfolios in a composite. Should Firm E create two separate composites for its fee-paying and non-fee-paying portfolios?*

In general, investment management fees should not be used as criteria for composite definition. Because the assets are managed in the same manner and follow the same strategy, the non-fee-paying portfolios should be included in the same composite as the fee-paying portfolios. The GIPS standards do not, however, require that non-fee-paying portfolios be included in a composite. If Firm E chooses to include non-fee-paying portfolios in the composite, Firm E is required to present, as of the end of each annual period, the percentage of the composite assets represented by the non-fee-paying portfolios.

2. *If a fund invests in publicly traded equities for both limited partnerships and separate accounts, should the manager set up different composites for each legal structure?*

A composite must include all portfolios that are managed according to the same strategy. Differences in legal structure alone would not warrant a separate composite definition. However, it is up to the manager to decide how results can be presented in the most meaningful way, and if differences in legal structure caused the implementation of the strategy of the portfolios to differ, then the manager would split limited partnerships and separate accounts into separate composites.

3. *A firm manages private client portfolios. Depending upon when the portfolio came under management, returns will vary because of opportunities available at the time. Can a firm establish composites based on the date a portfolio comes under firm management?*

Firms must always first consider the investment mandate, objective, or strategy when defining composites. In very specific situations, it may be appropriate to group portfolios into composites according to inception date as well as investment mandate, objective, or

strategy. Because composites represent an investment strategy over time, a composite based solely on inception date would, generally, not show representative results of how the strategy performed over time as market conditions change.

4. *A firm is hired to manage a multiple-strategy mandate. Must a discretionary, multiple-strategy portfolio be included in a multiple-strategy composite? Would the answer be the same if each of the portfolio's segments were included in a corresponding composite? For example, if a firm manages a discretionary balanced strategy that contains equity and fixed income segments, must the balanced portfolio be included in a balanced composite if the equity and fixed income segments (including cash) are included in their respective composites?*

The GIPS standards require that all fee-paying discretionary portfolios must be included in at least one composite. Accordingly, a discretionary multiple-strategy portfolio must be included in a multiple-strategy composite.

The answer would be the same if each of the portfolio's segments is included in the relevant composites. Including all the segments of a discretionary multiple-strategy portfolio in composites does not eliminate the requirement to include the total portfolio in a composite.

If the firm does not have discretion over the asset mix but has discretion over the segments of the various asset classes, the segments must be included in relevant composites (provided that they are representative of an investment strategy and managed with their own cash balances).

When generating the total firm assets number, an asset must be counted only once, even if it is included in more than one composite.

Provision 3.A.5

COMPOSITES MUST include new PORTFOLIOS on a timely and consistent basis after each PORTFOLIO comes under management.

Discussion

It is the responsibility of the firm to set reasonable guidelines for each composite regarding the inclusion of new portfolios into the composite. Firms are encouraged to establish a policy that includes new portfolios in composites as soon as possible, preferably at the start of the next full performance measurement period. The measurement period is the period for which the composite performance is calculated. Firms must include in the composite only those portfolios that are managed for the full performance measurement period. Portfolios that are not managed for the full performance measurement period must not be included in the composite. Portfolios are included in the composite calculation only if they are managed for the full measurement period.

Firms may need time to invest the assets of a new portfolio to reflect the firm's investment strategy, and the GIPS standards thus allow firms some discretion to determine when the new portfolio should be added to the composite. Firms must establish a policy on a composite-specific basis and apply it consistently.

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Firms may delay the inclusion of a new portfolio into a composite in the case of specific instructions from the client. For example, a client may indicate to the firm that assets will be deposited over an extended period, which may delay the full implementation of the firm's strategy until all assets are received.

Q&A

1. *Firm A has two composites, a global government fixed income composite and an emerging market fixed income composite. Do the GIPS standards require the firm to establish the same policy for including new portfolios in composites across the firm?*

The GIPS standards require that firms establish a policy for including new portfolios in each composite and apply the policy consistently on a composite-specific basis. Different strategies may result in different time frames for inclusion based on the liquidity of the assets involved. While in most situations it is fairly easy to purchase and sell global government fixed income securities, emerging market debt may be more illiquid and, therefore, may initially require a longer period of time to implement the firm's strategy. The global government fixed income composite might have a new portfolio inclusion policy with a shorter time frame relative to the emerging market fixed income composite.

2. *Firm B obtains a new client who will eventually invest \$25 million with the firm in its Value strategy. However, assets will be transferred to the manager in \$5 million increments over a period of 18 months. The firm's policy for the Value composite is to include new portfolios at the beginning of the first full month under management. How should Firm B treat this portfolio for composite inclusion purposes?*

Because Firm B is not receiving the entire funding at once, it must consider whether the incremental funding will affect its ability to implement the Value strategy. The timing of the client's funding might require the firm to exclude the portfolio beyond the first month under management. This can result in an exception to the composite's new portfolio inclusion policy. However, if Firm B determines that the incremental investing does not affect the implementation of the style or strategy, then Firm B must include the portfolio in the Value composite beginning with the first full month under management.

Provision 3.A.6

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.

Discussion

This requirement prevents survivorship bias by retaining the performance history of the portfolio while it was managed to the composite's strategy. Once a client notifies the firm of the termination, the firm generally loses its discretion over the portfolio (e.g., the firm is restricted on its management of the portfolio). In this case, the firm must include the portfolio in the composite through the last full measurement period for which the firm has discretion. If all the portfolios are removed from a composite, for any reason, the performance record of the composite comes to an end. If, after a period of time, portfolios are again included in the composite, the prior performance history of the composite must be presented but must not be linked to the ongoing composite performance results.

Q&A

1. *Firm A has a policy of removing terminated portfolios from composites on the first day of the month that the firm was notified of termination. If notification of a portfolio's termination is received on 25 May, when should it be removed from the composite if composite returns are calculated monthly?*

The firm's policy should be based on removing the portfolio from the composite after the last full measurement period for which the firm has discretion over the assets. Assuming monthly performance measurement periods, if the firm lost discretion to manage the portfolio effective 25 May, the portfolio must be included in the composite performance calculations through 30 April and must be excluded from the composite calculations for May.

2. *We have a portfolio for an individual in one of our composites, but the client passed away and the portfolio had to be closed and re-opened in another legal status. How do we treat this change for composite reporting purposes?*

From the perspective of the firm, it does not seem that the portfolio was actually "terminated," in that the portfolio did not leave the firm and the firm never lost its discretion over the portfolio. The portfolio's change in legal status alone would not be a valid reason to remove the portfolio from the composite if the assets never left the portfolio, the firm was never restricted in its management of the portfolio, and the strategy of the portfolio remained unchanged.

3-3**Provision 3.A.7**

PORTFOLIOS MUST NOT be switched from one COMPOSITE to another unless documented changes to a PORTFOLIO's investment mandate, objective, or strategy or the redefinition of the COMPOSITE makes it appropriate. The historical performance of the PORTFOLIO MUST remain with the original COMPOSITE.

Discussion

Firms are only permitted to move portfolios into and out of composites due to documented changes to a portfolio's investment mandate, objective, or strategy or in the case where the redefinition of a composite makes it appropriate. For purposes of the GIPS standards, documentation can include, but is not limited to, letters, faxes, e-mails, and/or internal memorandums documenting conversations with clients.

This requirement seeks to preclude or at least minimize the movement of portfolios into, out of, and between composites. Theoretically, once a firm creates composites based on its various investment strategies, portfolios will be managed to those strategies on a long-term basis. As a result, defining composites is a critical issue when complying with the GIPS standards.

However, over time, a client's investment objective may change and firms may adopt new investment strategies. In those instances, moving a portfolio from one composite to another may be necessary; however, the move must be based on a change in the portfolio's strategy that is directed by the client and is clearly identified and documented. Portfolios must not be moved from one composite to another due to changes in the tactical asset allocation. Portfolios can be moved into different composites only in the case of client-documented strategic asset allocation changes.

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While investment strategies can change over time, in most cases firms should not change the definition of a composite. Generally, changes in strategy result in the creation of a new composite. In some very rare cases, however, it may be appropriate to redefine a composite. If a firm determines that it is appropriate to redefine a composite, it must disclose the date of, description of, and reason for the redefinition. Changes to composites must not be applied retroactively.

Firms may choose to create a composite to reflect a new investment strategy. The firm may move the portfolios that meet the new composite definition into the new composite, subject to documented changes in client guidelines or investment mandate, objective, or strategy. The history of the existing portfolios must remain with the original composite.

Q&A

1. *Firm A manages a portfolio for a client who instructs the firm to change the portfolio's mandate from an intermediate duration bond portfolio to a long duration bond portfolio. Should Firm A place this portfolio in a different composite?*

Yes. A documented change in the client's investment guidelines would cause the portfolio to be removed from the intermediate duration bond composite and placed into the long duration bond composite according to the new portfolio inclusion policy. If the firm does not currently have a long duration bond composite, the firm must create one. This portfolio transfer will be treated like a terminated portfolio when it is removed from the intermediate duration bond composite, and will be treated like a new portfolio to the long duration bond composite. The portfolio's prior history must remain in the intermediate duration bond composite through the last full measurement period the portfolio was managed in the intermediate duration style.

2. *For the past five years, Firm C has maintained a global equity composite. Although the firm defined the strategy to allow investments in equity securities from any geographic area, the firm tactically did not hold any Japanese equities during that time. Now, Firm C wants to redefine the composite as global equities ex-Japan. Is this possible under the GIPS standards?*

Historically, Firm C did not actually manage the assets in the global ex-Japan style. Instead it made a tactical decision not to own Japanese equity securities. It had a broadly defined investment management style for the original composite that could have included Japanese equity securities. By redefining the strategy of the composite more narrowly, the new ex-Japan composite would not accurately reflect the investment strategy of the composite historically. Redefining composites in this way does not provide an accurate history of the mandate and would not be appropriate. Firm C is accountable for the tactical decision not to own any Japanese securities. Typically, Firm C would need to have documented changes in client guidelines in order to make such a change to the strategy of the portfolios in the composite.

3. *If we currently have a composite for a particular strategy and the strategy changes, can the performance track record continue to be associated with the new strategy? The change in question is the addition of resources to the investment process. To be precise, we have added a fundamental portfolio manager to a strategy that was previously run using a quantitative (models) process. The new portfolio manager is an additional layer added on top to further refine the stock picks. The quant models will still be used as before.*

As most firms evolve, they modify their investment process through the use of new technologies and resources. It would seem clients would expect their firm to refine and improve the investment process.

Composites must be defined according to investment mandate, objective, or strategy. In the situation presented, if the investment objective of the portfolios in the composite remains constant as the firm modifies its investment process, the firm should not create a new composite. If, however, the investment mandate, objective, or strategy of the portfolios in the composite has changed as a result of the addition of the new portfolio manager, the firm should create a new composite and the performance track record starts for that new composite when portfolios meeting the definition of the new composite are added to it. The firm must clearly document its decision and decision-making process.

4. *We currently have two composites in the small-cap growth universe. The guiding principles for managing the portfolios are the same, but the market-cap ranges differ on the low and high ends. One composite has stocks with market caps ranging between approximately \$100 million and \$1.0 billion. The other composite has stocks ranging from \$500 million to \$1.5 billion (with flexibility up to the largest stock in the Russell 2000 Growth Index).*

We would like to expand, with client acceptance, the market-cap range for all accounts in each product to encompass the full range, essentially eliminating the need for two products. How do we approach this from a composite standpoint, assuming the clients have accepted this change and there is documentation of the change?

When a firm decides to combine the investment mandate, objective, or strategy of two (or more) different composites, the firm will create a new composite. The new composite will consist of all portfolios of the combined composites. The existing composites that the firm wishes to combine into this new composite will cease to continue. The new composite will not have historical performance results because the new composite's strategy is newly implemented. The firm must include the terminated composites on the list of composite descriptions for at least five years after the composite termination date.

5. *We are changing our investment process and the personnel involved in the management of a U.K. strategy. The risk and return objectives will be lower, and the process for managing the strategy will be predominantly based on a bottom-up stock selection approach as opposed to the previous top-down asset allocation approach. Does this require a change in composite?*

The firm must determine if the changes in investment process and personnel will result in a change in the investment strategy of the portfolios in the composite. If this will be a new investment strategy offered by the firm, a new composite must be started with a current composite creation date and no composite history. If the changes in process and personnel involved do not result in a change in investment strategy, the firm must not create a new composite, but must revise the composite description and composite definition where appropriate. The firm must clearly document its decision and rationale.

6. *One of our portfolio managers is about to be promoted, and another manager will assume responsibility for the portfolios managed to the strategy. The new manager will use the same model but will apply his own judgment. The investment guidelines for these portfolios will not change when the new manager assumes responsibility for the portfolios. Do we need to create a new composite for the new manager's investment history?*

Because the firm has not changed the investment mandate, objective, or strategy, the portfolios must all continue in the composite and the composite's history will continue uninterrupted when the new portfolio manager assumes investment responsibility for the portfolios. The firm must also consider if the change in personnel qualifies as a significant event. Firms must disclose all significant events that would help a prospective client interpret the compliant presentation.

3 Explanation of the Provisions of the GIPS Standards

7. *One of the portfolios in our All-Cap Growth Equity Composite changed investment objective towards the end of the second quarter (client agreement date: June 21) from All-Cap (\$300 million and above market cap) to Mid-Cap Equity (\$1 billion to \$10 billion). Should the portfolio be taken out of the All-Cap Growth Equity Composite for June, even though the portfolio's investment objective only changed in the last nine days of the month? In talking to the portfolio managers involved, no changes were implemented during the short period because of the similarity of the two styles. Does the client's investment objective change automatically exclude the account from being in the All-Cap Growth Equity Composite for June?*

The firm must consider the circumstances surrounding the change in investment objective to determine when the portfolio will be removed from the All-Cap Growth Equity Composite. Shifts from one composite to another must be consistent with the guidelines set forth by the client. In this situation, if there was any latitude within the investment management agreement as to when the change should occur, the firm must determine when the change occurred and include the portfolio in the All-Cap Growth Equity Composite only through the last full measurement period that the portfolio was managed to the All-Cap Growth Equity strategy.

8. *In the 2005 edition of the GIPS standards, a portfolio is not permitted to be switched from one composite to another unless documented changes in client guidelines or the redefinition of the composite make it appropriate. The 2010 edition of the GIPS standards states that portfolios must not be switched from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite make it appropriate. Because the word "client" was removed from the provision, does this mean a portfolio can be moved from one composite to another based on a tactical asset allocation?*

No. Portfolios must not be moved into or out of composites due to changes in the tactical asset allocation. Portfolios can only be moved into different composites in the case of client-documented strategic asset allocation changes.

Provision 3.A.8

For periods beginning on or after 1 January 2010, a CARVE-OUT MUST NOT be included in a COMPOSITE unless the CARVE-OUT is managed separately with its own cash balance.

Discussion

A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multiple-strategy portfolio managed to a broader mandate. For example, the Asian securities from a Euro-Pacific portfolio or the equity portion of a balanced portfolio could be considered a carve-out. Carve-outs are generally based on asset class, geographic region, or industry sector.

Because they represent only a portion of a broader, more diversified strategy, carve-out returns are only a valid track record if they are representative of what would have been achieved in a portfolio dedicated to the carved-out strategy. The use of carve-outs gives the impression that the firm has experience managing portfolios dedicated to a particular strategy, when this may not be the case. For example, a carve-out of the U.K. equities in a global equity portfolio that holds only two U.K. equities is not representative of a diversified U.K.-only portfolio. Any carve-out included

in a composite must be representative of an actual segregated portfolio managed to that strategy. The carved-out segment must be discretionary and structured materially the same as a portfolio dedicated to that strategy and have a risk profile that is substantially similar.

Additionally, if the carve-out is not accounted for separately with its own cash balance, then the return is potentially not representative of a stand-alone portfolio. The GIPS standards require that returns from cash and cash equivalents held in portfolios must be included in all return calculations. Unless the carved-out portion is accounted for as a separate portfolio, there will be no cash associated with the returns.

Effective 1 January 2010, carve-outs must be managed separately with their own cash balances (i.e., allocation of cash is no longer allowed for periods beginning on or after 1 January 2010). If the firm intends to carve out an asset class, sector, industry, size range (e.g., large cap), or style type (e.g., value), each carved-out segment must have either its own cash balance or be accounted for separately with its own associated cash position. For periods prior to 1 January 2010, allocating cash to the carve-out was permissible. If carve-outs were included in a composite, cash must have been allocated to the carve-out in a timely and consistent manner or the carve-out must have been accounted for separately with its own cash balance.

Firms must establish policies and procedures for the creation, use, and calculation of carve-outs and must apply them consistently. Please refer to the Guidance Statement on the Treatment of Carve-Outs for more information.

Q&A

1. *Our firm has a balanced portfolio with a defined asset allocation of 25% U.S. equity, 25% non-U.S. equity, and 50% fixed income. Although each segment is managed in the same way as a stand-alone portfolio managed to the segment's strategy, we do not segregate the segments into separate portfolios with separate cash allocations. What is an acceptable method of allocating cash to the segments for periods prior to 1 January 2010?*

The GIPS standards require that returns from cash and cash equivalents held in portfolios must be included in all return calculations. Unless the carved-out portion is accounted for as a separate portfolio, there will be no cash associated with the returns. For periods prior to 1 January 2010, cash allocation was permitted. If carve-outs were included in a composite, cash must have been allocated on a timely and consistent manner. The GIPS standards do not require a specified cash allocation methodology. The firm must document the method for cash allocation and apply it consistently.

One suggested methodology would be to allocate cash to each segment based on the beginning-of-period values by identifying the cash allocation percentage for each portfolio segment at the beginning of the period. For example, at the beginning of the month, firms could identify the percentage of residual cash that will be allocated to the carve-outs at month end.

Assume that at the beginning of the measurement period the market values for the segments, excluding residual cash, are 26% U.S. equity, 23% non-U.S. equity, and 51% fixed income. The residual cash in the portfolio will be allocated 26% to U.S. equity, 23% to non-U.S. equity, and 51% to fixed income.

However, effective 1 January 2010, carve-outs must be managed separately with their own cash balances because allocation of cash is no longer allowed for periods beginning on or after 1 January 2010. This change is not retroactive, so the history of composites that included carve-outs with allocated cash must not change.

3 Explanation of the Provisions of the GIPS Standards

2. *For periods prior to 1 January 2010, Firm A carved out U.K. equity performance from its Euro-Pacific equity portfolios and combined it with its U.K. equity portfolios to create a U.K. Equity Composite. Before including the carve-out in the U.K. Equity Composite, the firm allocated cash to the U.K. equity segment on a pro rata basis, based on the level of U.K. equities as a percentage of the total equity exposure. What disclosure is necessary regarding the use of cash allocation for these historical periods?*

For periods prior to 1 January 2010, the U.K. equity segment may be included in the U.K. Equity Composite provided the segment meets the carve-out requirements, cash is allocated to the carve-out, and the method used to allocate the cash to the carve-out is disclosed. The firm must include in the U.K. Equity Composite all carve-outs from all portfolios meeting this definition.

Sample Disclosure:

“Firm A’s U.K. Equity Composite includes all dedicated U.K. equity portfolios. For periods prior to 1 January 2010, the composite also includes the U.K. equity segment of portfolios that are managed to the firm’s Euro-Pacific equity strategy. Cash is allocated to the carve-out segment returns on a pro rata basis depending on the proportion of U.K. assets to total portfolio assets based on beginning-of-period market values.”

For periods beginning on or after 1 January 2010, a carve-out must not be included in a composite unless the carve-out is managed separately with its own cash balance. Cash allocation is prohibited for periods that begin on or after this date.

3. *Firm B manages balanced portfolios and would like to carve out the equities to create an equity composite. Firm B charges 0.75% for its fixed income strategy, 1.50% for its equity strategy, and 1.00% for its balanced strategy. How should the investment management fee be allocated to the equity carve-out for presenting a net-of-fees return?*

Firms must allocate fees to each segment that are appropriate to the asset class. In this case, the firm must use the 1.50% as a model fee that it charges for equity management.

4. *Our firm has four composites that consist only of carve-outs with allocated cash from larger portfolios. We understand that effective 1 January 2010, carve-outs must not be included in composites unless they are actually managed separately with their own cash. For one particular composite, we plan to manage the portfolios separately with their own cash by manually administering the cash in accordance with the Guidance Statement on the Treatment of Carve-Outs. Given the nature of this labor-intensive operation, we believe that we cannot apply the same method to all four composites, but just to one, beginning 1 January 2010. Can we do so?*

Yes. The GIPS standards require that, for periods beginning on or after 1 January 2010, carve-outs must not be included in composites unless the carve-out is actually managed separately with its own cash balance. Therefore, any and all of the carve-outs with allocated cash must be removed beginning 1 January 2010. Firms must determine which of the segments of multiple-strategy portfolios are managed separately with their own cash balances to determine the universe of possible carve-outs. As a result, some composites may include carve-outs (managed separately with their own cash balance) after 1 January 2010 and some may not. If a firm creates a carve-out of a particular strategy, then all similar portfolio segments within the firm managed to that strategy and managed separately with their own cash balance must also be included in the composite.

5. *We manage five balanced portfolios. For periods prior to 1 January 2010, we carved out the equity segments of these balanced portfolios, allocated cash to the equity segments based on relative beginning-of-period assets, and included the equity segments with allocated cash in the Equity Composite. We understand that effective 1 January 2010, carve-outs must not be included in composites unless they are actually managed separately with their own cash.*

Of the five carve-outs, only three meet the 1 January 2010 requirement to be managed separately with their own cash balance. Can we include only these three carve-outs in the Equity Composite after 1 January 2010?

Yes. Beginning 1 January 2010, those carve-outs not managed separately with their own cash balance are not eligible for inclusion in composites because they do not meet the definition of a carve-out as of that date. If a firm creates a carve-out of a particular strategy, then all similar portfolio segments within the firm managed to that strategy and managed separately with their own cash balance must be included in the composite.

6. *For periods prior to 1 January 2010, our firm used carve-outs for the Equity Composite and allocated cash based on relative beginning-of-period assets. Generally, the percentage of carve-out assets in the Equity Composite was quite high. Beginning 1 January 2010, we have several portfolios that are solely invested in the equity strategy as a dedicated mandate, and due to the 1 January 2010 carve-out requirements, we are discontinuing the use of carve-outs with allocated cash in that composite. In this situation, can we link performance of the new, dedicated mandate portfolios to the previous performance history based on carve-outs? May we also show performance of the equity segment excluding cash?*

In this example, the Equity Composite will continue because it includes all portfolios managed in that strategy; therefore, the performance of the new dedicated mandate portfolios must be linked to the previous performance history that includes the carve-outs. The carve-outs with allocated cash must be removed from the composite effective 1 January 2010. From that date forward, this composite would only include portfolios that have a dedicated equity mandate. The performance of the equity-only segments may only be shown as supplemental information. Please see the sample presentation (shown below) for ABC Company's Equity Composite for an example of how the firm may show the performance of that composite.

Equity Composite
1 January 2001 through 31 December 2010

Year	Gross Return (%)	Net Return (%)	S&P 500 Total Return Index (%)	Equity-Only Gross Return* (%)	Internal Dispersion (%)	As of 31 December			
						Number of Accounts	Composite Assets (\$ millions)	Firm Assets (%)	Carve-Outs (%)
2010	25.77	25.12	28.58	25.90	n/a	4	42.60	2.17	n/a
2009	20.25	19.10	21.04	20.45	1.36	89	410.74	22.38	98
2008	-7.51	-8.16	-9.10	-7.65	1.04	109	476.97	21.94	97
2007	-7.59	-8.12	-11.93	-7.85	1.24	93	413.40	20.97	98
2006	-24.74	-25.14	-22.06	-24.95	1.30	67	296.71	17.23	94
2005	26.61	25.59	28.68	26.80	1.22	64	342.63	17.88	98

(continued)

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Equity Composite 1 January 2001 through 31 December 2010 (continued)

Year	Gross Return (%)	Net Return (%)	S&P 500 Total Return Index (%)	Equity-Only Gross Return* (%)	Internal Dispersion (%)	As of 31 December			
						Number of Accounts	Composite Assets (\$ millions)	Firm Assets (%)	Carve-Outs (%)
2004	14.01	13.09	10.88	14.20	0.57	61	337.88	16.73	93
2003	10.71	9.82	4.91	10.90	1.56	65	377.16	16.95	94
2002	14.35	13.42	15.80	14.50	0.60	128	516.19	20.65	96
2001	6.61	5.73	5.49	6.70	1.07	429	644.92	23.95	90

*Equity-only gross returns are supplemental information. See Note 5.

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ABC Company claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. ABC Company has not been independently verified.

1. ABC Company is an independent investment advisor registered under the Investment Advisers Act of 1940. ABC Company provides traditional portfolio management services to a diversified group of clientele, including corporate and Taft–Hartley retirement plans, foundations and endowments, as well as individual investment portfolios. A list of composite descriptions and additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations is available upon request.
2. The Equity Composite consists of all discretionary, fee-paying, domestic equity accounts managed to the equity model and benchmarked to the S&P 500 Index. The composite was created in 1999.
3. Gross returns are presented before investment management fees, custodial fees, and withholding taxes but net of all trading expenses. Net returns are net of model fees and are derived by deducting the highest applicable fee rate in effect for the respective time period from the gross returns each month. The fee schedule currently in effect is as follows: 0.85% of the first \$5 million; 0.70% of the next \$5 million; 0.50% of the next \$40 million; negotiable over \$50 million. Valuations are computed and performance is reported in U.S. dollars.
4. For periods prior to 1 January 2010, the Equity Composite included the equity segments of balanced accounts. On a monthly basis, cash was allocated to the equity segment based on relative net assets as of the beginning of each month. As of 1 January 2010, the composite no longer includes equity segments of balanced accounts.
5. The equity-only gross returns (excluding cash) represent the performance of only the equity assets of the accounts included in the composite and are supplemental to the Equity Composite.
6. The dispersion of annual returns is measured by the asset-weighted standard deviation of gross account returns represented within the composite for the full year.

Provision 3.A.9

If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM MUST NOT include PORTFOLIOS below the minimum asset level in that COMPOSITE. Any changes to a COMPOSITE-specific minimum asset level MUST NOT be applied retroactively.

Discussion

When a firm establishes a minimum asset level for including portfolios in a composite, the firm is indicating that portfolios below that level are too small to be representative of that strategy. If the firm sets a minimum asset level for portfolios to be included in a composite, no portfolios below that asset level can be included in that composite. Firms must disclose the minimum asset level, if any, below which portfolios are not included in a composite. Firms must also disclose any changes to the minimum asset level. Firms should not present a compliant presentation for a composite to a prospective client that is known not to meet that composite's minimum asset level. Firms must disclose the minimum asset level of the composite, if one exists, in each respective compliant presentation and must consistently apply the minimum. Firms must document and disclose changes to the minimum asset level and must not retroactively apply the new limit. Portfolios below the minimum are not necessarily non-discretionary; however, asset level can affect discretion.

Portfolios may fall below the minimum due to client withdrawals or depreciation in portfolio value. Firms must determine, as part of their policies regarding minimum asset levels, which value will be used to evaluate composite portfolios against the minimum asset level (e.g., beginning value, ending value, beginning value plus cash flows). If a firm establishes a minimum asset level, it must document its policies regarding how portfolios will be treated if they fall below the minimum and must apply these policies consistently. Firms should consider establishing a threshold for the application of the minimum asset level and a minimum time period in order to minimize portfolio movement into or out of a composite.

For example, the firm establishes a range of $\pm 5\%$ of the minimum asset level when determining when to remove a portfolio from the composite and/or the firm establishes that a portfolio must remain above/below the minimum for at least two periods prior to removal/addition. If a portfolio is removed from a composite, the prior history of the portfolio must remain in the composite. Like all policies, once the firm establishes a policy regarding the minimum asset level, it must be applied consistently. Once a portfolio is removed, the firm must determine if the portfolio meets any other composite definition and must include it in the appropriate composite(s) in a timely and consistent manner.

Firms should bear in mind that if all the portfolios in a composite fall below the minimum asset level and, according to the firm's policies, are removed from the composite, the performance record of the composite would come to an end. If, after a period of time, portfolios move above the minimum asset level or new portfolios are added to the composite, the prior performance history of the composite must be shown but not mathematically linked to the ongoing composite performance results.

Q&A

1. *We have a composite of 120 portfolios with a 10-year track record. We'd like to establish a composite minimum size to reflect the fact that we can no longer manage portfolios that have a value less than the minimum size according to the composite objective. This is largely due*

3 Explanation of the Provisions of the GIPS Standards

to the portfolios decreasing in size whereby there are not enough assets to buy the appropriate number of securities for the style. Would we lose the historical performance record of the composite by removing so many portfolios (more than half)?

The historical performance of a composite does not change if a firm establishes a new minimum for the composite. If a firm chooses to implement a minimum asset level or change a minimum asset level for an existing composite, the firm must document and disclose the change to the minimum and apply the new limit consistently going forward. The firm must not go back and restate historical performance to include or exclude portfolios using the new minimum asset level. Prospectively, the firm will include in the composite only those portfolios that meet the composite minimum.

2. *Is there a difference between a product minimum and a composite minimum?*

Yes. There is a difference between a product minimum and a composite minimum. A composite minimum represents the size below which a portfolio is considered non-discretionary for a specific strategy because the strategy cannot be fully implemented. A composite minimum determines whether a portfolio is included in a composite. A product minimum is used for marketing purposes as a guideline for accepting new portfolios. A firm may accept new clients that have less than the stated product minimum. A firm may have a product minimum and no composite minimum or vice versa or may have different amounts for a product minimum and a composite minimum. If a firm does have a composite minimum, that composite's performance should not be presented to a prospective client known not to meet the composite's minimum asset level.

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Provision 3.A.10

FIRMS that wish to remove PORTFOLIOS from COMPOSITES in cases of SIGNIFICANT CASH FLOWS MUST define "significant" on an EX-ANTE, COMPOSITE-specific basis and MUST consistently follow the COMPOSITE-specific policy.

Discussion

For the purposes of the GIPS standards, an external cash flow is defined as capital (cash or investments) that enters or exits a portfolio. A significant cash flow is defined as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. Transfers of assets between asset classes within a portfolio or manager initiated flows must not be used to move portfolios out of composites on a temporary basis. The significant cash flow may be defined by the firm as a single flow or an aggregate of a number of flows within a stated period of time.

Firms that wish to remove portfolios from composites in cases of significant cash flows must define "significant" on an ex-ante, composite-specific basis and must consistently follow the composite-specific policy. Once a significant cash flow policy is established for a composite, the firm must remove from the composite all portfolios that experience a significant cash flow.

The significant cash flow definition may be influenced by the characteristics of the asset class(es) within the strategy, such as market liquidity, and/or by the trading capabilities of the investment manager. (For instance, a significant cash flow may be considered 10 percent of a portfolio's value for an emerging market fixed-income composite but may be in excess of 50 percent of a portfolio's value for a more liquid composite, such as European equities.) In theory, the determination of

significance should primarily be based on the liquidity of the asset class and the investment strategy employed. Because of the dynamic nature of global markets and the inherent subjectivity involved, it is impractical to establish absolute levels of significance for each asset class. Theoretically, external cash flows that are relatively small on a composite level but relatively large on a portfolio level can potentially distort the portfolio's performance and skew the measure of internal dispersion. The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of portfolio assets (based on the most recent valuation). No other criteria, such as the impact or lack of impact of the significant cash flow on the respective portfolio's performance, may be considered. Once a significant cash flow policy has been established for a specific composite, the firm must consistently apply the significant cash flow policy to that composite. If a cash flow in a portfolio occurs that meets the definition of significance for that composite, the portfolio must be removed from the composite according to the established policy. The definitions and policies for significant cash flows may be changed, but the changes must not be applied retroactively.

Firms must establish policies for the timing of excluding portfolios that experience significant cash flows from composites, as well as policies for the timing of adding back those portfolios in composites. These policies must be established on a composite-specific basis.

As an alternative to a significant cash flow policy, a firm may consider the use of a temporary new account. This allows a firm to create a new portfolio into which a client's contributions are directed. Within this new portfolio, the firm will purchase securities. Once the new funds are invested, the securities are transferred in-kind to the existing portfolio contained within a composite. For a withdrawal, the securities are transferred in-kind to the temporary new account and then sold from the temporary new account. Like the significant cash flow policy, the temporary new account policy may be composite-specific. Firms that choose to use temporary new accounts for certain composites must define policies for using temporary new accounts on a composite-specific basis and must apply those policies consistently.

Q&A

1. *We are in the process of establishing our significant cash flow and large cash flow levels for each composite. We understand that establishing a significant cash flow policy is optional, whereas for periods beginning on or after 1 January 2010, firms must define the level of large cash flow for each composite to determine when portfolios in a composite must be valued. Can the levels used to define large cash flows and significant cash flows be the same? If not, does the level established for significant cash flows need to be greater than the level used for large cash flows?*

The GIPS standards define large cash flow as the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. Firms must define large cash flow levels for each composite to determine when portfolios in that composite must be valued. Portfolios that experience a large cash flow remain in the composite (unless it is also a significant cash flow, as defined). The determination of the large cash flow level may be influenced by a variety of factors, such as the nature of the strategy, historical and expected volatility of the strategy, and the targeted cash level of the strategy.

The GIPS standards define a significant cash flow as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy, thereby causing the portfolio to no longer be representative of the composite strategy. Firms that choose to adopt a significant cash flow policy for certain composites must define the significant cash flow level on a composite-specific basis. Portfolios that subsequently experience a significant cash flow are then

3 Explanation of the Provisions of the GIPS Standards

temporarily removed from the composite. The determination of the significant cash flow level may be influenced by a variety of factors, such as market liquidity and the trading capabilities of the investment manager.

It is not expected that the levels used to define large cash flows and significant cash flows will be the same. It is expected that the level used to define large cash flows will be less than the level established for significant cash flows because the cash flow amount that would cause a portfolio to need to be valued because performance may be distorted typically does not rise to the level that disrupts the implementation of the investment strategy.

2. *Can we choose to adopt a significant cash flow policy in which we remove portfolios from our composite in order to avoid valuing portfolios due to large cash flows?*

No. A firm must not adopt a significant cash flow policy solely for the purpose of reducing or eliminating the number of instances where portfolios must be valued due to large cash flows. The GIPS standards define a significant cash flow as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. The significant cash flow level chosen by the firm on a composite-specific basis must represent the firm's estimate as to the level of cash flows that would potentially disrupt the implementation of the investment strategy. Significant cash flow and large cash flow levels must be established independently.

3. *Can we temporarily suspend our significant cash flow policy when we only have one portfolio in the composite and then reinstate it once we have two portfolios in the composite?*

No. A significant cash flow policy, once adopted, must be applied consistently. If a firm has a single portfolio in a composite and that portfolio is temporarily removed from the composite due to the firm's significant cash flow policy, then the track record of the composite is broken and the continuous performance history ends. Once the portfolio is added back into the composite and the composite performance is restarted, the performance history must be presented for periods both before and after the break and cannot be linked across the break. A significant cash flow policy can be composite specific and does not need to be applied firm-wide. Firms that choose to adopt a significant cash flow policy for certain composites must define the significant cash flow level on a composite-specific basis. A significant cash flow policy may be amended as long as it is done prospectively and the amendment is documented in the firm's policies and procedures.

As an alternative to a significant cash flow policy, a firm may consider the use of a temporary new account. This allows a firm to create a new portfolio into which a client's contributions are directed. Within this new portfolio, the firm will purchase securities. Once the new funds are invested, the securities are transferred in-kind to the existing portfolio contained within a composite. For a withdrawal, the securities are transferred in-kind to the temporary new account and then sold from the temporary new account. Like the significant cash flow policy, the temporary new account policy may be composite-specific. Firms that choose to use temporary new accounts for certain composites must define policies for using temporary new accounts on a composite-specific basis and must apply those policies consistently.

Composite Construction—Recommendations

Provision 3.B.1

If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM SHOULD not present a COMPLIANT PRESENTATION of the COMPOSITE to a PROSPECTIVE CLIENT known not to meet the COMPOSITE'S minimum asset level.

Discussion

When a firm establishes a minimum asset level for including portfolios in a composite, the firm is indicating that portfolios below that level are too small to be representative of that strategy. In the interest of fair representation, it would not be in the prospective client's best interest to be shown a compliant presentation of a composite that does not represent a strategy that is available to the prospective client.

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Provision 3.B.2

To remove the effect of a SIGNIFICANT CASH FLOW, the FIRM SHOULD use a TEMPORARY NEW ACCOUNT.

Discussion

A significant cash flow may be defined by the firm for each composite. The definition must be determined as either a specific monetary amount or a percentage of portfolio assets and may be influenced by the characteristics of the asset class(es) within the strategy.

The firm could choose to establish a policy to create a temporary new account when a portfolio experiences a significant cash flow. If a portfolio experiences a significant cash inflow, the firm would create a temporary new account for the inflow of assets. The funds will remain in the temporary new account until they reflect the investment mandate for the portfolio. The performance of the assets in the temporary new account will not be reflected in the main portfolio's performance until these assets are invested and transferred into the main portfolio. The temporary new account must not be included in a composite. The assets of the temporary new account will be reflected in total firm assets if it is in existence at the end of a reporting period.

If the portfolio experiences a significant cash outflow, the firm would create a temporary new account for the outflow of assets. The temporary new account would be funded with the assets the manager will distribute to the client or will liquidate to meet the cash flow needs of the client. The portfolio with the remaining assets would continue in the composite and would reflect the outflow in the performance calculation. The temporary new account must not be included in a composite. The assets of the temporary new account will be reflected in total firm assets if it is in existence at the end of a reporting period.

3-4 DISCLOSURES

Disclosures—Requirements

Provision 4.A.1

Once a FIRM has met all the REQUIREMENTS of the GIPS standards, the FIRM MUST disclose its compliance with the GIPS standards using one of the following compliance statements. The claim of compliance MUST only be used in a COMPLIANT PRESENTATION.

For FIRMS that are verified:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.”

For COMPOSITES of a verified FIRM that have also had a PERFORMANCE EXAMINATION:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates].

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The [insert name of COMPOSITE] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request.”

For FIRMS that have not been verified:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has not been independently verified.”

Discussion

Firms must comply with all the requirements of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.

Strict adherence to the requirements of the GIPS standards does not necessarily guarantee fair and adequate performance reporting. The requirements of the GIPS standards do not cover the specific situations of every firm. In preparing compliant presentations and other performance reports, firms must keep in mind the spirit and objectives of the GIPS standards: fair representation and full disclosure. Meeting the intent of the GIPS standards will likely require actions beyond those that simply meet the minimum requirements. First and foremost, compliance with the GIPS standards requires adherence to all applicable laws and regulations regarding the calculation and presentation of performance.

A firm meeting all the requirements must use one of the following compliance statements in its compliant presentations.

For firms that are verified:

“[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.”

It is acceptable to combine both paragraphs of the required claim of compliance for a verified firm into a single paragraph. If not combined, the claim of compliance for a verified firm is complete only when both paragraphs are shown together, one after the other. A firm may not separate the two required paragraphs from each other.

For composites of a verified firm that have also had a performance examination:

“[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates].

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The [insert name of composite] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request.”

For composites of a verified firm that have also had a performance examination more than 24 months ago:

If the end date of the period(s) covered by the latest performance examination report is more than 24 months from the ending period that is presented in the most recent compliant presentation for that composite and the firm chooses to use the performance examination claim of compliance in the composite presentation, the sentence “Verification does not ensure the accuracy of any specific composite presentation.” must be included in the claim of compliance as follows:

“[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates].

3 Explanation of the Provisions of the GIPS Standards

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. The [insert name of composite] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request.”

When preparing the compliant presentation for a composite that has had a performance examination, the firm may choose to use either the verification or performance examination claim of compliance in the composite presentation. For example, a firm might choose to use the verification claim of compliance for all composites, including composites that have had a performance examination, if it wishes to standardize the claim of compliance for all composites throughout the firm. In this situation, the firm may also disclose that a specific composite has been examined.

If a verified firm has also had a performance examination completed, the firm may combine the respective paragraphs in the presentations for those composites that have had a performance examination. If not combined, the claim of compliance for a verified firm that has had a performance examination is complete only when both paragraphs are shown together, one after the other. A firm may not separate the two required paragraphs from each other.

3-4

For firms that have not been verified:

“[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has not been independently verified.”

Only firms that manage actual assets may claim compliance with the GIPS standards. This includes plan sponsors, foundations, endowments, and similar entities that manage discretionary assets either internally and/or via third-party sub-advisors. Organizations must not claim compliance if they do not manage actual, discretionary assets. Similarly, organizations that do not have discretion over the selection of the third-party investment managers must not claim compliance. However, they are encouraged to endorse the GIPS standards by requiring that third-party investment managers comply with the GIPS standards.

Software vendors must not claim compliance with the GIPS standards or state that their system complies with the GIPS standards. They may state that their system calculates performance that satisfies the portfolio and composite calculation requirements of the GIPS standards but must not state that using the software system automatically makes a firm compliant with the GIPS standards.

Consultant questionnaires often require investment management firms to fill in monthly or quarterly performance data. The questionnaires then ask the manager to indicate whether or not the data presented have been prepared in accordance with the GIPS standards. Questions regarding whether returns “are prepared” in compliance with the GIPS standards demonstrate a misunderstanding of the meaning of compliance. However, a firm that claims compliance with the GIPS standards may state that the returns “are prepared in compliance with the GIPS standards” if the following conditions are met:

- the performance information used to complete the questionnaire is consistent with the information used to prepare the respective composite's compliant presentation; and

- if applicable, the performance information used to complete the questionnaire is more current than the information currently included in the respective composite's compliant presentation, but will be used in the future to update the respective composite's compliant presentation; and
- if applicable, the performance information used to complete the questionnaire is older than the information currently included in the respective composite's compliant presentation, but could be used to report the composite's performance for periods prior to those currently included in the compliant presentation.

In all cases, firms must take steps to ensure that the information provided is not false or misleading. The firm must provide a compliant presentation to the consultant at the time of completing the initial questionnaire and, at a minimum, every 12 months thereafter.

Enforcement

CFA Institute (owner of the GIPS® trademark) may take appropriate action against any firm that misuses the mark "GIPS®" or any compliance statement, including false claims of compliance with the GIPS standards.

CFA Institute members, CFA charterholders, CFA candidates, CIPM certificants, and CIPM candidates who misuse the term "GIPS" or any compliance statement, misrepresent their performance history or the performance history of their firm, or falsely claim compliance with the GIPS standards are also subject to disciplinary sanctions under the CFA Institute Code of Ethics and Standards of Professional Conduct. Possible disciplinary sanctions include public censure, suspension of membership, and revocation of the CFA charter or CIPM certificate.

Regulators with jurisdiction over firms claiming compliance with the GIPS standards may also take enforcement actions against firms that falsely claim compliance with the GIPS standards.

Q&A

1. *Our firm is a pension plan sponsor, responsible for managing assets of our organization's pension plan. We have discretionary authority to manage the assets. For those asset classes for which we do not have in-house expertise, we hire third-party managers as sub-advisors for those assets. May we claim compliance with the GIPS standards?*

Yes. An organization that manages actual assets may claim compliance with the GIPS standards. This includes plan sponsors, foundations, endowments, and similar entities that manage discretionary assets either internally and/or via third-party sub-advisors. The use of a sub-advisor does not impact the ability of a firm to claim compliance with the GIPS standards, provided the firm has discretion over the selection of the sub-advisor. For periods beginning on or after 1 January 2006, a firm must disclose the use of a sub-advisor and the periods for which a sub-advisor was used. To claim compliance, the organization must adhere to all the requirements of the GIPS standards, including any updates, Guidance Statements (which includes the Guidance Statement on Definition of the Firm), interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.

2. *The 2010 edition of the GIPS standards requires a firm to disclose its verification status in the claim of compliance. May we disclose the name of our verifier within the claim of compliance? Is there suggested language?*

3 Explanation of the Provisions of the GIPS Standards

Yes. While a firm is not required to disclose the name of its verifier, a firm that has been verified may add such a disclosure to the compliant presentation. The disclosure may be included in the claim of compliance.

Sample Disclosure:

“Ching & Buddle, LLC, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Ching & Buddle, LLC, has been independently verified for the periods 1 January 2006 through 31 December 2011 by Jozy & Davies LLP. The verification report is available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.”

3. *Our firm has been verified for the period 1 January 2001 through 31 December 2010. We have one composite for which we received a performance examination for the period 1 January 2001 through 31 December 2006. We subsequently decided not to continue with further performance examinations for this composite. When preparing the compliant presentation for this composite, should we use the claim of compliance for firms that are verified or for composites of a verified firm that have also had a performance examination?*

When preparing the compliant presentation for a composite that has had a performance examination, the firm may choose to use either the verification or performance examination claim of compliance in the composite presentation. If the end date of the period(s) covered by the latest performance examination report is more than 24 months from the ending period that is presented in the most recent compliant presentation for that composite and the firm chooses to use the performance examination claim of compliance in the composite presentation, the sentence “Verification does not ensure the accuracy of any specific composite presentation.” must be included in the claim of compliance as shown below.

“[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates].

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. The [insert name of composite] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request.”

4. *Our firm is verified. The claim of compliance for a verified firm in the 2010 edition of the GIPS standards has two paragraphs. May we combine the two paragraphs of the claim of compliance into one paragraph?*

Yes, it is acceptable to combine both paragraphs of the required claim of compliance for a verified firm into a single paragraph. If a verified firm has also had a performance examination completed, the firm may similarly combine the respective paragraphs in the presentations for those composites that have had a performance examination.

5. *Our firm is verified. The claim of compliance for a verified firm in the 2010 edition of the GIPS standards has two paragraphs. May we separate the two paragraphs and include the second paragraph that describes the scope of verification in our other disclosures and not include it with the first paragraph of the claim of compliance?*

No. The claim of compliance for a verified firm is complete only when both paragraphs are shown together, one after the other. A firm may not separate the two required paragraphs from each other. Similarly, firms must not separate the paragraphs of the claim of compliance used for composites of a verified firm that have also had a performance examination.

6. *Consultant questionnaires often require managers to fill in quarterly performance charts. The questionnaires then ask the manager to indicate whether or not the numbers presented in the chart have been prepared in accordance with the GIPS standards. How should a firm respond to these questions?*

To claim compliance, the firm must meet the requirements of the GIPS standards on a firm-wide basis. Presentations claiming compliance must meet each requirement of the GIPS standards, including disclosure requirements. Performance results cannot be “in compliance” unless all the requirements of the GIPS standards are met. Questions regarding whether returns “are prepared” in compliance with the GIPS standards demonstrate a misunderstanding of the meaning of being in compliance with the GIPS standards. However, a firm that claims compliance with the GIPS standards may state that the returns “are prepared in compliance with the GIPS standards” if the following conditions are met:

- the performance information used to complete the questionnaire is consistent with the information used to prepare the respective composite’s compliant presentation; and
- if applicable, the performance information used to complete the questionnaire is more current than the information currently included in the respective composite’s compliant presentation but will be used in the future to update the respective composite’s compliant presentation; and
- if applicable, the performance information used to complete the questionnaire is older than the information currently included in the respective composite’s compliant presentation, but could be used to report the composite’s performance for periods prior to those currently included in the compliant presentation.

In all cases, firms must take steps to ensure that the information provided is not false or misleading. The firm must provide a compliant presentation to the consultant at the time of completing the initial questionnaire and, at a minimum, every 12 months thereafter.

7. *Provision 4.A.1 includes language for how a firm must disclose its claim of compliance with the GIPS standards. The compliance statements differ depending on the firm’s verification status, as well as the specific composite’s performance examination status. Each of the compliance statements is in quotes. Does this mean that we have to use the exact words in the respective compliance statement, or can we modify the language?*

3 Explanation of the Provisions of the GIPS Standards

The language in each compliance statement is not expected to change. However, there may be instances where it may be appropriate for a firm to modify the language slightly. For example, a firm may modify the language to include the name of the firm's verifier, if the firm wishes to disclose this information. A firm may also need to modify the language to add more details about the name of the firm that has been verified or the dates of the verification if the verification period was not continuous. Any modifications must be additive and must not result in a claim of compliance that is false or misleading. Also, a firm must not exclude any portion of the respective compliance statements.

Provision 4.A.2

FIRMS MUST disclose the definition of the FIRM used to determine TOTAL FIRM ASSETS and FIRM-wide compliance.

3-4

Discussion

To claim compliance with the GIPS standards, the firm must comply with the GIPS standards on a firm-wide basis. Accordingly, the firm must determine exactly how it will be defined for the purpose of compliance. The GIPS standards require that a firm must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity.

A distinct business entity is a unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices, that retains discretion over the assets it manages, and that should have autonomy over the investment decision-making process.

Possible criteria that can be used to determine this include:

- being a legal entity,
- having a distinct market or client type (e.g., institutional, retail, private client), and
- using a separate and distinct investment process.

As there are often a number of closely related units or divisions within larger investment management entities, it is critical to disclose the precise definition of the firm that is presenting the performance results and would be responsible for the management of the prospective client's assets. This provision requires the firm to disclose sufficient details of the entity that is presenting investment performance such that the firm is clearly identified.

Q&A

1. *Firm A is a multinational investment firm, with offices around the world, including in Japan, Australia, the U.K. and the U.S. Although all of its offices are part of the global parent company, each office is registered with the appropriate national regulatory authority and each is held out to clients and prospective clients as a distinct business entity. Firm A in the U.S. claims compliance with the GIPS standards. What should the definition of the firm disclosure be?*

Sample Disclosure:

“For the purpose of complying with the GIPS standards, the firm is defined as Firm A – U.S., which serves U.S. clients and is a subsidiary of Firm A, a multinational investment firm with offices globally. Firm A also has subsidiaries in the U.K., Australia, and Japan, which are not included in the definition of the firm for purposes of compliance with the GIPS standards.”

2. *Firm B manages money for both retail and institutional clients. An autonomous group, “Firm B Institutional Investment Management,” manages institutional assets. Another autonomous group, “Firm B Retail Investors,” manages retail assets. How should “Firm B Institutional Investment Management” disclose its firm definition?*

Sample Disclosure:

“For the purpose of complying with the GIPS standards, the firm is defined as Firm B Institutional Investment Management, the institutional asset management division of Firm B.”

3. *Company B is a multinational investment firm, with offices around the world, including in Japan, Australia, the United Kingdom, and the United States. Although all offices are part of the global parent, each office is registered with the appropriate national regulatory authority. Company B in Japan is ready to comply with the GIPS standards. However, Company B in the U.S. cannot claim compliance at this time. Can Company B in Japan claim compliance with the GIPS standards?*

Company B in Japan may be able to claim compliance with the GIPS standards if it can be defined as a separate “firm” for the purpose of claiming compliance with the GIPS standards, even though it is part of a multinational firm. Company B in Japan can define itself as a firm if it is held out to clients or prospective clients as a distinct business entity. Company B in Japan must disclose the definition of the firm in its compliant presentations. This definition should clearly state that for the purpose of claiming compliance with the GIPS standards, the firm is Company B in Japan so that the prospective client would not assume that any other part of Company B is claiming compliance with the GIPS standards. Company B in Japan would also be encouraged to disclose that the defined firm is a subsidiary of a larger parent company.

3-4

Provision 4.A.3

FIRMS MUST disclose the COMPOSITE DESCRIPTION.

Discussion

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. While the composite description is a required disclosure, the composite definition is not a required disclosure but must be made available upon request.

3 Explanation of the Provisions of the GIPS Standards

This disclosure provides information about the composite's investment strategy that is intended to help the prospective client when considering an investment product or strategy and reviewing the compliant presentation. The composite description should provide sufficient information to prospective clients to allow them to differentiate the significant features of the strategy from others within the firm and to compare products across firms. These features will likely impact both the historical and expected risk and returns.

Because the composite description must include all key features of the investment strategy, it is expected that firms will disclose in the composite description material risks, including their ability to use leverage, derivatives, and short positions (e.g., "the strategy may employ up to 200% leverage").

Generally, all investment products or strategies have some degree of inherent risk (e.g., market risk), but it is not intended that the composite description identify every risk of the strategy. Instead, firms must identify those risks, if any, that are key characteristics of the strategy and must disclose those risks. For example, investment concentration, correlation (or lack thereof), impact of changes in liquidity, exposure to counterparties, and the ability to employ significant leverage are features that may need to be included in the composite description.

The characteristics of some strategies may change given different market events. Firms should periodically review composite descriptions to ensure they are current.

Appendix C of the GIPS standards provides a Sample List of Composite Descriptions to illustrate how material risks can be disclosed as part of the composite description.

3-4

Q&A

1. *Please explain the difference between a "composite description" and a "composite definition." For example, the GIPS standards require firms to disclose the composite description in the compliant presentation; however, there is a Guidance Statement on Composite Definition.*

A 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. For example, a composite description might state that "the Large-Cap composite includes all non-taxable portfolios with at least a 90% target allocation to large-cap stocks. We define large-cap stocks as those securities with a capitalization of €5 billion or above." In addition to the general information regarding the investment mandate, objective, or strategy, a composite definition would include other factors concerning the characteristics of the portfolios included in the composite and is defined as detailed criteria that determine the assignment of portfolios to composites. Criteria may include investment mandate, style or strategy, asset class, use of derivatives, leverage and/or hedging, targeted risk metrics, investment constraints or restrictions, and/or portfolio type (e.g., segregated or pooled, taxable versus tax exempt). Other factors might include the new portfolio inclusion policy, the closed portfolio exclusion policy, and the details concerning how significant cash flows are handled.

Provision 4.A.4

FIRMS MUST disclose the BENCHMARK DESCRIPTION.

Discussion

Firms are required to disclose the benchmark description in each compliant presentation. The benchmark description is defined as general information regarding the investments, structure, and/or characteristics of the benchmark. The description must include the key features of the benchmark or the name of the benchmark for a readily recognized index or other point of reference. Each firm must decide for itself whether a benchmark is widely recognized. If the firm is not certain as to whether the benchmark is widely known, the firm must include the benchmark description.

Provision 4.A.5

When presenting GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRADING EXPENSES.

Discussion

Firms may present gross-of-fees returns, net-of-fees returns, or both. If a firm presents gross-of-fees returns, the firm must disclose if any fees other than trading expenses are deducted. When calculating gross-of-fees returns, trading expenses must be deducted; however, other expenses may also be deducted (e.g., custody fees). This disclosure helps prospective clients understand if any other fees are included in the gross-of-fees returns.

Sample Disclosure:

“Gross returns reflect the deduction of trading expenses and custodian fees.”

Please refer to the Guidance Statement on Fees for additional guidance.

3-4

Provision 4.A.6

When presenting NET-OF-FEES returns, FIRMS MUST disclose:

- a. If any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRADING EXPENSES;
- b. If model or actual INVESTMENT MANAGEMENT FEES are used; and
- c. If returns are net of any PERFORMANCE-BASED FEES.

Discussion

Firms may present gross-of-fees returns, net-of-fees returns, or both. If a firm presents net-of-fees returns, the firm must disclose if any fees other than trading expenses and investment management fees are deducted. When calculating net-of-fees returns, trading expenses and investment management fees must be deducted; however, other expenses may also be deducted (e.g., custody fees). This disclosure helps prospective clients understand the fees included in the net-of-fees returns.

When presenting net-of-fees returns, the firm must disclose if model or actual investment management fees are used to calculate net-of-fees returns. If net-of-fees returns are net of any performance-based fees, firms must also disclose this fact.

3 Explanation of the Provisions of the GIPS Standards

Sample Disclosure:

“Net returns are calculated using actual management fees, which includes performance fees. These fees are accounted for on an accrual basis.”

Please refer to the Guidance Statement on Fees for additional guidance.

Provision 4.A.7

FIRMS MUST disclose the currency used to express performance.

Discussion

The GIPS standards require that firms disclose the currency used to express performance. Firms must present all required information and additional information in the same currency (e.g., composite and benchmark returns, composite assets, risk and internal dispersion measures). Firms are recommended to present supplemental information in the same currency as the required and additional information. If a firm chooses to present a composite in a different currency, the firm must convert all of the information into the new currency. If the firm presents performance in multiple currencies in the same compliant presentation, the firm must ensure it is clear which currencies are used to express performance.

Labeling the columns within a compliant presentation with the appropriate currency would satisfy this requirement.

Sample Disclosure:

“Valuations are computed and performance results are reported in Canadian dollars.”

Q&A

1. *Can a firm calculate performance returns for a composite that consists of multiple portfolios that are managed in several different currencies? If so, what conversion method should be used?*

The GIPS standards require that firms disclose the currency used to express performance. In cases where a composite contains portfolios with different currencies, the firm must convert the individual portfolio returns to a single currency in order to calculate a composite return. In such an instance, the firms should disclose that the composite includes portfolios with different currencies that have been converted.

The GIPS standards do not recommend a particular way to convert performance from one currency to another. Two possible options for converting returns into a different currency are:

- when using the aggregate method of composite calculation, convert the underlying data (values and external cash flows) into the selected currency and then calculate the composite returns based on the converted values or
- when using the weighted average method of composite calculation, first calculate the individual portfolio returns and then convert the returns into the selected currency.

It is up to the firm to determine the composite-specific conversion method. Policies and procedures for converting returns must be established, documented, and applied consistently.

2. *Can a compliant presentation be converted and presented in a different currency?*

Yes. Firms can convert composite returns into an appropriate currency for a particular compliant presentation. If a firm chooses to present a composite in a different currency, the firm must convert all required information and additional information into the new currency (e.g., composite and benchmark returns, composite assets, risk and internal dispersion measures). Firms are recommended to present supplemental information in the same currency as the required and additional information. It should be noted that the firm must convert and present the entire composite performance history rather than only a portion.

If the firm presents performance in multiple currencies in the same compliant presentation, the firm must ensure it is clear which currencies are used to express performance.

Provision 4.A.8

FIRMS MUST disclose which measure of INTERNAL DISPERSION is presented.

3-4

Discussion

The GIPS standards do not mandate a specific measure of a composite's internal dispersion. Instead, firms are permitted to choose a measure for each composite and apply it consistently. Because firms may choose which measure of internal dispersion to present, disclosure of the chosen measure is required in the compliant presentation.

Sample Disclosure:

"Internal dispersion is calculated using the equal-weighted standard deviation of the annual gross returns of those portfolios that were included in the composite for the entire year."

Provision 4.A.9

FIRMS MUST disclose the FEE SCHEDULE appropriate to the COMPLIANT PRESENTATION.

Discussion

Firms must disclose the fee schedule appropriate to the compliant presentation. The fee schedule must reflect the firm's investment management fees that are applicable to prospective clients for the specific composite. The fee schedule can be asset based, performance based, or a combination of both.

The fee schedule is typically listed by asset level ranges and should be appropriate to the particular prospective client. The fee schedule must be current. While a current fee schedule may not assist a prospective client when interpreting historical performance because the actual fees paid

3 Explanation of the Provisions of the GIPS Standards

may be different from the fee schedule disclosed, it is the most relevant to the prospective client. The actual fee that the prospective client may pay (if it hires the firm) could also differ from the fee schedule disclosed in the compliant presentation.

This disclosure requirement is not satisfied if the firm does not include the fee schedule in a compliant presentation and instead makes reference to another document (e.g., Form ADV) that includes the fee schedule.

Sample Disclosure:

“The firm’s annual fee schedule is as follows:

First €10 million	0.80%
Next €40 million	0.60%
Above €50 million	0.30%”

Q&A

1. *Must the fee schedule be on the same page as the compliant presentation, or can it be on a separate page? Is it sufficient to refer to another document, such as the firm’s Form ADV, instead of disclosing the fee schedule?*

The fee schedule does not necessarily have to be on the same page as the other information that is required to be in a compliant presentation, but it must be part of the compliant presentation. The disclosure requirement is not satisfied if the firm excludes the fee schedule from the compliant presentation and makes reference to another document that includes the fee schedule, such as Form ADV.

3-4

Provision 4.A.10

FIRMS MUST disclose the COMPOSITE CREATION DATE.

Discussion

Firms are required to disclose the date on which the firm first grouped one or more portfolios to create a composite. The composite creation date is not necessarily the same as the composite inception date. The composite inception date is the initial date of the composite’s performance record. The composite creation date can be after the composite inception date, depending on when the firm first grouped the individual portfolios together. The intent of this disclosure is to enable prospective clients to determine when the composite was created and if it was created with the benefit of hindsight. This information allows a prospective client to compare the composite creation date with the composite inception date to determine whether the firm grouped portfolios together into a composite retroactively or whether the firm created the composite at the beginning of the performance track record.

Q&A

1. *Firm B claims compliance with the GIPS standards and presents performance since its inception on 1 January 1995. Initially, the firm grouped all of its portfolios into two composites, equity and fixed income. However, on 1 January 2002, the firm determined to divide the two composites into four smaller composites: Large-Cap Equity, Small-Cap Equity, Core Fixed*

Income, and Municipal Bonds. To create a historical record for each of the four new composites, the firm reallocated its portfolios into the four composites from 1995 through 2002. What should the firm disclose for the composite creation dates for the four new composites?

The composite creation date for the four new composites is 1 January 2002, even though the firm claimed compliance for several years and the assets were under management since 1995.

Provision 4.A.11

FIRMS MUST disclose that the FIRM'S list of COMPOSITE DESCRIPTIONS is available upon request.

Discussion

In each compliant presentation, the firm must disclose that the firm's list of composite descriptions is available upon request. The list of composite descriptions does not need to be included in each compliant presentation but must be readily available upon request. The list of composite descriptions must include the composite description for each current composite as well as a description for all composites that have terminated in the past five years. The composite description disclosed in the compliant presentation must be consistent with the one disclosed on the list of composite descriptions. Composite descriptions are 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. (See the Sample List of Composite Descriptions in Appendix C of the GIPS standards.)

This requirement exists to provide prospective clients a complete picture of the firm's composites, both current and terminated. By requesting the list of composite descriptions, prospective clients will have a better opportunity to evaluate whether the compliant presentation they have received is the most appropriate, as well as to determine if there are any other compliant presentations that they should also request to see.

Sample Disclosure:

"A list of composite descriptions is available upon request."

Provision 4.A.12

FIRMS MUST disclose that policies for valuing PORTFOLIOS, calculating performance, and preparing COMPLIANT PRESENTATIONS are available upon request.

Discussion

In each compliant presentation, firms must disclose the availability of policies for valuing portfolios, calculating performance, and preparing compliant presentations. The policies are not required to be included in each compliant presentation, but must be readily available upon request. Firms are not required to provide the related procedures, but may do so.

3 Explanation of the Provisions of the GIPS Standards

Sample Disclosure:

“The firm’s policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.”

Provision 4.A.13

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.

Discussion

Firms must provide enough information in a compliant presentation so that a prospective client understands how leverage, derivatives, and short positions have been employed historically and may be utilized going forward. While the composite description includes disclosure of the firm’s ability to use leverage, derivatives, and short positions, this disclosure instead requires that the firm disclose the leverage, derivatives, and short positions that have been utilized, if material. Taken together, these two disclosures provide a complete picture about the presence, use, and extent of leverage, derivatives, and short positions. This disclosure can be qualitative, quantitative, or both.

For example, assume a firm discloses in the composite description that the strategy may employ up to 200% leverage. To satisfy this disclosure requirement, the firm might state, “Since the inception of the strategy, the leverage has averaged 110% of the value; however, during 2007 the leverage averaged 160%, which greatly increases the sensitivity to market volatility and increases the potential for realized gains and/or losses.”

Provision 4.A.14

FIRMS MUST disclose all significant events that would help a PROSPECTIVE CLIENT interpret the COMPLIANT PRESENTATION.

Discussion

The GIPS standards are based on the principles of fair representation and full disclosure. Meeting these objectives requires a good faith commitment on the part of the firm to adhere to the spirit of the GIPS standards. This provision requires that firms disclose all significant events that would help explain the firm’s compliant presentation to a prospective client. The primary goal of this requirement is to provide relevant information to prospective clients so that they can understand the potential impact of the significant event on the investment strategy and the firm. Significant events are determined by the firm and would include, for example, a material change in personnel responsible for investment management, significant changes to the investment management process, historical records that were lost due to a catastrophic event, or a change in firm ownership.

Depending on the situation, a general statement describing the significant event that has occurred may be sufficient. Other situations may require firms to disclose specific information pertaining to the significant event.

Sample Disclosures:

Sample 1: “In June 2011, Firm G determined that the custodian bank used by all of the firm’s proprietary mutual funds had failed to file reclaimable withholding tax refund requests with the appropriate authorities. At that time, all accrued reclaimable withholding taxes were written off, decreasing the composite’s monthly return by 1.25%.”

Sample 2: “On 15 April 2007, a management-led buyout of ABC’s interest in Firm Z was completed. In conjunction with this buyout, an affiliate of Firm Z that provided quantitative investment management was transferred to ABC, resulting in the 2007 decrease in total firm assets.”

Sample 3: “In January 2012, the parent company of Firm M announced plans to exit the investment management business and sell Firm M.”

Sample 4: “In October 2010, we restructured the way client accounts are managed. Prior to this date, a single portfolio manager was responsible for each portfolio. Subsequently, each portfolio is assigned to a team of portfolio managers. In all instances, the composite strategies have not changed.”

3-4

Q&A

1. *Firm A has an equity composite that is managed by one portfolio manager, who is prominently displayed in the firm’s marketing materials. This manager leaves the firm, and another manager is hired to continue managing the composite according to the same strategy. What disclosures should be made?*

Each firm must determine which significant events would help a prospective client interpret the compliant presentation. When a strategy has a single investment decision maker who leaves and is replaced with a new investment decision maker, this event qualifies as a significant event which must be disclosed. Although the investment strategy remains the same with the new manager, the firm must disclose the change in personnel responsible for the management of the equity composite.

2. *Firm B acquires another firm. The amount of total firm assets and composite assets in each of Firm B’s composites increases significantly after the purchase. Should the firm make any disclosures regarding these events?*

The GIPS standards require that firms disclose any significant events within the firm that would help prospective clients interpret the compliant presentation. An acquisition of a new entity would likely qualify as a significant event because many aspects of the firm’s management, operations, investment processes, and staffing may change. It must be disclosed in a compliant presentation if it is determined that the acquisition is a significant event.

Sample Disclosure:

“Firm B acquired Firm X on 1 June 2000. As a result, Firm B’s total firm assets were greatly increased.”

Provision 4.A.15

For any performance presented for periods prior to 1 January 2000 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of noncompliance.

Discussion

Firms may link non-GIPS compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2000. If the firm chooses to present non-compliant performance for periods prior to 1 January 2000, the firm must disclose which periods are not in compliance. Prospective clients and existing clients are encouraged to inquire about the reasons why the periods prior to 1 January 2000 are not compliant and consider the effects of non-compliance on the historical performance.

Q&A

1. *Firm A presents its performance history since its inception in 1990 and claims compliance with the GIPS standards. The performance record since 1996 adheres to requirements of the GIPS standards. However, the firm did not include accrued income in the return calculation for the period from 1990 to 1995. What disclosure is necessary to allow the firm to link its pre-1996 non-compliant history with the ongoing compliant history?*

Firm A must disclose on its compliant presentation that the performance record from 1990 to 1995 is not in compliance. This disclosure informs a prospective client that the performance record prior to 1996 is not in compliance with the GIPS standards and allows the prospective client to request more information about why the performance is not in compliance.

Provision 4.A.16

If the FIRM is redefined, the FIRM MUST disclose the date of, description of, and reason for the redefinition.

Discussion

In some cases, due to corporate restructuring and merger and acquisition activities, the changes within the firm may be so significant that it is held out to the public as a new firm. The new firm must determine if there is a continuation from the prior firm or if the restructuring is so substantial that it is essentially a new firm.

Changes in investment style or personnel are not valid reasons for redefining the firm, unless the changes are such that the firm is held out to the public in a significantly different way. A simple name change is not sufficient reason to redefine the firm and restart the performance record. In some cases, a firm definition may change without the firm losing its performance history. In all cases, the underlying principles of the GIPS standards must be considered: fair representation and full disclosure. The GIPS standards require that changes in a firm's organization must not lead to alteration of historical composite performance.

Sample Disclosure:

“As of 1 January 2006, XYZ Firm includes both the London and Tokyo office of XYZ Company. Previously, the firm included only the London office. The firm was redefined to include the Tokyo office to reflect an expansion of the organization”

Provision 4.A.17

If a COMPOSITE is redefined, the FIRM MUST disclose the date of, description of, and reason for the redefinition.

Discussion

Investment strategies can change over time. In some cases, this results in the termination of one composite and the creation of a new composite. In other cases, it may be appropriate to redefine the composite. If a composite is redefined, the firm must disclose the date of, description of, and reason for the redefinition.

Sample Disclosures:

Sample 1: “As of 1 January 2006, the Large-Cap Composite has been redefined to exclude carve-outs. These carve-outs included allocated cash. We removed carve-outs from composites in anticipation of the then future requirement to no longer allow carve-outs with allocated cash to be included in composites.”

Sample 2: “Effective 1 January 2009, the Small-Cap Composite was redefined to exclude mutual funds from the composite; subsequently, only institutional portfolios are included. Previously, the mutual fund’s liquidity needs did not create a significant difference in the way the mutual fund was managed versus the institutional portfolios. However, due to the decreased supply of small-cap investments that meet our small-cap strategy’s criteria, combined with the consistent growth in the mutual fund’s assets, the fund is frequently no longer able to be fully invested in our small-cap strategy.”

Sample 3: “As of 1 July 2011, the fixed income strategy includes the use of futures and options to more efficiently modify duration. As of this date, portfolios that do not allow the use of options and futures were removed from the composite.”

Provision 4.A.18

FIRMS MUST disclose changes to the name of a COMPOSITE.

Discussion

When prospective clients are evaluating composites over time and across firms, it is important that they understand exactly which composites they are assessing. If a firm changes the name of a composite, the change must be disclosed in a compliant presentation. The name change must be disclosed for a minimum of one year and potentially for more than one year if the firm determines the disclosure is still relevant and meaningful.

3 Explanation of the Provisions of the GIPS Standards

Sample Disclosure:

“As of 1 January 2006, the S&P 500 composite has been renamed the Large-Cap Composite.”

Q&A

1. *How long does a composite name change disclosure have to be presented?*

The disclosure must be included in the composite’s compliant presentation for as long as it is relevant to the compliant presentation. The disclosure must be included for a minimum of one year and potentially for more than one year if the firm determines the disclosure is still relevant and meaningful. The firm must consider the underlying principles of the GIPS standards, which are full disclosure and fair representation, when determining a course of action.

Provision 4.A.19

FIRMS MUST disclose the minimum asset level, if any, below which PORTFOLIOS are not included in a COMPOSITE. FIRMS MUST also disclose any changes to the minimum asset level.

3-4

Discussion

The firm may establish a minimum asset level for a composite to identify portfolios that are too small to be representative of the intended strategy. Firms must disclose the minimum asset level of the composite, if one exists, in each respective compliant presentation. If any changes have been made to the minimum asset level of a composite, the firm must document and disclose changes to the minimum asset level and must not retroactively apply the new limit.

The Guidance Statement on Composite Definition provides additional guidance on composite minimums.

Sample Disclosure:

“The minimum portfolio size for inclusion in Composite LMN is €500,000. Prior to 2002, portfolios with assets below €400,000 were not included in Composite LMN.”

Provision 4.A.20

FIRMS MUST disclose relevant details of the treatment of withholding tax on dividends, interest income, and capital gains, if material. FIRMS MUST also disclose if BENCHMARK returns are net of withholding taxes if this information is available.

Discussion

Global investing requires recognition of the tax consequences of investing in different countries. The GIPS standards do not require firms to reflect withholding taxes, either reclaimable or non-reclaimable taxes, in a certain manner. Firms may choose whether or not to reflect the impact of withholding taxes when calculating performance. The GIPS standards recommend that performance

be reported net of non-reclaimable withholding taxes on dividends, interest, and capital gains and also recommend that reclaimable foreign withholding taxes be accrued. If withholding taxes are material, firms must disclose how withholding taxes are treated when calculating performance.

Sample Disclosure:

“Portfolio returns are net of all foreign non-reclaimable withholding taxes. Reclaimable withholding taxes are recognized if and when received. Benchmark returns are net of withholding taxes.”

Provision 4.A.21

For periods beginning on or after 1 January 2011, FIRMS MUST disclose and describe any known material differences in exchange rates or valuation sources used among the PORTFOLIOS within a COMPOSITE and between the COMPOSITE and the BENCHMARK.

Discussion

Portfolios within a composite may use different exchange rates and valuation sources. Additionally, exchange rates and valuation sources may differ between the composite and the benchmark. Differences may exist as a result of the sources used (e.g., WM/Reuters versus Bloomberg) or the time of day (e.g., 1200h versus 1600h). For periods beginning on or after 1 January 2011, if the firm knows of any such material differences, the firm must disclose and describe these differences. For periods prior to 1 January 2011, the firm must disclose and describe any known differences, whether material or not. This disclosure allows prospective clients to identify any variance due to differences in exchange rates or valuation sources that may positively or negatively impact the comparison of the composite’s return to that of the benchmark.

If the same exchange rate or valuation source is used for all portfolios in the composite and for the composite benchmark, no disclosure is necessary.

Sample Disclosures:

Sample 1: “Exchange rates used for the benchmark are WM/Reuters Closing Spot Rates™ at 1600 hours London time; the composite uses WM/Reuters Closing Spot Rates at 1600 hours New York time.”

Sample 2: “All portfolios within the composite are valued using WM/Reuters 4:00 p.m. (London) exchange rates and XX valuation sources. Mutual funds within the composite are also fair valued as of 4:00 p.m. (New York) if markets have materially changed after the London close. The XYZ Benchmark is valued as of 4:00 p.m. (London).”

Provision 4.A.22

If the COMPLIANT PRESENTATION conforms with laws and/or regulations that conflict with the REQUIREMENTS of the GIPS standards, FIRMS MUST disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards.

3 Explanation of the Provisions of the GIPS Standards

Discussion

Firms must comply with all applicable laws and regulations regarding the calculation and presentation of performance. Firms must also comply with all of the requirements of the GIPS standards. Compliance with applicable laws and regulations does not necessarily result in compliance with the GIPS standards. Firms claiming compliance must comply with the GIPS standards and all applicable laws and regulations, unless there is a conflict. In the rare cases where laws and regulations conflict with the GIPS standards, firms are required to comply with the laws and regulations and disclose the manner in which the laws and/or regulations conflict with the GIPS standards.

This disclosure will assist prospective clients in comparing compliant presentations among firms where reporting requirements may differ due to local laws or regulations.

Provision 4.A.23

For periods prior to 1 January 2010, if CARVE-OUTS are included in a COMPOSITE, FIRMS MUST disclose the policy used to allocate cash to CARVE-OUTS.

3-4

Discussion

A carve-out is defined as a portion of a portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multiple-strategy portfolio managed to a broader mandate. For periods beginning on or after 1 January 2010, if carve-outs are included in a composite, the carve-outs must be managed separately with their own cash balance. After 1 January 2010, carve-outs must not be included in a composite unless the carve-outs are actually managed separately with their own cash. For periods prior to 1 January 2010, firms are allowed to allocate cash to carve-outs and the policy used to allocate cash to carve-outs must be disclosed.

The Guidance Statement on the Treatment of Carve-Outs provides additional guidance.

Sample Disclosure:

“Until 31 December 2009, cash was allocated to carve-outs monthly based on the relative value of the equity segment to the total portfolio value.”

Q&A

1. *For periods prior to 1 January 2010, Firm A carved out U.K. equity performance from its Euro-Pacific equity portfolios and combined it with its U.K. equity portfolios to create a U.K. Equity Composite. Before including the carve-out in the U.K. Equity Composite, the firm allocated cash to the U.K. equity segment on a pro rata basis, based on the level of U.K. equities as a percentage of the total equity exposure. What disclosure is necessary?*

For periods prior to 1 January 2010, the U.K. equity segment may be included in the U.K. Equity Composite provided the segment meets the carve-out requirements, cash is allocated to the carve-out, and the policy used to allocate the cash to the carve-out is disclosed. For periods prior to 1 January 2010, the firm must include in the U.K. Equity Composite all carve-outs from all portfolios meeting this definition.

Sample Disclosure:

“Firm A’s U.K. Equity Composite includes all dedicated U.K. equity portfolios. For periods prior to 1 January 2010, the composite also included the U.K. equity segment of portfolios that were managed to the firm’s Euro-Pacific equity strategy. Cash was allocated to the carve-out segment returns on a pro rata basis depending on the proportion of U.K. assets to total portfolio assets based on beginning-of-period values.”

Provision 4.A.24

If a COMPOSITE contains PORTFOLIOS with BUNDLED FEES, FIRMS MUST disclose the types of fees that are included in the BUNDLED FEE.

Discussion

A bundled fee is a fee that combines multiple fees into one total or “bundled” fee. Bundled fees can include any combination of investment management fees, trading expenses, custody fees, and/or administrative fees. Two examples of bundle fees are all-in fees and wrap fees.

All-In Fee: All-in fees are a type of bundled fee that can include any combination of investment management fees, trading expenses, custody fees, and administrative fees. All-in fees are client specific and typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.

Wrap Fee: Wrap fees are a type of bundled fee and are specific to a particular investment product. The wrap fee is charged by a wrap fee sponsor for investment management services and typically includes associated trading expenses that cannot be separately identified. Wrap fees can be all-inclusive, asset-based fees and may include a combination of investment management fees, trading expenses, and/or administrative fees. A wrap fee portfolio is sometimes referred to as a “separately managed account” (SMA) or “managed account.”

Sample Disclosure:

“Portfolios within the composite pay a bundled fee, which includes all charges for trading costs, portfolio management, custody, and other administrative fees.”

Provision 4.A.25

For periods beginning on or after 1 January 2006, FIRMS MUST disclose the use of a SUB-ADVISOR and the periods a SUB-ADVISOR was used.

Discussion

Some firms utilize a sub-advisor to manage part or all of a particular strategy. For example, if a firm specializes in managing equities, it might hire a sub-advisor to manage the fixed income portion of its balanced portfolios. The GIPS standards require that firms include the performance of assets assigned to a sub-advisor in a composite provided the firm has the authority to allocate the assets to a sub-advisor.

3 Explanation of the Provisions of the GIPS Standards

If a firm has discretion over the selection of the sub-advisor (i.e., can hire and/or fire), the firm must claim the sub-advisor's performance as part of its performance history and include the assets in total firm assets. Because the sub-advisor has discretion over the actual investment of the assets and the firm has discretion over the selection of the sub-advisor, both the firm and the sub-advisor are able to claim the performance of the assets as their own. The firm is able to claim this performance because the sub-advised portion of the portfolio is essentially viewed as an asset (similar to purchasing a mutual fund within the portfolio) and the firm must be held responsible for its decision to utilize a sub-advisor. The firm can only include the sub-advisor's performance record relevant to those assets assigned by the firm. If a firm does not have discretion over sub-advisor selection, it must not include the sub-advisor's performance in its performance history.

Please refer to the Guidance Statement on Definition of the Firm for additional guidance on the use of sub-advisors.

Sample Disclosure:

"A sub-advisor was used to provide international equity exposure in the Growth Composite for the year 2006."

3-4

Provision 4.A.26

For periods prior to 1 January 2010, FIRMS MUST disclose if any PORTFOLIOS were not valued at calendar month end or on the last business day of the month.

Discussion

Consistency in monthly portfolio valuation dates will result in improved comparability of data. For periods beginning on or after 1 January 2010, firms must value portfolios as of the calendar month-end or the last business day of the month.

Sample Disclosure:

"For periods prior to 1 January 2010, portfolios in the Value Composite were valued as of the last Friday of the month as well as the last business day of the year. Subsequently, portfolios are valued as of month-end and on any day when a portfolio has a cash flow that exceeds 5% of the portfolio's value."

Provision 4.A.27

For periods beginning on or after 1 January 2011, FIRMS MUST disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles in Chapter II of the GIPS standards) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE.

Discussion

In the GIPS Valuation Principles, the following hierarchy is recommended for creating policies and procedures for determining fair value for portfolio investments on a composite-specific basis.

- a. Investments must be valued using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available. If not available, then investments should be valued using;
- b. Objective, observable quoted market prices for similar investments in active markets. If not available or appropriate, then investments should be valued using;
- c. Quoted prices for identical or similar investments in markets that are not active (markets in which there are few transactions for the investment, the prices are not current, or price quotations vary substantially over time and/or between market makers). If not available or appropriate, then investments should be valued based on;
- d. Market-based inputs, other than quoted prices, that are observable for the investment. If not available or appropriate, then investments should be valued based on;
- e. Subjective unobservable inputs for the investment where markets are not active at the measurement date. Unobservable inputs should only be used to measure fair value to the extent that observable inputs and prices are not available or appropriate. Unobservable inputs reflect the firm's own assumptions about the assumptions that market participants would use in pricing the investment and should be developed based on the best information available under the circumstances.

The last level of the recommended hierarchy discusses the use of subjective unobservable inputs for the investments where markets are not active at the measurement date. For periods beginning on or after 1 January 2011, firms must disclose the use of subjective unobservable inputs for valuing portfolio investments (as described in the GIPS Valuation Principles in Chapter II of the GIPS standards) if the portfolio investments valued using subjective unobservable inputs are material to the composite.

Sample Disclosure:

“Typically, between 20% and 30% of each portfolio's investments are valued using subjective, unobservable inputs. These inputs are supported by no market activity and instead are based on the firm's internal proprietary pricing models.”

Provision 4.A.28

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.

Discussion

Firms must establish policies and procedures for determining portfolio valuations. For periods beginning on or after 1 January 2011, those valuations must meet the definition of fair value. The GIPS Valuation Principles set forth a recommended valuation hierarchy that firms should incorporate into the policies and procedures for determining fair value for portfolio investments. Firms

3 Explanation of the Provisions of the GIPS Standards

must establish a valuation hierarchy on a composite-specific basis. It is acceptable for firms to apply a different hierarchy provided it satisfies the definition of fair value. If the valuation hierarchy materially differs from the recommended hierarchy, the firm must disclose this fact.

Sample Disclosure:

“All portfolio investments are valued using the firm’s internal proprietary valuation models to determine fair value. Our valuation procedures materially differ from the recommended valuation hierarchy in the GIPS standards.”

Provision 4.A.29

If the FIRM determines no appropriate BENCHMARK for the COMPOSITE exists, the FIRM MUST disclose why no BENCHMARK is presented.

Discussion

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

Sample Disclosure:

“Because the composite’s strategy is absolute return where investments are permitted in all asset classes, no benchmark is presented as we believe that no benchmark that reflects this strategy exists.”

Provision 4.A.30

If the FIRM changes the BENCHMARK, the FIRM MUST disclose the date of, description of, and the reason for the change.

Discussion

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

- The benchmark is changed from one benchmark to another on a prospective basis only.
- The benchmark is changed for all periods (i.e., retroactively).

In most cases, the firm should only change the benchmark going forward and not change the benchmark retroactively. However, there may be times when a firm determines that it is appropriate to change the benchmark for a given composite retroactively. For example, because benchmarks are continually evolving, if the firm finds that a new benchmark is a better representation of an investment strategy, the firm may consider changing the benchmark retroactively. The firm must

disclose the date the benchmark is changed, the description of the change, and the reason for the change. The firm must also disclose that the benchmark has been changed retroactively. In addition, firms are encouraged to continue to present the old benchmark.

If a firm uses a custom benchmark that is a blend of one or more benchmarks, a change in the weights of the constituent benchmarks is not considered a benchmark change within the scope of this provision. For example, the benchmark may change every quarter as part of the normal procedure. In this instance, it is appropriate to disclose that the benchmark is rebalanced quarterly using the weights of the asset classes in the model portfolio. A firm is not required to disclose how the asset class weights have changed each quarter but may do so. If a firm uses a custom benchmark or combination of multiple benchmarks, the firm must disclose the benchmark components, weights, and rebalancing process.

Changes to the benchmark primarily intended to make performance look better by lowering the benchmark return violate the spirit of the GIPS standards.

Sample Disclosure:

“Benchmark results presented are a combination of two indices. ABC Index was used prior to 30 September 2010; ABC Value Index is used subsequently. This change was made to better align the benchmark with the composite’s increasing value tilt.”

3-4

Q&A

1. *Firm A manages an equity composite in which the investment strategy has attempted to mirror the S&P 500. Firm A now wants to expand the investment strategy to include non-U.S. large-cap equities and change the benchmark to a blended index of the S&P 500 and the MSCI EAFE indices. If Firm A discloses the date of, description of, and the reason for the benchmark change and explains how the new index is created and rebalanced, is that sufficient for Firm A to continue claiming compliance with the GIPS standards?*

No. In this case, because the benchmark defined the strategy for the composite, a change in the benchmark results in a change to the investment strategy. A material change in the strategy results in the need for Firm A to create a new composite reflecting the new strategy.

2. *Firm B has historically used the Large-Cap Index as the benchmark for its U.S. Equity Composite. However, Firm B recently changed its benchmark retroactively to the Broader Large-Cap Index in the composite presentation. In the compliant presentation, the firm provides the date of the change and explains that the Broader Large-Cap Index is a benchmark that better reflects the composite’s investment history. However, the change was made because the lower return of the Broader Large-Cap Index provided a lower hurdle rate for the returns of the composite. Is this change permissible under the GIPS standards?*

No. Firm B has changed its benchmark primarily to improve its historical performance by lowering the benchmark return. Firm B has violated the GIPS standards even though it has technically met the requirements of the GIPS standards by providing the date of, description of, and reason for the change.

3. *Firm C historically used the MSCI EAFE Index as the benchmark for the firm’s Global ex-U.S. strategy, even though the strategy included investments in emerging markets and the benchmark did not. When the MSCI ACWI ex-U.S. Index was introduced, the firm changed benchmarks because the new index included emerging markets, which more closely represented the firm’s strategy. Is this permissible according to the GIPS standards?*

3 Explanation of the Provisions of the GIPS Standards

Yes. In this case, the firm can change the benchmark to the MSCI ACWI ex-U.S. because it is more representative of the composite's investment strategy. The firm must disclose the date of, description of, and reason for the change. If historical data are available for the new benchmark, the firm could consider changing the benchmark retroactively.

4. *Our balanced composite strategy takes active asset allocation decisions across a range of asset classes. The weights of the asset classes within the benchmark are updated quarterly to reflect changes to the balanced composite's model portfolio. The GIPS standards require that if a firm changes the benchmark, the firm must disclose the date of, description of, and reason for the change. Given the nature of the benchmark, the benchmark is subject to change each quarter. What must be disclosed to satisfy this requirement?*

The requirement to disclose the date of, description of, and reason for a change in the benchmark is intended to describe substantive changes in the benchmark. Firms must determine if the change in aspects of the benchmark are important enough to warrant disclosure of the change. The GIPS standards also require that if a custom benchmark or combination of multiple benchmarks is used, the firm must disclose the benchmark components, weights, and rebalancing process. In this example, the benchmark may change every quarter as part of the normal procedure. It is required to disclose the description of the benchmark(s); if the benchmark is widely known, the benchmark name can be used to satisfy this requirement. In addition, it is appropriate in this instance to disclose that the benchmark is rebalanced quarterly using the weights of the asset classes in the model portfolio. A firm is not required to disclose how the asset class weights have changed each quarter. If the benchmark for the composite were to change from a benchmark created quarterly using the asset class weights of the model portfolio to just one benchmark reflecting the investment strategy of the composite, that would be a substantive change that would need to be disclosed.

3-4

Provision 4.A.31

If a custom BENCHMARK or combination of multiple BENCHMARKS is used, the FIRM MUST disclose the BENCHMARK components, weights, and rebalancing process.

Discussion

When custom benchmarks are used, the firm must disclose the benchmark components, weights, and rebalancing process. For example, if the firm combines two indices for the composite benchmark, the WWXX benchmark, the following would be an appropriate disclosure:

“The WWXX benchmark is a combination of 50% WW index and 50% XX index and is rebalanced monthly.”

Firms may also use a portfolio-weighted custom benchmark, which is created using the benchmarks of the individual portfolios in the composite. If such a benchmark is used, and assuming that the rebalancing is done monthly, firms must disclose that the benchmark is rebalanced monthly using the weighted average returns of the benchmarks of all of the portfolios included in the composite. Firms are not required to disclose how the underlying portfolio benchmarks and weights have changed each month. Additionally, in the spirit of full disclosure and fair representation, firms

must disclose the components that comprise the portfolio-weighted custom benchmark, including the weights that each component represents, as of the most recent annual period-end. Firms should also offer to provide this information for prior periods upon request.

Q&A

1. *For one of our composites, we use a portfolio-weighted custom benchmark that is created monthly using the benchmarks of the individual portfolios in the composite. The GIPS standards require that if a firm changes the benchmark, the firm must disclose the date of, description of, and reason for the change. Given the nature of the benchmark, the benchmark is subject to change each month. What must be disclosed to satisfy this requirement?*

The GIPS standards require that if a custom benchmark or combination of multiple benchmarks is used, the firm must disclose the benchmark components, weights, and rebalancing process. In this example, the benchmark may change every month as part of the normal procedure. It is required in this instance to disclose that the benchmark is rebalanced monthly using the weighted average returns of the benchmarks of all of the portfolios included in the composite. A firm is not required to disclose how the underlying portfolio benchmarks and weights have changed each month. If the benchmark for the composite were to change from a portfolio-weighted custom benchmark created monthly using the benchmarks of the individual portfolios in the composite to a market index, this would be a benchmark change that must be disclosed.

In the spirit of full disclosure and fair representation, firms must disclose the components that comprise the portfolio-weighted custom benchmark, including the weights that each component represents, as of the most recent annual period end. Firms should also offer to provide this information for prior periods upon request.

Sample disclosure:

“The Long U.S. Government/Credit Custom Benchmark is calculated using the benchmarks of portfolios in the composite. The benchmark is rebalanced monthly based on the beginning values of portfolios included in the composite. As of 31 December 2009, the breakdown of the benchmark is 88.2% Barclays Capital U.S. Long Government/Credit Index and 11.8% Barclays Capital U.S. Long Government/Credit A+ Index. The breakdown of the custom benchmark for different time periods is available upon request.”

Provision 4.A.32

If the FIRM has adopted a SIGNIFICANT CASH FLOW policy for a specific COMPOSITE, the FIRM MUST disclose how the FIRM defines a SIGNIFICANT CASH FLOW for that COMPOSITE and for which periods.

Discussion

A significant cash flow is defined as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000)

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or a percentage of portfolio assets (based on the most recent valuation). If a firm has adopted a significant cash flow policy for a specific composite, the firm must disclose how the firm defines a significant cash flow for that composite and for which periods.

Please refer to the Guidance Statement on the Treatment of Significant Cash Flows for additional guidance.

Sample Disclosures:

Sample 1: “Firm ABC defines a significant cash flow for the European Developed Markets Equity Composite as an external cash flow within a portfolio equal to or greater than €50,000,000.”

Sample 2: “Firm ABC defines a significant cash flow for the portfolios of the European Developed Markets Equity Composite as one or more external cash flows during the month equaling an absolute value greater than 25% of the portfolio’s assets at the beginning of the month.”

3-4

Provision 4.A.33

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.

Discussion

For periods ending on or after 1 January 2011, firms must present the three-year annualized ex-post standard deviation of the composite and benchmark using 36 monthly returns as of each annual period-end.

If 36 monthly returns are not available for the composite, firms are not required to present the ex-post standard deviation for either the benchmark or the composite. Firms must disclose that 36 monthly returns are not available for the composite.

If 36 monthly returns are not available for the benchmark but are available for the composite, firms are only required to present the ex-post standard deviation for the composite. In this instance, because 36 monthly returns are not available for the benchmark, firms must not present a three-year ex-post standard deviation for the benchmark using data points other than monthly. Firms must disclose that 36 monthly returns are not available for the benchmark.

Sample Disclosure:

“The three-year annualized standard deviation is not presented as of 31 December 2011 because the composite does not yet have 36 monthly returns as of this date.”

Q&A

1. *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. Additionally, 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.*

The benchmark for one of our composites does not have 36 monthly returns available to calculate the three-year annualized ex-post standard deviation because only quarterly benchmark returns are available. However, the composite does have 36 monthly returns available. Are we required to present the three-year annualized ex-post standard deviation for the composite when there is no corresponding standard deviation for the benchmark?

Yes. Firms must present the three-year annualized ex-post standard deviation for the composite if 36 monthly returns are available, even if 36 monthly returns are not available for the benchmark. Firms must disclose if the three-year annualized ex-post standard deviation of the benchmark is not presented because 36 monthly returns are not available.

Provision 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.

3-4

Discussion

For some composites, firms may determine that the three-year annualized ex-post standard deviation is not relevant or appropriate. In those instances, firms must continue to present the three-year annualized ex-post standard deviation and present another three-year ex-post risk measure in addition to the standard deviation. Firms must describe why ex-post standard deviation is not relevant or appropriate. Firms must also describe the additional risk measure presented and why the firm considers it to be more appropriate and relevant to the strategy.

Q&A

1. *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. If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must also present a three-year ex-post risk measure in addition to the three-year annualized ex-post standard deviation. We do not believe that standard deviation is a relevant or appropriate measure for our composite strategy. May we present an ex-ante measure of risk in addition to the three-year annualized ex-post standard deviation to satisfy this requirement?*

No. If a firm does not believe that ex-post standard deviation is relevant or appropriate for the composite, the firm must also present a three-year ex-post measure of risk in addition to the three-year annualized ex-post standard deviation. The firm must describe why ex-post standard deviation is not relevant or appropriate, the additional risk measure that is presented, and why it was selected. An ex-ante measure of risk may be presented as supplemental information. However, this would not satisfy the requirement to present an ex-post measure of risk in addition to the three-year annualized ex-post standard deviation if the firm does not believe that standard deviation is relevant or appropriate for the composite.

3 Explanation of the Provisions of the GIPS Standards

Provision 4.A.35

FIRMS MUST disclose if the performance from a past firm or affiliation is LINKED to the performance of the FIRM.

Discussion

The GIPS standards state that performance of a past firm or affiliation must be linked to or used to represent the historical performance of a new or acquiring firm if, on a composite-specific basis:

1. Substantially all of the investment decision makers are employed by the new or acquiring firm (e.g., research department staff, portfolio managers, and other relevant staff);
2. The decision-making process remains substantially intact and independent within the new or acquiring firm, and
3. The new or acquiring firm has records that document and support the performance.

If the portability requirements are met on a composite-specific basis and performance from the past firm or affiliation is linked to the performance of the firm, firms must disclose this fact. See the Guidance Statement on Performance Record Portability for additional information.

Sample Disclosure:

“Performance shown prior to 31 December 2009 represents results achieved by the Small-Cap Team while it was a part of ABC Investments.”

Disclosures—Recommendations

Provision 4.B.1

FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

Discussion

If a change to the valuation policies and/or methodologies is material, firms should disclose the change in order to enable prospective clients to understand the potential effect of such a change.

Sample Disclosure:

“Prior to 1 March 2007, illiquid securities were valued internally. Subsequently, illiquid securities are valued using a third-party pricing service.”

Provision 4.B.2

FIRMS SHOULD disclose material changes to calculation policies and/or methodologies.

Discussion

Firms have discretion to determine which policies and methodologies are used for calculating performance. While these policies must adhere to all applicable calculation requirements, firms may choose from a wide variety of methodologies. Firms may change calculation policies and/or methodologies; however, firms must not change a calculation policy or methodology for the sole purpose of increasing performance. If a change to the calculation policies and/or methodologies is material, firms should disclose the change in order to enable prospective clients to understand the potential effect of such a change.

Sample Disclosure:

“Effective 1 January 2005, portfolio returns are calculated daily. Previously, portfolio returns were calculated monthly using the Modified Dietz method.”

3-4

Provision 4.B.3

FIRMS SHOULD disclose material differences between the BENCHMARK and the COMPOSITE’S investment mandate, objective, or strategy.

Discussion

It is recommended that firms disclose any material differences between the benchmark and the composite’s investment mandate, objective, or strategy to assist prospective clients in evaluating the strategy so that they can understand the material differences between the composite and the benchmark.

Sample Disclosure:

“The Absolute Return composite invests in stocks both long and short regardless of country of domicile or market capitalization. The composite benchmark is the T-bill rate, which is the hurdle rate, and is composed of materially different investments.”

Provision 4.B.4

FIRMS SHOULD disclose the key assumptions used to value PORTFOLIO investments.

Discussion

Valuation is the critical component of the performance calculation; therefore, it is recommended that firms disclose the key assumptions used when valuing portfolio investments.

3 Explanation of the Provisions of the GIPS Standards

Sample Disclosure:

“Investments are valued using recent market quotations. If there is no publicly traded reference, equity investments are valued using a market multiple approach for similar investments in active markets, and fixed income investments are valued using inputs such as interest rates, yield curve shape, volatility, prepayments, and credit risk.”

Provision 4.B.5

If a parent company contains multiple firms, each FIRM within the parent company SHOULD disclose a list of the other firms contained within the parent company.

Discussion

The term “firm” is used in two different ways in Provision 4.B.5. “FIRM” is used to indicate a GIPS-compliant firm as defined in the GIPS Glossary, while “firm” is used in Provision 4.B.5 to indicate an entity that does not claim compliance with the GIPS standards.

A parent company may have two or more units, divisions, departments, or offices that are defined as separate firms within the context of the GIPS standards. Each firm’s definition will reflect the specific circumstances at the firm and must reflect how it is held out to the public as a distinct business entity. In order to avoid confusion, a firm claiming compliance with the GIPS standards must be sure that it is clearly defined relative to the other firms within the parent company and that it is apparent which firm is claiming compliance. In the interest of fair representation and full disclosure, it is recommended that each firm that claims compliance with the GIPS standards within the parent company (i.e., “FIRM” in Provision 4.B.5) disclose a list of the other organizations (i.e., “firms” in Provision 4.B.5) within the parent company.

Sample Disclosure:

“The Firm is the institutional division of ABC parent company. The private banking and retail divisions of ABC parent company also claim compliance with the GIPS standards.”

Provision 4.B.6

For periods prior to 1 January 2011, FIRMS SHOULD disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles in Chapter II of the GIPS standards) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE.

Discussion

For periods beginning on or after 1 January 2011, firms must disclose the use of subjective unobservable inputs for valuing portfolio investments. It is best practice for firms to apply this disclosure for periods prior to 1 January 2011 as well.

Provision 4.B.7

For periods prior to 1 January 2006, FIRMS SHOULD disclose the use of a SUB-ADVISOR and the periods a SUB-ADVISOR was used.

Discussion

For periods beginning on or after 1 January 2006, firms must disclose the use of a sub-advisor and the periods a sub-advisor was used. For periods prior to 1 January 2006, it is best practice for firms to disclose the use of a sub-advisor and the periods a sub-advisor was used.

Provision 4.B.8

FIRMS SHOULD disclose if a COMPOSITE contains PROPRIETARY ASSETS.

3-4

Discussion

Proprietary assets are defined as investments owned by the firm, the firm's management, and/or the firm's parent company that are managed by the firm. Firms may manage a portfolio of their own proprietary assets along with client portfolios or before they manage client portfolios in a certain strategy. Portfolios of proprietary assets may have certain characteristics that client portfolios may not have (e.g., fees, trading agreements). This disclosure informs prospective clients about the firm's own capital invested in the strategy. Disclosure of proprietary assets within a composite will provide prospective clients insight into the underlying portfolios and assist with their assessment of the investment strategy being evaluated.

Proprietary assets can either be fee-paying portfolios or non-fee-paying portfolios. If portfolios of proprietary assets do not pay an investment management fee, they are considered to be non-fee-paying portfolios. If a composite includes non-fee-paying portfolios, the firm must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period end. In any case, firms should disclose if a composite contains proprietary assets.

3-5 PRESENTATION AND REPORTING

Presentation and Reporting—Requirements

Provision 5.A.1.a

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- a. At least five years of performance (or for the period since the **FIRM**'s inception or the **COMPOSITE INCEPTION DATE** if the **FIRM** or the **COMPOSITE** has been in existence less than five years) that meets the **REQUIREMENTS** of the GIPS standards. After a **FIRM** presents a minimum of five years of GIPS-compliant performance (or for the period since the **FIRM**'s inception or the **COMPOSITE INCEPTION DATE** if the firm or the **COMPOSITE** has been in existence less than five years), the **FIRM** **MUST** present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.

3-5

Discussion

In order to claim compliance, a firm is required to meet all applicable requirements of the GIPS standards on a firm-wide basis when creating the initial minimum five-year track record of investment performance history. All of the firm's actual, fee-paying, discretionary portfolios must be placed in appropriate composites to create the five-year record. If the firm (or composite) has been in existence less than five years, the firm must present performance since inception of the firm (or the composite).

Once a firm (or composite) has its initial minimum five years of history, the firm must continue to add annual returns to each compliant presentation for the next five years (at a minimum), so that after five years of claiming compliance with the GIPS standards, the firm will have a ten-year performance record for its composites. Firms are recommended to present a composite's history for more than the minimum required periods.

Please see the sections of the GIPS standards on Real Estate, Private Equity, and Wrap Fee/ Separately Managed Account (SMA) Portfolios for additional information on the effective dates for these types of portfolios.

Q&A

1. *Firm A has been in existence since 1990 but did not decide to comply with the GIPS standards until 2001. Beginning 1 January 2001, what periods of performance must Firm A present to claim compliance with the GIPS standards?*

At a minimum, Firm A must show its performance in compliance with the GIPS standards from 1 January 1996 through 31 December 2000, which represents a five-year compliant performance record. Each year for at least five years thereafter, the firm must continue

to add an annual return to its existing composites, building to a ten-year compliant track record. A (minimum) ten-year GIPS-compliant performance record is then available after 31 December 2005.

During this ten-year period, Firm A may create new composites and terminate others (e.g., as portfolios open and close). It is possible that these new or terminated composites will not have a ten-year performance record at 31 December 2005.

2. *Firm B has been in existence since 1 January 1998 and has restated its entire performance history in compliance with the GIPS standards on 1 January 2006. What periods of performance must Firm B present to claim compliance with the GIPS standards?*

When first claiming compliance with the GIPS standards, Firm B must show its most recent five-year history in compliance with the GIPS standards since the firm has been in existence for more than five years. The firm could also choose to show performance since inception (i.e., an eight-year performance record, 1998 through 2005) or any period in between (i.e., a six- or seven-year performance record). Firm B must continue to build to a ten-year history, at a minimum, going forward.

3. *Firm C has been in existence since 1985 and is currently considering its options for coming into compliance with the GIPS standards. The firm determines its performance history does not satisfy one of the GIPS calculation requirements. For various reasons, the firm cannot restate its performance from the last five years in order to create a five-year compliant record as required by the GIPS standards; however, it is able to recreate the performance from the last year and show a one-year “GIPS-compliant” return. Can Firm C claim compliance with the GIPS standards?*

No. The GIPS standards require firms to present at least five years of performance (or performance since firm or composite inception if the firm or composite is less than five years old). In order to claim compliance, Firm C must build a compliant performance record going forward and should be able to claim compliance in four years.

4. *Can a firm that has only been in existence for three years claim compliance with the GIPS standards?*

Yes. Firms that have been in existence less than five years may claim compliance with the GIPS standards. The firm must do so for the period since the firm’s inception, which in this case would be for three years.

5. *Our firm has been compliant with the GIPS standards since its inception. Our initial composite with our growth–equity strategy has over five years of performance history. We subsequently added a new mid-cap strategy, leading to the creation of a separate mid-cap composite. This mid-cap composite does not have the five years of performance history yet. May we present a compliant presentation for the mid-cap composite prior to the composite having five years of history?*

Yes. Even though the mid-cap composite does not have five years of performance history, the mid-cap composite must be created and a compliant presentation must be made available. The compliant presentation must include performance from inception of the composite.

6. *One of our composites temporarily lost all of its member portfolios, resulting in a “break” in performance. The inception date was 1 January 2004, and there were 10 accounts in the composite through 31 July 2005. As of 1 August 2005, 6 portfolios were liquidated and 4 fell below the minimum account size, leaving the composite with no portfolios. On 30 April 2006, 2 of*

3 Explanation of the Provisions of the GIPS Standards

the portfolios that had previously fallen below the composite minimum exceeded the minimum account size, effectively reinstating the composite with the same strategy. How should we present this composite's compliant presentation as of 31 December 2007?

Since all of the portfolios in the composite were either terminated or fell below the minimum level and according to the firm's policies were removed from the composite, the performance record of the composite would come to an end as of 31 July 2005. Since after a period of time portfolios moved above the minimum or new portfolios were added to the composite, the prior performance history of the composite must be shown but must not be linked to the ongoing composite performance results.

For the purpose of performance presentation, as of 31 December 2007, the composite had an uninterrupted performance track record from 1 January 2004 to 31 July 2005, a "performance break" or "performance gap" from 1 August 2005 to 30 April 2006, and an uninterrupted performance track record from 1 May 2006 to 31 December 2007.

Under the principles of fair representation and full disclosure, the GIPS standards require firms to handle such cases with the highest transparency. In this instance, the firm must present both periods of performance. However, the periods before and after the break must be presented separately—for example:

Period	Period Returns (%)		Composite Dispersion (%)	Number of Portfolios as of End of Period	Assets Under Management as of End of Period (USD millions)	
	Composite	Benchmark			Composite	Total Firm
1 Jan–31 Dec 2007	X%	X%	X%	5	X	X
1 May–31 Dec 2006	X%	X%	—	2	X	X
1 Jan–31 Jul 2005	X%	X%	—	—	—	—
1 Jan–31 Dec 2004	X%	X%	X%	10	X	X

While the firm may present a cumulative return for the period from 1 January 2004 through 31 July 2005, it must not link periods with "performance breaks" and present a cumulative return over such periods (e.g., from 1 January 2004 to 31 December 2007). The same would apply to presentation of any recommended risk measures based on cumulated periods (e.g., volatility).

The firm may not choose to omit performance for the incomplete years (e.g., for 2005 and 2006 in the previous example), justifying this by the GIPS requirement to present annual returns. Such interpretation would not meet the goals of fair representation and full disclosure.

Provision 5.A.1.b

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- b.** **COMPOSITE** returns for each annual period. **COMPOSITE** returns **MUST** be clearly identified as **GROSS-OF-FEES** or **NET-OF-FEES**.

Discussion

The GIPS standards require, at a minimum, the presentation of annual composite returns. Firms must clearly label the annual presentation periods. Firms must define the annual reporting period on a composite-by-composite basis and apply it consistently. For purposes of comparability, firms should report composite performance on a calendar year-end basis.

If partial-year returns are presented, the periods covered must be clearly disclosed. Partial-year returns must not be annualized.

Composite returns may be presented either gross-of-fees or net-of-fees. Firms may present both gross-of-fees and net-of-fees composite returns in a compliant presentation. For more information on the required and recommended treatment of fees, please refer to the Guidance Statement on Fees.

Q&A

1. *The GIPS standards require the presentation of annual returns. My firm was just created this year and, as such, does not yet have any annual returns. Can my firm claim compliance with the GIPS standards now or must we wait until we have at least one annual return?*

If the firm is less than 12 months old, it is permitted to present its performance since firm or composite inception and claim compliance with the GIPS standards. The firm may claim compliance as soon as it meets the requirements of the GIPS standards and has performance to report. The GIPS standards require at least five years of performance (or a record for the period since firm inception or the composite inception date, if the firm or composite has been in existence less than five years) that meets the requirements of the GIPS standards. This provision is not intended to prevent a new firm from complying with the GIPS standards until it has an entire 12-month period of performance. Returns for periods of less than one year must not be annualized.

Provision 5.A.1.c

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- c.** For **COMPOSITES** with a **COMPOSITE INCEPTION DATE** of 1 January 2011 or later, when the initial period is less than a full year, returns from the **COMPOSITE INCEPTION DATE** through the initial annual period-end.

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Discussion

The GIPS standards require that returns be presented for the partial year from composite inception date through the end of the initial annual period for composites with an inception date of 1 January 2011 or later. For example, assume that a firm presents composite returns for annual periods ended 31 December, and a new composite is created with a track record beginning 1 April 2012. The compliant presentation for this composite must include the composite return for the period from 1 April 2012 through 31 December 2012. Subsequently, a firm must add annual returns, building up to a minimum 10-year track record.

For composites with a composite inception date prior to 1 January 2011, when the initial period is less than a full year, firms should present returns from the composite inception date through the initial annual period end.

Provision 5.A.1.d

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- d. For **COMPOSITES** with a **COMPOSITE TERMINATION DATE** of 1 January 2011 or later, returns from the last annual period end through the **COMPOSITE TERMINATION DATE**.

3-5

Discussion

The GIPS standards require that returns from the last annual period-end through the composite termination date be presented for composites with a termination date of 1 January 2011 or later. For example, assume that a firm presents composite returns for the annual period ended 31 December 2011 and a composite terminates so that the track record ends 31 August 2012. The compliant presentation for this composite must include the composite return for the period from 1 January 2012 through 31 August 2012.

Provision 5.A.1.e

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- e. The **TOTAL RETURN** for the **BENCHMARK** for each annual period. The **BENCHMARK MUST** reflect the investment mandate, objective, or strategy of the **COMPOSITE**.

Discussion

Benchmarks are important tools that aid in the planning, implementation, and review of a portfolio's investment policy. They also help facilitate discussions with prospective clients regarding the relationship between risk and return. As a result, firms are required to present a total return for the benchmark that reflects the composite's investment mandate, objective, or strategy for each annual period in all compliant presentations. A firm may present more than one benchmark. The benchmark description(s) must be disclosed.

In addition to the required annual benchmark returns, firms must also present benchmark returns for the same periods for which composite returns are presented. For example, if the compliant presentation includes quarterly composite returns, quarterly benchmark returns must also be included.

Q&A

1. *Can portfolios included in the same composite have different benchmarks?*

Yes. A firm may decide that it is appropriate to include portfolios with different benchmarks in the same composite. Additionally, the firm may present multiple benchmarks in the composite compliant presentation. The GIPS standards require that the total return for the benchmark that reflects the investment mandate, objective, or strategy of the composite be presented for each annual period.

2. *Can a price-only index be used as the composite benchmark?*

The GIPS standards require that the total return for the benchmark be presented. This means that a price-only index would not satisfy the requirements of the GIPS standards. Firms must not use a price-only benchmark even if no appropriate total return benchmark is available for a specific strategy. In such cases, if no appropriate total return benchmark is available for a specific strategy, firms must not show a benchmark and must disclose why no benchmark is presented.

3-5

Provision 5.A.1.f

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- f. The number of **PORTFOLIOS** in the **COMPOSITE** as of each annual period end. If the **COMPOSITE** contains five or fewer **PORTFOLIOS** at period end, the number of **PORTFOLIOS** is not **REQUIRED**.

Discussion

Each compliant presentation must include information about the number of portfolios included in the composite. These figures must be presented as of the end of each annual period that is included in the compliant presentation. This requirement provides information to prospective clients on whether the composite is composed of a small number of portfolios or many.

In cases where there are five portfolios or fewer in a composite at period-end, the firm may choose to not present the actual number of portfolios in the composite. The firm might choose to do this to protect the identity and confidentiality of its clients. However, because firms must include information about the number of portfolios in the composite, firms must either state that the composite contains “five or fewer portfolios” (or similar language) or present the actual number of portfolios in the composite.

Provision 5.A.1.g

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- g.** **COMPOSITE** assets as of each annual period end.

Discussion

Each compliant presentation must include the amount of composite assets. This figure must be determined as of the end of each annual period that is included in the compliant presentation.

When the composite strategy employs leverage, the composite assets and total firm assets must be presented net of the leverage and not grossed up as if the leverage did not exist.

This requirement provides information to prospective clients on the size of the composite (measured by the amount of assets it contains) and the relative size of the composite in relation to the total firm assets.

Provision 5.A.1.h

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- h.** Either **TOTAL FIRM ASSETS** or **COMPOSITE** assets as a percentage of **TOTAL FIRM ASSETS**, as of each annual period end.

Discussion

Each compliant presentation must include either total firm assets or composite assets as a percentage of total firm assets. These figures must be determined as of the end of each annual period that is included in the compliant presentation.

Total firm assets are defined as all discretionary and non-discretionary assets for which the firm has investment management responsibility. Total firm assets include assets assigned to a sub-advisor provided the firm has discretion over the selection of the sub-advisor. Assets that are advisory only, where the firm has no control as to whether investment recommendations are accepted or where the firm does not have trading authority over the assets, must not be included in total firm assets.

When the composite strategy employs leverage, the composite assets and total firm assets must be presented net of the leverage and not grossed up as if the leverage did not exist.

Total firm assets include cash and cash equivalents (e.g., money market funds, certificates of deposit). Firms must be sure that assets are not double-counted because double-counting assets would not fairly represent the firm's assets.

This requirement provides information to prospective clients on the relative size of the composite in relation to the total firm assets.

Q&A

1. *Our compliant presentation includes disclosure of both total firm assets and composite assets as a percentage of total firm assets. May we include both disclosures in the presentation?*

Yes, firms may show both disclosures in their presentations. Because only one of these disclosures is required, the firm may choose in the future to discontinue showing one of the disclosures.

Provision 5.A.1.i

The following items **MUST** be presented in each COMPLIANT PRESENTATION:

- i. A measure of INTERNAL DISPERSION of individual PORTFOLIO returns for each annual period. If the COMPOSITE contains five or fewer PORTFOLIOS for the full year, a measure of INTERNAL DISPERSION is not REQUIRED.

Discussion

Internal dispersion is a measure of the spread of the annual returns of individual portfolios within a composite. It allows prospective clients to determine how consistently the firm implemented its strategy across the portfolios in the composite for the full annual period. Measures may include high–low, range, or standard deviation (asset weighted or equal weighted) of portfolio returns as well as other statistical measures.

The GIPS standards do not mandate a specific measure to calculate the internal dispersion. Instead, the firm is permitted to choose a measure for each composite and apply it consistently. The firm may change which internal dispersion measure is presented but should not use different measures from year to year. A widely used internal dispersion measure is standard deviation (“internal standard deviation”). Firms are required to disclose which internal dispersion measure is presented.

Because the internal dispersion measure represents the spread of annual returns of individual portfolios within the composite for the full year, only the portfolios that have been managed for the full annual period are to be included in the internal dispersion calculation. Firms must identify the portfolios in the composite that have been included for the full annual period and calculate the annual return for each of those portfolios. Firms must use those annual returns to calculate the composite’s internal dispersion.

The firm should disclose which results (gross-of-fees or net-of-fees) are used to calculate the internal dispersion. If the firm presents only gross-of-fees returns in the compliant presentation, the firm should use gross-of-fees returns to calculate the internal dispersion measure. If a firm presents only net-of-fees returns in the compliant presentation, the firm should use net-of-fees returns to calculate the internal dispersion measure.

The internal dispersion of the individual portfolio returns must be presented for each annual period that is included in the compliant presentation. In cases where there are five or fewer portfolios in a composite for the full annual period, the measure of internal dispersion is not required to be presented. However, because firms must include some information about the internal dispersion of individual portfolio returns, firms must indicate that the internal dispersion measure is not applicable or include similar language. The firm may instead choose to present an internal dispersion measure.

Internal Standard Deviation A widely used measure of internal dispersion is the standard deviation across equal-weighted portfolios, S_c . The formula is as follows:

3 Explanation of the Provisions of the GIPS Standards

$$S_C = \sqrt{\frac{\sum [R_i - MEAN(R)]^2}{n}}$$

where R_i is the return on the i th portfolio that has been in the composite for the full annual period, n is the number of portfolios in the composite for the full annual period (the use of either n or $n - 1$ in the denominator of the standard deviation calculation is acceptable), and $MEAN(R)$ is the equal-weighted mean return of the portfolios in the composite for the full annual period, where

$$MEAN(R) = \frac{R_{PORT1} + R_{PORT2} + \dots + R_{PORTn}}{n}$$

where R_{PORT1} is the time-weighted return for the first portfolio in the composite for the full annual period and n is the number of portfolios in the composite for the full annual period. Because only portfolios that have been managed for the full annual period are included in the internal dispersion calculation, n may be different from the number of portfolios shown in the compliant presentation.

High-Low and Range The high–low and the range are the simplest and most easily understood measures of internal dispersion. Their key advantages are simplicity, ease of calculation, and ease of interpretation. One disadvantage of these measures is that one extreme value or outlier can skew the internal dispersion measure. In addition, by themselves, the high–low and the range of returns are not particularly rigorous measures of internal dispersion.

3-5

Q&A

1. Firm A has a composite that consists of 15 portfolios. Ten of the portfolios have been in the composite for the entire year. How could Firm A calculate a measure of internal dispersion?

	Beginning Value	Annual Return
Portfolio 1	100,000	5.2%
Portfolio 2	300,000	4.9%
Portfolio 3	200,000	5.5%
Portfolio 4	500,000	5.6%
Portfolio 5	100,000	5.1%
Portfolio 6	250,000	4.7%
Portfolio 7	450,000	5.2%
Portfolio 8	200,000	4.8%
Portfolio 9	300,000	5.3%
Portfolio 10	200,000	5.0%
Composite Value	2,600,000	
Equal-Weighted Return		5.1%

Firm A could disclose the high and low or range of portfolio returns (i.e., High–Low = 5.6%–4.7%; range = 0.9%) or could disclose the internal standard deviation. The equal-weighted internal standard deviation is calculated as follows:

$$S_R = \sqrt{\frac{(0.052 - 0.051)^2 + (0.049 - 0.051)^2 + \dots + (0.050 - 0.051)^2}{10}} = 0.0028, \text{ or } 0.28\%.$$

2. *As of 31 December 2000, Firm B has 18 portfolios in its Aggressive Growth composite, which earned 22.4% for the year. However, during 2000, the composite lost three portfolios and gained five portfolios during the year. Which portfolios must Firm B use to calculate an internal dispersion measure for the composite?*

Firm B must calculate an internal dispersion measure using only those 13 portfolios that were included in the composite for the full year.

3. *If the internal dispersion measure is calculated using only portfolios that are included in the composite for the full year yet composite performance for the year includes portfolios that were added or removed from the composite during the year, do the two numbers really have relevance to one another? This especially holds if the actual composite performance differs materially from the performance of the full-year-only composite because the composite performance was impacted by “partial year” portfolios that are not included in the internal dispersion calculation.*

The GIPS standards acknowledge that by using only portfolios that have been included in the composite for the full year for the annual internal dispersion calculation, the internal dispersion number will not precisely correlate with the actual composite performance.

The internal dispersion will inform a prospective client of the spread of annual returns of those portfolios included in the composite for the year. The GIPS standards do not require a specific measure of internal dispersion. A firm could present the standard deviation, the range, quartiles, or any other appropriate measure of internal dispersion.

4. *How should a firm that calculated portfolio returns quarterly prior to 1 January 2001 and monthly thereafter meet the GIPS standards requirement of including a measure of internal dispersion in a compliant presentation?*

When disclosing the internal dispersion of portfolio returns within each composite, only the portfolios that have been included in the composite for the full annual period are included in the internal dispersion calculation. The returns (monthly or quarterly) of those full-year portfolios must be calculated and linked together to determine the annual returns for each portfolio. The annual returns of these portfolios must be used to compute the composite internal dispersion.

Provision 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.

3 Explanation of the Provisions of the GIPS Standards

Discussion

Evaluating past performance requires an understanding of the risks taken to achieve the results. Standard deviation is universally defined as a measure of the variability of returns. The GIPS standards now require the presentation of “external standard deviation,” a measure that quantifies the variability of the composite and benchmark returns over time. For periods ending on or after 1 January 2011, firms must present, as of each annual period-end, the three-year annualized ex-post standard deviation (external standard deviation) using monthly returns for both the composite and the benchmark.

Standard deviation for both the composite and the benchmark must be calculated using 36 monthly returns. The same formula must be used to calculate external standard deviation for the composite and the benchmark. 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 the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate for the composite, the firm must still present this measure and disclose why the firm believes this measure is not appropriate. In addition, the firm must also present an additional ex-post risk measure that it determines is more relevant or appropriate for the composite’s investment mandate, objective, or strategy and describe the additional risk measure presented and why it was selected. The periodicity of the composite and the benchmark must be identical when calculating the additional ex-post risk measure.

Acknowledging that there are a number of calculation variations in widespread use, the GIPS standards do not prescribe a specific methodology for calculating external standard deviation. Firms are required to select a methodology on a composite-specific basis, document it in their policies and procedures, and consistently apply that methodology. Firms are required to maintain records supporting all calculations presented in compliant presentations.

External Standard Deviation A widely used measure of external standard deviation is as follows:

$$S_C = \sqrt{\frac{\sum [R_i - MEAN(R)]^2}{n}}$$

where R_i is the return on the i th monthly composite or the benchmark return, n is the number of monthly returns used for the external standard deviation calculation (the use of both n and $n - 1$ in the denominator of the standard deviation calculation can be supported), and $MEAN(R)$ is the mean monthly return of the composite or the benchmark over the period for which external standard deviation is being calculated, where

$$MEAN(R) = \frac{R_{COMPRETURN1} + R_{COMPRETURN2} + \dots + R_{COMPRETURNn}}{n}$$

where $R_{COMPRETURN1}$ is the time-weighted return for the composite and n is the number of returns used in the calculation (required to be 36 monthly returns to satisfy this requirement).

To annualize the three-year annualized ex-post standard deviation calculated using monthly returns, the result of the standard deviation (S) formula above must be multiplied by the square root of 12.

The firm should disclose on which results (gross-of-fees or net-of-fees) the external ex-post standard deviation is calculated and presented. If the firm presents only gross-of-fees returns in the compliant presentation, the firm should use gross-of-fees returns to calculate the external standard deviation. If a firm presents only net-of-fees returns in the compliant presentation, the firm should use net-of-fees returns to calculate the external standard deviation.

Q&A

1. *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. There are a number of variations in the way in which standard deviation can be calculated. Is there a preferred methodology?*

No. Standard deviation is a universally recognized measure, and while there are different variations, the GIPS standards do not require one particular calculation methodology. A firm must determine which calculation methodology (or methodologies) will be used and must use the selected methodology (or methodologies) consistently. The same methodology must be used for both the composite and the benchmark.

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. We calculate composite returns daily. May we calculate the three-year annualized ex-post standard deviation using daily returns versus monthly returns?*

No. For the purpose of meeting the requirement to disclose the three-year annualized ex-post standard deviation, monthly returns must be used. Requiring the same periodicity for all firms allows for comparability between firms. In this instance, daily returns can be linked to create monthly returns, which can then be used to calculate the required three-year annualized ex-post standard deviation (using monthly returns).

3. *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. If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must also present a three-year ex-post risk measure in addition to the three-year annualized ex-post standard deviation. We do not believe that standard deviation is a relevant or appropriate measure for our composite strategy. May we present an ex-ante measure of risk in addition to the three-year annualized ex-post standard deviation to satisfy this requirement?*

No. If a firm does not believe that ex-post standard deviation is relevant or appropriate for the composite, the firm must also present a three-year ex-post measure of risk in addition to the three-year annualized ex-post standard deviation. The firm must describe why ex-post standard deviation is not relevant or appropriate, the additional risk measure that is presented, and why it was selected. Ex-ante measures of risk do not satisfy the ex-post risk measure requirement and must only be presented as supplemental information.

4. *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. If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must also present a three-year ex-post risk measure in addition to the three-year annualized ex-post standard deviation. To satisfy this requirement, may we present an ex-post proprietary measure of risk?*

Yes. If a firm does not believe that ex-post standard deviation is relevant or appropriate for the strategy, the firm must also present a three-year ex-post measure of risk in addition to the three-year annualized ex-post standard deviation. An ex-post proprietary measure of risk may be presented as the additional risk measure. The firm must describe why ex-post standard deviation is not relevant or appropriate, the additional risk measure that is presented, and why it was selected.

3 Explanation of the Provisions of the GIPS Standards

5. *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. If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must also present a three-year ex-post risk measure in addition to the three-year annualized ex-post standard deviation. Our global equity composite is calculated monthly and has a benchmark for which only quarterly returns are calculated by a third-party. We present the three-year annualized ex-post standard deviation of the composite but do not believe it is relevant to our strategy.*

We are trying to determine which additional risk measure we will present to satisfy the requirement to present an additional three-year ex-post measure of risk if the firm determines that standard deviation is not relevant or appropriate for the composite. We would like to select a three-year ex-post risk measure that can be presented for both the composite and benchmark. As composite returns are calculated monthly and benchmark returns are calculated quarterly, this does not seem possible as it fails the periodicity test. What should we do?

The periodicity of the composite and the benchmark must be the same when calculating ex-post risk measures. In this circumstance, the firm would be required to use quarterly composite returns, not monthly returns, when calculating the required additional ex-post risk measure. The firm must also determine that there are enough data points for the selected measure to be statistically significant so as not to be misleading. The firm must describe why the ex-post standard deviation is not relevant or appropriate, the additional risk measure that is presented, and why it was selected. The firm is still required to show the three-year annualized ex-post standard deviation using monthly returns for the composite and disclose that the measure is not presented for the benchmark because monthly returns for the benchmark are not available.

6. *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. If the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate, the firm must present a three-year ex-post risk measure in addition to the three-year annualized ex-post standard deviation. We believe that standard deviation is not appropriate for our composite strategy; therefore, we will present an additional three-year ex-post measure of risk. We would like to present an additional ex-post risk measure that uses a different periodicity than monthly periods. How should we present this additional risk measure that uses a different periodicity?*

If a firm does not believe that standard deviation is relevant or appropriate for the strategy, the firm must present a three-year ex-post measure of risk in addition to the three-year annualized ex-post standard deviation. The firm must describe why ex-post standard deviation is not relevant or appropriate, the additional risk measure that is presented, and why it was selected. The additional risk measure that is presented must have the same periodicity for both the composite and the benchmark but is not required to be calculated using 36 monthly returns. In considering the additional risk measure periodicity, the firm must satisfy itself that there are sufficient data points for the selected three-year ex-post measure to be statistically significant so as not to be misleading. When describing the risk measure and why the additional risk measure was selected, the firm should ensure that the different periodicity is adequately explained.

Provision 5.A.3

FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2000.

Discussion

Performance for periods after 1 January 2000 that does not comply with the GIPS standards must not be presented as part of a GIPS-compliant presentation for any reason (except for the real estate, private equity, and wrap fee/separately managed account [SMA] composites). The GIPS standards allow firms to link non-GIPS-compliant performance to the composite's GIPS-compliant history provided that only GIPS-compliant performance is shown for periods beginning on or after 1 January 2000.

For example, assume a firm has been in existence since 1995 and wants to present its entire performance history. Also assume the firm wants to claim compliance beginning 1 January 2005. The firm must present returns that meet the requirements of the GIPS standards for periods beginning on or after 1 January 2000. The firm is encouraged to bring its entire history into compliance, but is not required to do so. If any non-compliant performance is presented for periods prior to 1 January 2000, the firm must disclose the periods of non-compliance.

The purpose of this requirement is to ensure that all performance presented after 1 January 2000 complies with the GIPS standards so that prospective clients can more easily compare performance results between firms.

Q&A

1. *Firm A has been in existence since before 1 January 2000 and determines that it would like to begin to claim compliance with the GIPS standards. Is Firm A required to restate its entire history in compliance with the GIPS standards in order to claim compliance?*

No. Firm A needs only to initially present the most recent five years of its performance history that adhere to the GIPS requirements in order to claim compliance. After the firm presents a minimum of five years of GIPS-compliant performance, the firm must add an additional year of performance each year, building up to a minimum of ten years of GIPS-compliant performance. In addition to the required performance returns, Firm A could link its non-GIPS-compliant history prior to 1 January 2000 without restating its performance prior to 1 January 2000 in compliance with the GIPS standards, provided it discloses that the performance for periods prior to 1 January 2000 is not in compliance. Firms must not link non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance.

Provision 5.A.4

Returns for periods of less than one year MUST NOT be annualized.

3 Explanation of the Provisions of the GIPS Standards

Discussion

The GIPS standards require that composite performance reflect only the performance of actual assets managed by the firm. When annualizing performance for periods of less than one year, the partial-year return is “extended” in order to create an annual return. The extrapolation of the partial-year return produces a simulated return and does not reflect the performance of actual assets. Therefore, performance for periods of less than one year must not be annualized.

Q&A

1. *Firm A was established on 1 March 1998 and claims compliance with the GIPS standards. The firm presents the performance history for its balanced composite in annual increments by calendar year. From its inception (1 March 1998) through 31 December 1998, the balanced composite earned a return of 14.6%. Can Firm A annualize the 10-month return and present the result as the annual return for 1998?*

No. Firms are not permitted to annualize partial-year returns. The firm must clearly disclose that the composite’s 1998 return is for the partial period of 1 March 1998 through 31 December 1998.

3-5

Provision 5.A.5

For periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a COMPOSITE includes CARVE-OUTS , the FIRM MUST present the percentage of COMPOSITE assets represented by CARVE-OUTS as of each annual period end.

Discussion

A carve-out is defined as a portion of a portfolio that is by itself representative of a distinct investment strategy. If a firm includes carve-outs in composites, the firm must present the percentage of the composite assets represented by carve-outs as of each annual period end beginning on or after 1 January 2006 and ending prior to 1 January 2011. This disclosure provides prospective clients with the information needed to determine the amount of the total composite return that is derived from carve-outs.

The firm may add a column in the performance section of the compliant presentation and could title it “% of composite represented by carve outs,” or the firm could add a written disclosure providing the percentage of the composite composed of carve-outs as of each annual period end from 1 January 2006 through 31 December 2010.

Provision 5.A.6

If a COMPOSITE includes non-fee-paying PORTFOLIOS, the FIRM MUST present the percentage of COMPOSITE assets represented by non-fee-paying PORTFOLIOS as of each annual period end.

Discussion

Non-fee-paying portfolios may be included in the firm's composites. If the firm decides to include non-fee-paying portfolios in a composite, the firm is required to disclose the percentage of composite assets represented by non-fee-paying portfolios as of the end of each annual period. If the composite does not contain any non-fee-paying portfolios, no disclosure is necessary. Examples of non-fee-paying portfolios are portfolios consisting of the firm's own pension plan assets or portfolios managed for friends or employees that are not charged investment management fees. If a firm temporarily waives the investment management fee for a portfolio that is normally charged a fee, the portfolio is still considered a fee-paying portfolio (with a fee of zero for that period) and may not be excluded from the composite because it is non-fee-paying.

Non-fee-paying portfolios are permitted but not required to be included in a composite; however, firms may choose to include them in one or more appropriate composites. If the firm includes non-fee-paying portfolios in a composite, they are subject to the same rules as fee-paying portfolios. For example, the firm must not move a non-fee-paying portfolio into and out of a composite without documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes it appropriate. The firm must also include all other non-fee-paying discretionary portfolios meeting the definition of the composite. The decision of whether or not to include non-fee-paying portfolios in a composite may be made on a composite-by-composite basis.

Q&A

1. *Firm A has a number of fee-paying portfolios managed to a growth investment strategy. Firm A also manages several pro-bono portfolios following this same strategy for other clients who do not pay fees on these portfolios. All of the growth portfolios are included in one composite, with non-fee-paying assets composing 15% of the total assets of the composite as of 31 December 1999. What disclosure is required by the GIPS standards with regard to the non-fee-paying assets in the composite?*

The firm must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period end. Firm A could make the following disclosure as part of its Growth Composite presentation when presenting 1999 performance data: "This composite contained 15% non-fee-paying portfolios as of 31 December 1999." Alternatively, the firm could add a column to its performance table titled, "% composite assets composed of non-fee-paying portfolios," and list the percentage at the end of each annual period.

Provision 5.A.7

If a COMPOSITE includes PORTFOLIOS with BUNDLED FEES, the FIRM MUST present the percentage of COMPOSITE assets represented by PORTFOLIOS with BUNDLED FEES as of each annual period end.

Discussion

A bundled fee is a fee that combines multiple fees into one total or "bundled" fee. Bundled fees can include any combination of investment management fees, trading expenses, custody fees, and/or administrative fees. Two examples of bundle fees are all-in fees and wrap fees.

3 Explanation of the Provisions of the GIPS Standards

All-In Fee All-in fees are defined as a type of bundled fee that can include any combination of investment management fees, trading expenses, custody fees, and administrative fees. All-in-fees are client specific and typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.

Wrap Fee Wrap fees are defined as a type of bundled fee and are specific to a particular investment product. The wrap fee is charged by a wrap fee sponsor for investment management services and typically includes associated trading expenses that cannot be separately identified. Wrap fees can be all-inclusive, asset-based fees and may include a combination of investment management fees, trading expenses, custody fees, and/or administrative fees. A wrap fee portfolio is sometimes referred to as a “separately managed account” (SMA) or “managed account.”

Example:

Year	Bundled Fee Assets as % of Composite Assets
2003	100%
2002	100%
2001	100%
2000	100%
1999	100%
1998	0%
1997	0%

The bundled fee includes all charges for trading costs, portfolio management, custody, and other administrative fees.

3-5

Provision 5.A.8

- a. Performance of a past firm or affiliation **MUST** be **LINKED** to or used to represent the historical performance of a new or acquiring **FIRM** if, on a **COMPOSITE**-specific basis:
 - i. Substantially all of the investment decision makers are employed by the new or acquiring **FIRM** (e.g., research department staff, portfolio managers, and other relevant staff);
 - ii. The decision-making process remains substantially intact and independent within the new or acquiring **FIRM**; and
 - iii. The new or acquiring **FIRM** has records that document and support the performance.
- b. If a **FIRM** acquires another firm or affiliation, the **FIRM** has one year to bring any non-compliant assets into compliance.

Discussion

When a manager, group of managers, or an entire firm joins a new firm, the performance of the past firm or affiliation must be linked to or used to represent the historical performance of a new or acquiring firm if all of the stated conditions are met on a composite-specific basis. If the firm satisfies the conditions of portability, where:

- substantially all of the investment decision makers (e.g., research department staff, portfolio managers, and other relevant staff), are employed by the new or acquiring firm
- the decision-making process remains substantially intact and independent within the new or acquiring firm, and
- the new or acquiring firm has records that document and support the performance,

then the composite performance from the past firm or affiliation must be linked with the ongoing results of the new or acquiring firm.

Firms must disclose if the performance from a past firm or affiliation is linked to the ongoing performance of the firm. Performance of the composite for the periods prior to the acquisition or merger will represent performance only from the prior firm or affiliation. On a prospective basis, the ongoing results may consist of portfolios from the past firm or affiliation that have transferred to the new or acquiring firm and continue the same investment mandate or strategy as well as portfolios from the new or acquiring firm that meet the definition of the composite.

The term “firm” is used in two different ways in Provision 5.A.8.b. “FIRM” is used to indicate a GIPS-compliant firm as defined in the GIPS Glossary, while “firm” is used in Provision 5.A.8.b to indicate an entity that does not claim compliance with the GIPS standards. The GIPS standards recognize the difficulties that firms encounter when transferring assets from one firm to another or when merging two firms. Similar to the idea of a grace period to facilitate the addition of new portfolios into existing composites, in the case of an acquisition or merger, the GIPS standards permit a one-year grace period to bring the assets of a non-compliant firm into compliance with the GIPS standards. Assets of the non-compliant firm must meet all the requirements of the GIPS standards as of the first full reporting period one year after the acquisition date. In the meantime, although not all assets managed by the compliant firm are in compliance with the GIPS standards (because of the acquisition), the compliant firm may continue to claim compliance with the GIPS standards. The compliant firm must disclose all significant events that would help the prospective client to interpret the compliant presentation.

Q&A

1. *At Firm X, portfolio managers A, B, and C are part of a six-person investment management team responsible for managing Firm X’s Growth and Income Composite. Firm Y hires managers A, B, and C to start a growth and income strategy at Firm Y. Does Firm Y meet the portability test for requiring substantially all investment decision makers to be employed by the new firm?*

Firm Y must determine if portfolio managers A, B, and C constitute “substantially all of the investment decision-makers” for the Growth and Income Composite. Firm Y must also determine if all the other rules of portability are met. If the portability requirements are met, Firm Y must link the prior performance from Firm X. If the portability requirements are not met, the historical performance from Firm X must not be linked to the performance of Firm Y. If the portability requirements are not met, the performance from

3 Explanation of the Provisions of the GIPS Standards

Firm X can only be shown as supplemental information, provided Firm Y has records that document and support the performance of the Growth and Income Composite. Firms must adhere to all requirements regarding the use of supplemental information.

2. *At Firm T, Manager D is responsible for Firm T's Emerging Markets Composite. Although Manager D makes all the investment decisions for the portfolios in the composite, Manager D is supported by Firm T's research department and trading desk. Firm U is seeking to establish an emerging markets investment strategy and hires Manager D to join Firm U. Does Firm U meet the portability test for requiring substantially all investment decision makers to be employed by the new firm?*

Firm U must determine if Manager D constitutes “substantially all of the investment decision makers” for the Emerging Markets Composite, considering the research department and trading desk did not join Firm U. Firm U must also determine if all the other portability requirements are met. If the portability requirements are met, Firm U must link the prior performance from Firm T. If the portability requirements are not met, the historical performance from Firm T must not be linked to the performance of Firm U. If the portability requirements are not met, the performance from Firm T can only be shown as supplemental information, provided Firm U has records that document and support the performance of the Emerging Markets Composite. Firms must adhere to all requirements regarding the use of supplemental information.

3. *Firm D and Firm J, each with a similar European Fixed Income Composite, decide to merge. The new merged firm, Firm DJ, will combine the investment management expertise and resources from both firms in order to offer one European fixed income strategy. To show a performance history for this collective composite, Firm DJ wants to combine the historical performance of the two similar composites. Can these historical track records be blended and shown in compliance with the GIPS standards?*

No. Firm DJ cannot combine the history of the two pre-merger composites and show it as a presentation in compliance with the GIPS standards. Firm DJ must determine whether one of the historical composites can serve as the “surviving” composite. If there was a clear survivor, the surviving composite’s history must be linked to the ongoing record of Firm DJ’s new European Fixed Income Composite. The performance of the non-surviving composite should be made available upon request.

If there was no clear surviving strategy, the new European Fixed Income Composite would not have any performance history, as it represents a new strategy for the firm. The history of the styles at both Firm D and Firm J should be shown separately as supplemental information and, if not shown, should be made available upon request.

For instance, if the management of the new composite is led by the managers from Firm D and the composite is managed in a similar manner as was previously done at Firm D, Firm DJ would choose Firm D’s performance history as the surviving record and, if all the portability requirements are met, its composite historical performance must be linked to the ongoing performance of DJ’s European Fixed Income Composite.

If the investment management philosophy of the new composite represents a blending of the two previous management styles, there is not a surviving composite. The new European Fixed Income Composite would not have any performance history; however, the track records of the composites at both Firm D and Firm J can and should be shown to prospective clients as supplemental information and, if not shown, should be made available upon request.

4. *Manager Q leaves Firm S to join Firm V. Manager Q was the sole investment decision maker for a composite strategy, Manager Q obtained copies of the historical records supporting the performance of the composite strategy (with the permission of Firm S), and the investment process for the strategy will remain substantially intact and independent at Firm V. Because all the rules of portability apply, Firm V links Manager Q's performance history to its composite's ongoing results at Firm V. Can Firm S continue to claim the historical track record even though the manager responsible for the performance is no longer with the original firm?*

Yes. The Guidance Statement on Performance Record Portability states, "Performance is the record of the firm, not of the individual." If Firm S continues managing the composite according to the same mandate and strategy by replacing Manager Q with a new manager, the original firm must use the historical performance of that composite to represent the ongoing performance achieved by the new manager. However, the firm must disclose any significant events within the firm (such as personnel changes) that would help a prospective client interpret the compliant presentation.

5. *Firm A claims compliance with the GIPS standards. On 31 December 1999, Firm A acquires Firm B, which does not claim compliance with the GIPS standards. Must Firm A stop claiming compliance until all of the assets acquired from Firm B are brought into compliance?*

No. Firm A can continue to claim compliance with the GIPS standards provided that it incorporates all of the acquired assets of Firm B and brings them into compliance with the GIPS standards within one year of the date of acquisition by Firm B—by 1 January 2001 (similar to the treatment of the acquisition of a new account).

6. *If Firm A acquires Firm B and all of the portability requirements are met, is Firm A required to present Firm B's historical performance or can Firm A choose to not present Firm B's historical performance?*

The GIPS standards are based on the fundamental principles of fair representation and full disclosure. If all of the portability requirements are satisfied and Firm B is included in the definition of Firm A, it would be misleading for Firm A to discard Firm B's historical performance. Accordingly, Firm A cannot disregard Firm B's historical performance. If Firm A were permitted to exclude Firm B's historical performance, it would be cherry-picking, which is against the spirit of the GIPS standards.

7. *The Guidance Statement on Performance Record Portability states:*

When a manager, group of managers, or an entire firm joins a new firm or affiliation, the GIPS standards require that performance of a past firm or affiliation must be linked to or used to present the historical performance of a new or acquiring firm if, on a composite-specific basis:

- *substantially all of the investment decision makers are employed by the new or acquiring firm (e.g., research department staff, portfolio managers, other relevant staff);*
- *the decision-making process remains substantially intact and independent within the new or acquiring firm; and*
- *the new or acquiring firm has records that document and support the performance.*

Where it says "on a composite-specific basis," what does "composite" refer to in this instance? Can a firm create the composite history from the prior firm based only on the portfolios that transfer to the new firm if the history is representative of the old composite?

3 Explanation of the Provisions of the GIPS Standards

The concept of portability revolves around the ability to bring a track record from one firm to another. It would not be representative to recreate a record with only selected portfolios. The word “composite” refers to the entire composite from the old firm. In order for a firm to be able to link the composite from the old firm to the ongoing performance of the new firm, the entire composite performance history, including all portfolios, must be used. While the GIPS standards do not have a requirement that all portfolios must transfer from the old firm to the new firm, the firm must have all the records needed to document and support the entire composite performance history.

Presentation and Reporting—Recommendations

Provision 5.B.1

FIRMS SHOULD present GROSS-OF-FEES returns.

3-5

Discussion

In some situations, the only fees that the firm controls are the investment management fees and the trading expenses (i.e., the direct and indirect cost of buying or selling the assets). Because the gross-of-fees return includes only the return on investments and the associated trading expenses, it is the best measure of the firm’s investment management ability and can be thought of as the “investment return.” Gross-of-fees returns allow prospective clients to better compare performance between firms. In addition, because fees are sometimes negotiable, presenting gross-of-fees returns shows the firm’s expertise in managing assets without the impact of the firm’s or client’s negotiating skills. Accordingly, firms are recommended to present gross-of-fees returns in compliant presentations.

For more information on the required and recommended treatment of fees, please refer to the Guidance Statement on Fees.

Provision 5.B.2.a

FIRMS SHOULD present the following items:

- a. Cumulative returns of the COMPOSITE and the BENCHMARK for all periods;

Discussion

Cumulative returns of the composite and benchmark for all periods provide additional useful information to prospective clients by indicating what the total rate of return was for a defined period of performance. Cumulative returns can be provided in addition to the annual returns that are required under the GIPS standards.

To calculate cumulative returns of a composite for any period, the historic daily, monthly, quarterly, or annual sub-period returns are geometrically linked according to the following formula:

$$R_{CUM} = [(1 + R_1) \times (1 + R_2) \times \dots \times (1 + R_n)] - 1,$$

where R_1 is the composite return for Period 1 and R_n is the composite return for the most recent period.

Example: Firm ABC has the following annual returns that were calculated from monthly returns for Composite FGH:

	Composite FGH
2000	2.3%
2001	(4.7%)
2002	6.9%
2003	3.2%
2004	0.9%
Jan 2005 – Jun 2005	-3.1%

To calculate the cumulative returns for 5½ years from January 2000 through June 2005 for Composite FGH:

Composite FGH

$$\begin{aligned} \text{Cumulative Return} &= [(1.023) \times (0.953) \times (1.069) \times (1.032) \times (1.009) \times (0.969)] - 1 \\ &= 0.052 \text{ or } 5.2\%. \end{aligned}$$

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Provision 5.B.2.b

FIRMS SHOULD present the following items:

- b. Equal-weighted mean and median COMPOSITE returns;

Discussion

Averaging the performance of all the portfolios in a composite for a specified period, regardless of size, provides an equal-weighted composite return for that period. The equal-weighted mean return is the simple (un-weighted) average of the individual portfolio returns in a composite. The simple average, together with the internal dispersion, provides a measure of the manager's ability to obtain consistent returns for all portfolios regardless of size.

The GIPS standards recommend presentation of equal-weighted mean and median returns for the composite.

The formula for the equal-weighted mean composite return, R_{EQUAL} , is

$$R_{EQUAL} = \frac{R_{PORT1} + R_{PORT2} + \dots + R_{PORTn}}{n},$$

where R_{PORT1} is the time-weighted return for the first portfolio in the composite and n is the number of portfolios in the composite.

For a series of returns with an odd number of returns in the series, listed from low to high, the median return is the number in the middle.

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For a series of returns with an even number of returns in the series, the median is the average of the two numbers in the middle of the series.

For example, the median annual return for a composite that has the following three portfolio annual returns, 2.3%, 2.7%, 3.9%, the middle number, the median annual return, is 2.7%.

If the composite has the following four portfolio annual returns, 2.3%, 2.7%, 3.9%, 4.1%, the median annual return is $[(2.7\% + 3.9\%)/2]$, or 3.3%.

Provision 5.B.2.c

FIRMS SHOULD present the following items:

- c. Quarterly and/or monthly returns; and

Discussion

More frequent returns help prospective clients evaluate a composite's track record. In addition to the required annual returns, firms are recommended to present composite returns for quarterly or monthly periods as additional information in compliant presentations.

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Provision 5.B.2.d

FIRMS SHOULD present the following items:

- d. Annualized COMPOSITE and BENCHMARK returns for periods longer than 12 months.

Discussion

Firms are recommended to show the results of both the composite and the benchmark for periods longer than 12 months in annual terms to help prospective clients in the evaluation of the composite's track record. Annualized returns represent the geometric average annual compound return achieved over the defined period of more than one year. Annualized performance is only permitted for periods of one year or more.

$$\text{Annualized Return (\%)} = \{(1 + R)^{1/n} - 1\} \times 100,$$

where R is the cumulative return for the period, which is calculated by geometrically linking the sub-period returns during the period, and n is the number of years in the period.

For example, a portfolio's cumulative return for a five-year period is 150.0%. It has a five-year average annual compound return, or annualized return, of 20.11%:

$$\left[(1 + 1.5)^{\frac{1}{5}} - 1 \right] = 0.2011 = 2.11\%.$$

If the 150% is earned over 12.5 years, its 12.5-year average annual compound return, or annualized return, is

$$\left[(1 + 1.5)^{\frac{1}{12.5}} - 1 \right] = 0.0761 = 7.61\%.$$

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.

Discussion

For periods beginning on or after 1 January 2011, firms must present the three-year annualized ex-post standard deviation (using monthly returns) of the composite and the benchmark as of each annual period end. It is considered to be best practice to apply this requirement retroactively.

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.

Discussion

In order to provide context so that the prospective client can better understand the ex-post standard deviation, firms are recommended to present annualized returns for the composite and benchmark for the same periods that annualized standard deviation is presented. For example, if a firm chooses to present five-year, seven-year, and ten-year annualized standard deviations in addition to the required three-year annualized standard deviation, firms are encouraged to also present the corresponding five-year, seven-year, and ten-year annualized returns for the composite and the benchmark.

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.

Discussion

In order to provide context so that the prospective client can interpret the annualized composite and benchmark returns, firms are recommended to present the annualized ex-post standard deviation (using monthly returns) for both the composite and benchmark for the same periods that annualized composite and benchmark returns are presented. For example, if a firm chooses to present the five-year, seven-year, and ten-year annualized composite and benchmark returns, firms are encouraged to also present the corresponding five-year, seven-year, and ten-year annualized ex-post standard deviation of the composite and benchmark.

Provision 5.B.6

FIRMS SHOULD present additional relevant COMPOSITE-level EX-POST risk measures.

Discussion

Currently, there is not a single risk measure that comprehensively and consistently captures every risk to which an asset class, product, or strategy is exposed or sensitive. There are many risk and quantitative measures that are routinely calculated to help evaluate and understand the return and risk characteristics of a particular investment strategy. Determining which risk measures are appropriate for a strategy requires an understanding of the characteristics and limitations of each measure and insight into the portfolio construction process and investment strategy. Several risk measures are commonly used within the industry, but there is less of a consensus over what constitutes relevant risk measures when evaluating portfolios containing derivatives, alternatives, and/or illiquid assets. Some firms have developed proprietary measures, which, while providing insight into the strategy, make comparisons across managers problematic. Firms should present additional relevant composite-level ex-post risk measures.

There are a number of factors that should be considered when selecting relevant risk measures, including

- **Comparability:** The risk measure selected should allow objective comparisons across firms to be made.
- **Computational transparency:** All inputs to the calculation should be readily available and understood.
- **Interpretational transparency:** In isolation as a single figure or presented as a time series, the risk measure should aid interpretation and provide context to the performance figures presented.
- **Investment process or strategy consistency:** The risk measure should provide insight into the underlying investment process.
- **Risk measure stability:** The selected risk measure should be sensitive to market and portfolio movements but should not exhibit excessive range swings such that interpretation of the absolute and relative values is compromised.

Provision 5.B.7

FIRMS SHOULD present more than 10 years of annual performance in the COMPLIANT PRESENTATION.

Discussion

Once a firm (or composite) has its initial minimum five-year (or since inception) history, the firm must continue to add annual returns to each compliant presentation for the next five years (at a minimum) so that the firm will build up to a ten-year performance record for its composites.

At some point, a firm will have a minimum ten-year track record for a specific composite. In addition to the ten-year track record, when the firm eventually adds an additional annual return to the compliant presentation, the firm may delete the information for the oldest year included or may instead present a longer track record. Firms are recommended to include more than the minimum ten years of annual performance in a compliant presentation to provide more information to prospective clients. If any performance is presented that does not comply with the GIPS standards (only applicable to periods prior to 1 January 2000), firms must disclose the period(s) of non-compliance.

Provision 5.B.8

FIRMS SHOULD comply with the GIPS standards for all historical periods.

Discussion

Firms must initially comply with the GIPS standards for a minimum of five years, or since the firm or composite inception if the firm does not yet have a five-year history. Firms must then continue to build a compliant track record such that the firm will eventually have a ten-year compliant track record. Firms are encouraged to comply with the GIPS standards for more than the minimum required period historically and to also present performance for more than the minimum required period in compliant presentations.

Firms are recommended to comply with the GIPS standards for all historical periods, including for periods prior to 1 January 2000. If any performance is presented that does not comply with the GIPS standards (only applicable to periods prior to 1 January 2000), firms must disclose the period(s) of non-compliance.

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Provision 5.B.9

FIRMS SHOULD update COMPLIANT PRESENTATIONS quarterly.

Discussion

More current compliant presentations help prospective clients evaluate a composite's track record. In the interest of fair representation and full disclosure, firms should update compliant presentations, including all required disclosure and presentation items, on a quarterly basis.

3-6 REAL ESTATE

Introduction

The real estate provisions in Section 6 of Chapter I of the Global Investment Performance Standards (GIPS®) apply to

- wholly owned or partially owned properties;
- real estate commingled funds, separate accounts, and unit trusts;
- unlisted, private placement securities issued by private real estate investment trusts (REITs) and real estate operating companies (REOCs); and
- equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where some portion of return to the investor is related to the performance of the underlying real estate assets.

The following investment types are not considered real estate and, therefore, must follow Sections 0–5 in Chapter I of the GIPS standards:

- publicly traded real estate securities;
- mortgage-backed securities (MBS, CMBS); and
- private debt investments, including commercial and residential loans where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying real estate.

Because this asset class is not traded on a public market exchange, real estate valuations are not easily determinable. Each investment is different as to the construction, size, location, and tenant composition, making it more challenging to compare investment performance because valuation is more subjective than in most other asset classes. Consequently, the unique nature of this asset class necessitates provisions and guidance specifically for real estate.

Firms must document policies and procedures for determining which portfolios are considered real estate portfolios for the purpose of complying with the GIPS standards.

Unless otherwise noted, the following real estate provisions supplement the required and recommended provisions in Sections 0–5 in Chapter I of the GIPS standards.

Unless otherwise noted, the following real estate provisions are effective 1 January 2011. All real estate composites that include performance for periods beginning on or after 1 January 2011 must comply with all the requirements and should adhere to the recommendations of the following real estate provisions.

Real Estate—Requirements

Input Data—Requirements (the following provisions do not apply: 1.A.3.a, 1.A.3.b, and 1.A.4)

Provision 6.A.1

For periods beginning on or after 1 January 2011, REAL ESTATE investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II of the GIPS standards.

Discussion

Beginning 1 January 2011, firms must value portfolios in accordance with the GIPS Valuation Principles and the following definition of fair value. The term “fair value” is broader than market value, and its definition was developed considering the work done by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as well as other organizations. The two values are likely to be the same when there are a sufficient number of transactions occurring in the market for an identical or materially similar property. Fair value is defined as the amount at which an investment could be exchanged in a current arm’s length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation must be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation must represent the firm’s best estimate of the market value. Fair value must include accrued income.

Markets are not always liquid and investment prices are not always objective and/or observable. For illiquid or hard-to-value investments or for investments where no observable market value or market price is available, additional steps are necessary. A firm’s valuation policies and procedures must address situations where the market prices may be available for similar but not identical investments, inputs to valuations are subjective rather than objective, and/or markets are inactive instead of active.

Although a firm may use external third parties to value investments, the firm still retains responsibility for compliance with the GIPS standards, which includes the GIPS Valuation Principles.

For periods prior to 1 January 2011, real estate investments must be valued at market value. The term “market value” was previously defined for real estate in the 2005 edition of the GIPS standards as follows. Please note that this definition was in essence a fair value definition:

The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- a. *Buyer and seller are typically motivated.*
- b. *Both parties are well informed or well advised and each acting in what they consider their own best interests.*

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- c. *A reasonable time is allowed for exposure in the open market.*
- d. *Payment is made in terms of currency or in terms of financial arrangements comparable thereto.*
- e. *The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*

Provision 6.A.2

For periods beginning on or after 1 January 2008, REAL ESTATE investments MUST be valued at least quarterly.

Discussion

Beginning 1 January 2008, firms must value real estate investments at least quarterly. Quarterly valuations are important for investors to be able to compare performance with benchmarks, which are typically updated quarterly. Quarterly valuations are also needed for comparability with other asset classes. This quarterly valuation requirement can be met either by internal or external valuations. In certain jurisdictions, it is standard industry practice to value real estate based upon external valuations obtained from an independent appraiser rather than internal valuations, due to independence considerations.

For periods prior to 1 January 2008, real estate investments must be valued at least once every 12 months. While it used to be standard practice to value real estate investments annually, advances in data and technology have made it feasible to value real estate investments more frequently, as reflected in the current requirement. This annual valuation requirement for periods prior to 1 January 2008 can be met either by internal or external valuations, whereas Provision 6.A.4 may be met only through external valuations.

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Provision 6.A.3

For periods beginning on or after 1 January 2010, FIRMS MUST value PORTFOLIOS as of each quarter end or the last business day of each quarter.

Discussion

Consistency in quarterly portfolio valuation dates will result in improved comparability of data for all compliant presentations. When calculating and presenting composite returns, if the constituent portfolios are valued at different end dates, this does not allow for the comparability of information between firms. Therefore, to facilitate comparability, as of 1 January 2010, firms must value portfolios as of each quarter-end or the last business day of each quarter.

Provision 6.A.4

REAL ESTATE investments MUST have an EXTERNAL VALUATION:

- a. For periods prior to 1 January 2012, at least once every 36 months.
- b. For periods beginning on or after 1 January 2012, at least once every 12 months unless client agreements stipulate otherwise, in which case REAL ESTATE investments MUST have an EXTERNAL VALUATION at least once every 36 months or per the client agreement if the client agreement requires EXTERNAL VALUATIONS more frequently than every 36 months.

Discussion

Regardless of the terms of the client agreement, for periods prior to 1 January 2012, each real estate investment must have an external valuation at least once every 36 months. For periods beginning on or after 1 January 2012, in the absence of a client agreement to the contrary, each real estate investment must have an external valuation at least once every 12 months. If a client agreement specifies a different frequency for external valuations, such as every 24 months, the real estate investments in that portfolio must have an external valuation completed at least once every 24 months. The external valuation process must adhere to practices of the relevant valuation governing and standard setting body. Although appraisal standards may allow for a range of estimated values, it is recommended that a single value (final value conclusion) be obtained from external valuers or appraisers because only one value can be used for performance reporting. It is also recommended that the external appraisal firm be rotated every three to five years.

Investors typically prefer external valuation because it is independent, unbiased, and an “expert” estimate of value that is perceived by the marketplace to be more reliable than internal valuation. Firms are encouraged to discuss the importance of external valuation with their investors because valuation is the major element used in the performance return calculation and the external appraisal typically provides a point of reference for subsequent internal valuations performed by the firm. An investment manager may not always be successful in convincing its clients to move to more frequent external valuation because typically the client pays the cost of the appraisal. However, in many markets, the cost of obtaining external appraisals, including subsequent updates, are not significant due to advances in technology as well as increased availability of market data. If a client insists that an external valuation be performed less frequently than at least once every 12 months, the firm will still be able to satisfy the external valuation requirement by obtaining external appraisal(s) as frequently as specified in the client agreement. However, if the client agreement specifies an external valuation frequency greater than at least once every 36 months or indicates that no external valuation is required, then for purposes of complying with the GIPS standards, the firm must obtain external valuations on these investments at least once every 36 months.

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Provision 6.A.5

EXTERNAL VALUATIONS must be performed by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser. In markets where these professionals are not available, the FIRM MUST take necessary steps to ensure that only well-qualified independent property valuers or appraisers are used.

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Discussion

External valuations must be performed by an independent external professionally designated, certified, or licensed commercial property valuer/appraiser. Throughout the world, there are several associations that provide a professional appraisal designation in addition to licensing or certification. In markets where these professionals are not available, the firm must ensure that only well-qualified independent property valuers or appraisers are used. Even if these professionals are not available, it would be unusual to not be able to find a well-qualified independent valuer or appraiser who can value a property in a particular market. The firm must not use external valuations where the valuer's or appraiser's fee is contingent upon the investment's appraised value.

Calculation Methodology—Requirements (the following provisions do not apply: 2.A.2.a, 2.A.4, and 2.A.7)

Provision 6.A.6

FIRMS MUST calculate PORTFOLIO returns at least quarterly.

Discussion

Because real estate is not publicly traded like stocks and bonds, return calculation requirements are different. The portfolio calculation frequency is aligned with the minimum valuation frequency, which is quarterly; therefore, firms must calculate portfolio returns at least quarterly. In more mature markets, monthly or quarterly valuation are the norm, while in other markets, including Asia and some European countries, annual valuations predominate. In those markets where more frequent valuations are available, firms should calculate portfolio returns more frequently because this will lead to the calculation of more meaningful and accurate returns.

Provision 6.A.7

All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.

Discussion

Transaction expenses are defined as all actual legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing portfolio investments as well trading expenses, if any.

Fees and expenses must be evaluated to determine their proper treatment when calculating returns. Firms are required to deduct actual transaction expenses incurred during the period when calculating both gross-of-fees and net-of-fees returns. Acquisition, disposition, and financing services performed by the firm, an affiliate of the firm, or a third party on a particular transaction are considered "transaction expenses" and must be deducted from both gross-of-fees and net-of-fees returns. These transaction expenses (also referred to as "brokerage expenses") are direct costs incurred upon implementation of a particular investment transaction and are considered

true transaction expenses. If any of these transaction services are performed by the firm or an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation. Please note that the true acquisition and disposition transaction expenses described above are different from investment management fees specifically associated with acquisition and disposition services performed by the investment manager. It is common practice in the real estate industry that investment management agreements separate the investment management fee into one or more of the following components: base investment management, acquisition, disposition, and financing. In this scenario, the fees specifically relating to acquisition and disposition are typically considered to be part of the investment management fee because these relate to the investment management responsibilities performed by the firm in formulating its investment decisions as part of the normal investment decision-making process. Please note that financing fees, if applicable, are typically identified separately in the investment management agreement and are classified as transaction costs because they are usually related to post-acquisition refinancing.

Gross-of-fees and net-of-fees returns must also be net of all property-level expenses. Real estate portfolios often utilize leverage. Returns must be calculated after the impact of leverage. Please see Provisions 6.A.8 and 6.A.9 for requirements related to component returns.

Provision 6.A.8

For periods beginning on or after 1 January 2011, INCOME RETURNS and CAPITAL RETURNS (component returns) MUST be calculated separately using geometrically LINKED TIME-WEIGHTED RATES OF RETURN.

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Discussion

Real estate investors typically want to know the contribution from the income and capital return components to the total return. The income return is generally viewed as more stable, and the capital return is generally viewed as less stable. Historically, there was little industry guidance on how to calculate and present income and capital component returns. As a result of linking, cross-product/interaction terms are created that result in annual income and capital component returns that typically will not sum to the total return. For periods prior to 1 January 2011, some firms adjusted either the income or capital component returns (or both) such that the income and capital returns equaled the total return. This adjustment is no longer permitted for periods beginning on or after 1 January 2011. As a result, the GIPS standards now require the separate geometric linking of component returns. Please see additional guidance on component returns at the end of the real estate section of this Handbook.

Provision 6.A.9

COMPOSITE TIME-WEIGHTED RATES OF RETURN, including component returns, MUST be calculated by asset-weighting the individual PORTFOLIO returns at least quarterly.

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Discussion

Composite returns must be asset weighted as opposed to equal weighted. The larger portfolios in the composite will, therefore, have a greater impact on the overall composite performance. Since the portfolios within the composite must be valued at least quarterly, the composite return must be calculated at least quarterly. Please see Provision 2.A.6 for further information on asset-weighting portfolio returns.

Disclosure—Requirements (the following provisions do not apply: 4.A.5, 4.A.6.a, 4.A.15, 4.A.26, 4.A.33, and 4.A.34)

Provision 6.A.10.a

The following items **MUST** be disclosed in each **COMPLIANT PRESENTATION**:

- a. The **FIRM**'s description of discretion.

Discussion

All actual, fee-paying, discretionary portfolios must be included in at least one composite. This requirement applies across asset classes, including real estate, and will ensure that at all times firms will include all portfolios in the appropriate composite(s).

Discretion is the ability of the firm to implement its intended investment strategy. Each firm must document its definition of discretion and must apply the definition consistently. As stated in the Guidance Statement on Composite Definition, there are degrees of discretion and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy.

The firm's definition of discretion must include criteria such that if the firm has sole responsibility or sufficient decision-making authority for major investment decisions, the real estate portfolio must be considered discretionary. Major decisions include, but are not limited to, determining investment search and selection, acquisitions, dispositions, investment structuring, financing, capital improvements, leasing, and operating budgets. In some cases, client-imposed restrictions may result in some decision-making authority being retained by the client. However, if the firm has sufficient decision-making authority to implement the intended investment mandate, objective, or strategy, the portfolio should, where possible, be considered discretionary.

Please see further discussion on investment discretion for real estate portfolios in the Guidance Statement on Real Estate.

Sample Disclosures:

Sample 1: "The firm has responsibility for sourcing, valuing, and managing the acquisition and disposition of assets. Although some of the firm's separate accounts require client approval for the acquisition and disposition of assets, the firm defines such portfolios as discretionary because its recommendations are consistent with the investment strategy and such client approvals are typically perfunctory."

Sample 2: "The firm has complete discretion for all investment activities within the fund."

Provision 6.A.10.b

The following items **MUST** be disclosed in each **COMPLIANT PRESENTATION**:

- b. The **INTERNAL VALUATION** methodologies used to value **REAL ESTATE** investments for the most recent period.

Discussion

Because there are many approaches for valuing real estate investments, firms must disclose the methodologies used by the firm to internally value the real estate investments for the most recent period. In an internal review, the valuation method used to internally value real estate investments is determined by the firm's management. Commonly used methods for estimating value include the discounted cash flow valuation model, the capitalized income approach, the sales comparison approach, the cost approach, and a review and assessment of the known economic, market, and financial variables and factors that can cause material changes in the value of real estate investments. Any assumptions utilized must be fair and unbiased. The internal valuation process must be applied consistently from period to period. A firm may replicate its annual procedures on a quarterly basis, or the firm may establish different quarterly valuation procedures. Each firm must decide for itself what steps are necessary to determine that real estate investments are properly valued on a quarterly basis.

As required by Provision 0.A.5, a firm must document its 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. With respect to real estate investments, ensuring the existence and ownership of client assets may be satisfied by site inspections and reviewing real estate ownership documentation, such as titles and results of lien searches. In addition, real estate property visitation is typically part of the valuation process. The firm must document its real estate internal valuation policies, procedures, methodologies, and hierarchy, including any changes, and must apply them consistently. Please note that in certain jurisdictions, it is standard industry practice to value real estate based upon external valuations obtained from an independent appraiser rather than internal valuations due to independence considerations. If all real estate investments within a composite have been externally valued, this disclosure would not be applicable.

For periods beginning on or after 1 January 2011, firms must disclose the use of subjective unobservable inputs for valuing portfolio investments (as described in the GIPS Valuation Principles in Chapter II of the GIPS standards) if the portfolio investments valued using subjective unobservable inputs are material to the composite. 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. Please also see Provisions 4.A.27 and 4.A.28 for further information.

Sample Disclosure:

"Real estate investments are internally valued quarterly by the firm. All valuations are performed as of the calendar quarter-ends. Internal real estate investment valuations rely primarily on the application of market discount rates to future projections of net cash flows

3 Explanation of the Provisions of the GIPS Standards

(gross real estate cash flows less debt service) and capitalized terminal values over the expected holding period of each property. Due to the nature of real estate investments, valuations are in part based upon subjective unobservable inputs.”

Provision 6.A.10.c

The following items **MUST** be disclosed in each **COMPLIANT PRESENTATION**:

- c. For periods beginning on or after 1 January 2011, material changes to valuation policies and/or methodologies.

Discussion

Consistent with the recognition that valuations are a significant input into the performance equation and that the valuation of real estate investments involves the use of subjective estimates, for periods ending on or after 1 January 2011, firms are required to disclose material changes to valuation policies and/or methodologies that might affect performance results or make historical comparability of performance results difficult. This includes any changes to international guidelines that have had a material impact on valuation practices or adoption of different accounting principles, valuation policies, or industry guidelines. Some examples of a material change include, but are not limited to, the following:

- new valuation principles adopted by a local accounting standards board;
- adoption of new international standards in lieu of local standards;
- change of economic criteria used to value investments; and/or
- change from discounted cash flows basis to a comparables basis.

Sample Disclosure:

“For periods prior to 1 January 2011, real estate investments were internally valued quarterly by the firm. Beginning 1 January 2011, real estate investments are externally appraised on a quarterly basis.”

Provision 6.A.10.d

The following items **MUST** be disclosed in each **COMPLIANT PRESENTATION**:

- d. For periods beginning on or after 1 January 2011, material differences between an **EXTERNAL VALUATION** and the valuation used in performance reporting and the reason for the differences.

Discussion

Occasionally, a firm may believe that an external valuation as of the valuation date does not accurately reflect the value of the investments and will override this value for performance reporting. If the external valuation is not used to calculate and report performance, any material differences between the external valuation and the valuation used in performance reporting, as well as the reason for the difference, must be disclosed.

Sample Disclosure:

“The external valuation for 31 March 2011 for some of the assets of the ABC Fund was materially different from our internal valuation and was not used in performance reporting because the firm determined that some of the cash flow projections in the appraisal contained material errors in the leasing assumptions used by the external appraiser. The internal valuations of these assets were up to 10% higher than the external valuations. These assets represented 33% of composite assets as of 31 December 2011.”

Provision 6.A.10.e

The following items **MUST** be disclosed in each COMPLIANT PRESENTATION:

- e. The frequency REAL ESTATE investments are valued by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/ APPRAISER.

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Discussion

Firms must disclose the frequency of external real estate valuations to allow a prospective client to understand how often investments are externally valued. This information is helpful because internal valuations may not capture as much volatility in the market due to the various valuation policies that may be employed.

Sample Disclosures:

Sample 1: “For periods prior to 1 January 2012, investments were externally appraised by an independent appraiser at least once every 36 months. Beginning 1 January 2012, assets are externally appraised annually.”

Sample 2: “For periods prior to 1 January 2012, assets were externally appraised by an independent appraiser at least once every three years. Beginning 1 January 2012, assets in six of the seven portfolios currently in the composite are independently appraised on an annual basis. One portfolio’s investments, which represented approximately 14% of the composite’s assets as of 31 December 2011, will continue to be externally valued every three years as required by the client agreement.”

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Provision 6.A.10.f

The following items **MUST** be disclosed in each **COMPLIANT PRESENTATION**:

- f. When component returns are calculated separately using geometrically **LINKED TIME-WEIGHTED RATES OF RETURN**.

Discussion

Given the inconsistencies in calculating component returns prior to 1 January 2011, firms are required to disclose when component returns are calculated separately using geometrically linked time-weighted rates of return, even though such a methodology is required for periods beginning on or after 1 January 2011. See Provision 6.A.8 for more information.

Sample Disclosure:

“Income and capital returns may not equal total returns due to the geometric linking (compounding) of quarterly returns.”

Provision 6.A.10.g

The following items **MUST** be disclosed in each **COMPLIANT PRESENTATION**:

- g. For periods prior to 1 January 2011, if component returns are adjusted such that the sum of the **INCOME RETURN** and the **CAPITAL RETURN** equals the **TOTAL RETURN**.

Discussion

As discussed in Provision 6.A.8, for periods prior to 1 January 2011, some firms adjusted either the income or capital component returns (or both) such that the income and capital returns equaled the total return. If this practice was in place prior to 1 January 2011, it must be disclosed to help the user properly interpret historical performance results.

Sample Disclosure:

“For periods prior to 1 January 2011, capital returns were adjusted so that income and capital returns equaled annual total returns. For subsequent periods, income and capital returns may not equal total returns due to the geometric linking (compounding) of quarterly returns.”

Provision 6.A.11

For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, **FIRMS MUST** disclose the periods of non-compliance.

Discussion

For real estate composites, firms may link non-GIPS-compliant performance to their GIPS-compliant history, provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006. If the firm chooses to present non-compliant performance for periods prior to 1 January 2006, the firm must disclose which periods are not in compliance. Prospective clients and current clients are encouraged to inquire about the reasons why the periods prior to 1 January 2006 are not compliant and consider the effects of non-compliance on the historical performance. Please also see Provisions 6.A.15 and 6.A.23.a for more information.

Sample Disclosure:

“The returns presented for periods prior to 2006 are not in compliance with the GIPS standards.”

Provision 6.A.12

When presenting GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.

Discussion

Gross-of-fees returns must be reduced by any transaction expenses incurred during the period but are not required to reflect the deduction of investment management and other fees, including investment-level administrative costs. In many jurisdictions, however, it is common practice in the real estate industry to deduct investment-level administrative costs when computing gross-of-fees (and net-of-fees) returns. Investment-level administrative costs can include administration, audit, custodian, trustee, and valuation fees. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. If the investment-level administrative fees and expenses include services performed by the investment management firm or by an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation. Please note that administrative and other fees can be incurred at the property level. The disclosures described here relate to investment-level fees, not property-level fees.

Sample Disclosures:

Sample 1: “Gross-of-fees returns are presented net of administration, audit, and valuation fees.”

Sample 2: “As is typical in real estate investment funds, all fund administrative costs (organizational costs, audit, valuation, and legal fees) have been deducted from both gross-of-fees and net-of fees returns.”

Provision 6.A.13

When presenting NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.

3 Explanation of the Provisions of the GIPS Standards

Discussion

Net-of-fees returns must reflect the deduction of transaction expenses and investment management fees. Net-of-fees returns may also reflect the deduction of any other fees or expenses the firm chooses to deduct. Investment management fees typically include a recurring asset-based management fee (often calculated on the basis of invested or committed capital), a performance-based management fee (often based on the performance of the portfolio on an absolute basis or relative to a benchmark), and certain types of transaction-based investment management fees. Other fees, including investment-level administrative costs, are not required to be deducted from net-of fees (or gross-of-fees) returns. In many jurisdictions, however, it is common practice in the real estate industry to deduct investment-level administrative costs when computing both net-of-fees and gross-of-fees returns. If the investment-level administrative fees and expenses include services performed by the investment management firm or an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation. See Provision 6.A.12 for further discussion of investment-level administrative costs. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses. Please note that administrative and other fees can be incurred at the property level. The disclosures described above relate to investment-level fees, not property-level fees. Please also see Provision 6.A.7 for further discussion of investment management fees. In practice, investment management fees can be paid either inside or outside of the investment vehicle, which can have an effect on returns. Firms should disclose how such fees are paid.

Sample Disclosure:

“Net-of-fees returns are net of actual investment management fees, including incentive fees, which are recorded on an accrual basis. Net-of-fees returns are also presented net of administrative fees.”

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Presentation and Reporting—Requirements (the following provisions do not apply: 5.A.1.i, 5.A.2, and 5.A.3)

Provision 6.A.14

FIRMS MUST present component returns in addition to TOTAL RETURNS. COMPOSITE component returns MUST be clearly identified as GROSS-OF-FEES OR NET-OF-FEES.

Discussion

A firm may choose to present total returns that are gross-of-fees, net-of-fees, or both, in compliant presentations. Likewise, a firm may choose to present component returns that are gross-of-fees, net-of-fees, or both, in compliant presentations. If a firm chooses to present only gross-of-fees total returns in the compliant presentation, then the firm should also present gross-of-fees component returns; however, gross-of-fees and/or net-of-fees component returns must be presented. If a firm chooses to present only net-of-fees total returns in the compliant presentation, then the firm should also present net-of-fees component returns; however, gross-of-fees and/or net-of-fees component returns must be presented. If a firm chooses to present both gross-of-fees and net-of-fees total returns in the compliant presentation, the firm at a minimum should present gross-of-fees

component returns; however, gross-of-fees and/or net-of-fees component returns must be presented. Please see additional guidance on component returns in the Time-Weighted Component Returns for Real Estate Portfolios section at the end of this chapter.

Performance results must be clearly identified to enable prospective clients to properly interpret and compare performance. In order to compare performance, they need to know what the performance results represent, and therefore, component returns must be presented and clearly identified.

Provision 6.A.15

FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.

Discussion

The GIPS real estate provisions allow firms to link non-GIPS-compliant performance to their GIPS-compliant history, provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006. The purpose of this provision is to allow firms to show additional performance that pre-dates the required five years of GIPS-compliant performance that is initially required to be presented per Provision 5.A.1.a. Firms are reminded that they must comply with all applicable laws and regulations regarding the calculation and presentation of performance and they must not present performance or performance-related information that is false or misleading.

For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

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Provision 6.A.16.a

The following items MUST be presented in each COMPLIANT PRESENTATION:

- a. As a measure of INTERNAL DISPERSION, high and low annual TIME-WEIGHTED RATES OF RETURN for the individual PORTFOLIOS in the COMPOSITE. If the COMPOSITE contains five or fewer PORTFOLIOS for the full year, a measure of INTERNAL DISPERSION is not REQUIRED.

Discussion

Internal dispersion is a measure of the spread of annual returns of individual portfolios within a composite. It allows prospective clients to determine how consistently the firm implemented its strategy across the portfolios in the composite for the full annual period. The required measure of internal dispersion for real estate composites is the high and low annual time-weighted rate of return.

Because the internal dispersion measure represents the spread of annual returns of individual portfolios within the composite for the full year, only the portfolios that have been managed for the full annual period are to be included in the internal dispersion calculation. Firms must identify the portfolios in the composite that have been included for the full annual period and calculate the annual return for each of those portfolios. Firms must use those annual returns to calculate

3 Explanation of the Provisions of the GIPS Standards

the composite's internal dispersion. The firm should disclose on which results (gross-of-fees or net-of-fees) the internal dispersion measure is calculated and presented. If the firm presents only gross-of-fees returns in the compliant presentation, the firm should use gross-of-fees returns to calculate the internal dispersion measure. If a firm presents only net-of-fees returns in the compliant presentation, the firm should use net-of-fees returns to calculate the internal dispersion measure.

Each compliant presentation must include information about the internal dispersion of individual portfolio returns. These figures must be presented as of the end of each annual period that is included in the compliant presentation. In cases where there are five or fewer portfolios in a composite for the full annual period, the measure of internal dispersion is not required to be presented. However, because firms must include some information about the internal dispersion of individual portfolio returns, firms must indicate that the internal dispersion measure is not applicable or include similar language. The firm may instead choose to disclose why no internal dispersion measure is presented.

Additional internal dispersion measures can be presented as additional information and may include, but are not limited to, the range or standard deviation (asset weighted or equal weighted) of portfolio returns.

Provision 6.A.16.b

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- b.** As of each annual period end, the percentage of **COMPOSITE** assets valued using an **EXTERNAL VALUATION** during the annual period.

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Discussion

Disclosing the percentage of the composite valued using an external valuation during the annual period provides investors with the amount of assets valued using external appraisals. Investors typically prefer external valuation because it is independent and unbiased and an “expert” estimate of value that is perceived by the marketplace to be more reliable than internal valuation.

Additional Requirements for Real Estate Closed-End Fund Composites

Calculation Methodology—Requirements

Discussion

Beginning with the 2005 edition of the GIPS standards, specific requirements and recommendations were included for the private equity asset class. Because of the unique characteristics of private equity, since inception internal rates of return (SI-IRR) are required as opposed to time-weighted rates of return (TWRR). Private equity investment vehicles are typically closed-end funds where the investment manager controls the drawdown of capital into the fund and the eventual distribution of capital and profits back to investors.

Although a TWRR is required to be presented for real estate composites, the 2005 edition of the GIPS standards also included a recommendation to present the SI-IRR for real estate composites because of the similarities between private equity investments and closed-end real estate funds. Both have a fixed life, are not open for subscriptions and/or redemptions, and are generally illiquid. The final return on the fund is generally known only at the terminal date of the closed-end fund.

For real estate closed-end fund composites, the use of a TWRR measure was deemed to be insufficient by itself because a TWRR does not capture the critical effect of cash flow management within the control of the investment manager. The 2010 edition of the GIPS standards includes a new requirement to present the SI-IRR and other related quantitative measures for real estate closed-end fund composites in addition to the previously required TWRR for each annual period. The SI-IRR provides performance measurement comparability for real estate composites with closed-end vehicle structures as well as for most private equity composites, whereas the TWRR provides performance measurement comparability for all asset classes other than private equity.

The independent, private, fixed-life, closed-end fund vehicle is increasingly being used in real estate. A closed-end fund vehicle can be organized in a variety of legal forms (e.g., limited partnership, trust, unit trust) depending on the jurisdiction. A firm may have several funds in existence at any one time, each of which is independent from the others. These funds typically have a defined “start date” and most often have a fixed life that can be extended by a pre-set number of defined periods (e.g., two one-year periods) upon agreement of the investors. This is termed a closed-end fund because the number of investors/shares is fixed for the life of the fund and closed to new investors, although ownership interest may be transferred (sold) to another investor under certain circumstances. This also means that the capital available for investment (capital commitments) is fixed for the life of the fund and the fund is not open for subscriptions and/or redemption. Closed-end funds have a capital call (drawdown) process in place that is controlled by the general partner.

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Provision 6.A.17

FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).

Discussion

The GIPS real estate provisions require that real estate closed-end fund composites present the net-of-fees since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. When first coming into compliance, firms must initially present at least five years of performance (or for the period since the firm’s inception or the composite inception date if the firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

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In a fixed-life, closed-end real estate fund, the decisions to raise capital, draw down capital in the form of capital calls, and distribute proceeds are all at the discretion of the real estate manager. The timing of the cash flows is part of the investment decision process. The real estate firm's performance must reflect the results of those timing decisions, and thus the IRR is also required in addition to the time-weighted return.

In general, the IRR is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. The SI-IRR is a specific version of the IRR where the measurement period covers the entire investment period since inception.

The IRR is the return for which the net present value of a cash flow series is equated to zero and is calculated as follows:

$$0 = \sum_{i=0}^I CF_i (1 + r_{IRR})^{-\left(\frac{t_i}{365}\right)},$$

where

CF_i = cash flow i [negative values for inflows (paid-in capital) and positive values for outflows (distributions)]

i = number of cash flows (1, 2, ..., I) during the measurement period

r_{IRR} = annualized internal rate of return

t_i = number of calendar days between the beginning of the measurement period and the date of cash flow i

The since inception internal rate of return (SI-IRR) is a special version of the IRR where the period-end value of the investment is treated as a synthetic terminal cash outflow and is calculated as follows:

$$0 = \left[\sum_{i=0}^I CF_i (1 + r_{SI-IRR})^{-\left(\frac{t_i}{365}\right)} \right] + \left[V_E (1 + r_{SI-IRR})^{-\left(\frac{TD}{365}\right)} \right],$$

where

CF_i = cash flow i [negative values for inflows (paid-in capital) and positive values for outflows (distributions)]

i = number of cash flows (1, 2, ..., I) during the measurement period

r_{SI-IRR} = annualized since inception internal rate of return

t_i = number of calendar days between the beginning of the measurement period and the date of cash flow i

TD = total number of calendar days in the measurement period

V_E = value of the investment at the end of the measurement period. In the case of closed-end funds, this is typically the net asset value at the end of the measurement period

Note: the above annualized formula assumes a 365 day per year convention and may have slight inaccuracies when the measurement period contains a leap year(s).

Firms must calculate and present the annualized SI-IRR. If the period is less than a full year, firms must present the non-annualized SI-IRR. The non-annualized SI-IRR is calculated as follows:

$$R_{SI-IRR} = \left[(1 + r_{SI-IRR})^{\frac{TD}{365}} \right] - 1,$$

where

R_{SI-IRR} = non-annualized since inception internal rate of return

r_{SI-IRR} = annualized since inception internal rate of return

TD = total number of calendar days in the measurement period

Note: the above formula assumes a 365 day per year convention and may have slight inaccuracies when the measurement period contains a leap year(s).

Provision 6.A.18

The SI-IRR MUST be calculated using quarterly cash flows at a minimum.

Discussion

Using daily cash flows to calculate SI-IRR results in a more accurate return calculation than using quarterly cash flows. However, real estate investment managers generally calculate SI-IRR using quarterly rather than daily cash flows. This is consistent with the reporting of real estate performance on a quarterly basis.

Composite Construction—Requirements

Provision 6.A.19

COMPOSITES MUST be defined by VINTAGE YEAR and investment mandate, objective, or strategy. The COMPOSITE DEFINITION MUST remain consistent throughout the life of the COMPOSITE.

Discussion

The GIPS standards are structured around the concept of composites. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. Real estate closed-end fund composites must be defined by vintage year and investment mandate, objective, or strategy, and the composite definition utilized must remain consistent throughout the life of the composite. Thus, a 2009 vintage year composite cannot change from being classified as an opportunistic real estate composite to a value-added real estate composite, even though it may have more value-added investments as the strategy evolves.

The vintage year is an important concept for real estate closed-end fund composites and could limit real estate closed-end fund composites to one fund per composite because firms are unlikely to raise a second fund with the same strategy in the same vintage year. There are two methods of classifying funds by vintage year: the year of the fund's first drawdown or capital call from its investors or the year when the first committed capital from outside investors is closed and legally binding. Firms must disclose the vintage year of the composite and how the vintage year is defined.

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It is important to note that the calculation of the SI-IRR relies on the first cash flow. The definition of vintage year does not impact the SI-IRR calculation, but it will have an impact on the benchmark that is chosen. The benchmark chosen to compare performance of the composite must reflect the same vintage year used for the composite.

Disclosure—Requirements

Provision 6.A.20

FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.

Discussion

Most real estate closed-end funds have a finite life, which varies from five to ten years. It is also common practice to have multiple extensions whereby some of the funds may extend their lives in increments of one to two years. The residual value of the investments may be *de minimis* at that final liquidation date, but the longer the life, the lower the fund's SI-IRR will be, all other things being equal. At some point, the fund is finally liquidated either by disposing of the remaining investments or by writing off any remaining investments. The final liquidation date is the date when the last portfolio in a composite is fully distributed or written off.

Sample Disclosures:

Sample 1: “The 2005 Opportunistic Strategy Closed-End Fund Composite was liquidated as of 15 October 2010.”

Sample 2: “This real estate closed-end fund had a four-year investment time horizon that ended on 15 April 2010 and that was extended for one year due to changes in investment and/or exit opportunities of the underlying fund.”

Provision 6.A.21

FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation.

Discussion

The SI-IRR calculation is sensitive to the relative timing of cash flows. In some cases, especially early in the life of a fund, using a quarterly cash flow dating convention can have a very different outcome than using a monthly or daily convention due to the compounding effect of the SI-IRR. Accordingly, firms are required to disclose the frequency of cash flows used in the SI-IRR calculation. For real estate closed-end fund composites, the SI-IRR must be calculated using quarterly cash flows at a minimum and are recommended to be calculated using daily cash flows.

Sample Disclosure:

“The SI-IRR is calculated using quarterly cash flows.”

Provision 6.A.22

FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.

Discussion

The disclosure of the vintage year increases the transparency and comparability by allowing prospective clients to understand the time frame when the composite was initiated or first closed to investment.

The concept of the vintage year is to set a starting date so that funds started in the same year can be compared on an equal basis. While there may be several ways that the start date could be determined, for compliance with the GIPS standards, the relevant start date is the vintage year of the fund. The GIPS standards require that the vintage year be determined by one of two methods: based on the year of the fund's first drawdown or capital call from its investors or based on the year when the first committed capital from outside investors is closed and legally binding.

Sample Disclosures:

Sample 1: "The vintage year of the 2006 Value-Added Strategy Real Estate Closed-End Fund Composite is 2006 and was determined by the year of the first drawdown of capital."

Sample 2: "The composite vintage year is 2006, which was determined based on the fund's first capital call in April 2006."

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Presentation and Reporting—Requirements**Provision 6.A.23.a**

The following items MUST be presented in each COMPLIANT PRESENTATION:

- a. FIRMS MUST present the NET-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance.

Discussion

Real estate closed-end fund composites must present the net-of-fees since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. In practice, investment management fees can be paid either inside or outside of the investment vehicle, which can have an effect on returns. Firms should disclose how such fees are paid. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm's inception or the composite inception date if the firm or the composite has been in

3 Explanation of the Provisions of the GIPS Standards

existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

Most investors will want to see the entire track record of annual SI-IRRs. It is typical that returns will be negative in the early years and will then likely turn positive. The plot of the cumulative since inception net cash flows or since inception returns of a fund is typically referred to as the “J-curve.” The early negative returns are the result of the fact that in some funds, like closed-end value-added and opportunistic funds, it will take time before the fund’s value exceeds paid-in capital. In addition, in the early cash flows, the cash flows called for management fees may be larger than the cash flows made for investment purposes. As a result, it is recognized that the early years of a fund are not indicative of long-term performance. This is especially true for real estate closed-end fund composites because the early capital calls for management fees and length of time for investment development and growth mean that early returns will usually be highly negative until the fund recovers from the J-curve effect. However, the J-curve effect should be minimized with respect to a gross-of-fees return because management fees typically are not deducted in a gross-of-fees calculation.

The measurement period for an SI-IRR is the period from the inception date of the investment vehicle and/or composite through the end of the period that is being reported. Please note that the term “since inception” is independent of the calculation method used. For example, it is possible to calculate a “since inception time-weighted rate of return.” Although it is not required or recommended in the GIPS standards, it is also possible to calculate an IRR between any two points in time within an investment period that is not necessarily since-inception.

In a “since inception” IRR calculation, the beginning date remains constant and does not change. The measurement period for an SI-IRR becomes increasingly longer as the ending date is extended, whereas the beginning date is constant. A TWRR as typically disclosed in a compliant presentation does not have a constant beginning date like an SI-IRR, but rather is a mathematical linking of several interim independent sub-periods. Conversely, the SI-IRR has only one measurement period – from inception to the end of the period being measured, with no linking of interim independent sub-periods.

It is necessary to use the period end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the real estate closed-end fund composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period starting with the period ending 31 December 2006 (assuming a calendar-year-end period). If this firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Provision 6.A.23.b

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- b. For periods beginning on or after 1 January 2011, when the initial period is less than a full year, **FIRMS MUST** present the non-annualized **NET-OF-FEES SI-IRR** through the initial annual period end.

Discussion

Firms are required to present any partial-year SI-IRR performance for the initial reporting period, on a non-annualized net-of fees basis, for composites that begin on or after 1 January 2011. For example, a fund that began on 30 November 2011 and has a one-month net-of-fees initial return through 31 December 2011 of 3% would be required to present that 3% as the partial year's performance. The annualized return of 42.6% must not be presented. Many spreadsheet and software applications automatically annualize all returns and firms are reminded that for periods of less than a year, the firm must "de-annualize" any annualized returns that are calculated.

The method chosen to de-annualize is at the discretion of the firm. For example, the firm may de-annualize the return from the bottom up by compounding daily cash flows for the investment period or by taking the implied annual return and calculating the equivalent return for the investment period. In the situation above, the 42.6% implied annualized return could be de-annualized by the following formulas:

$$\left\{ \left[\left(1 + 0.426 \right) \left(\frac{1}{12} \right) \right] - 1 \right\} \times 100 = 3\% \text{ or } \left\{ \left[\left(1 + 0.426 \right) \left(\frac{30.42}{365} \right) \right] - 1 \right\} \times 100 = 3\%,$$

both resulting in a de-annualized one-month return of 3%.

Please note there may be some minor differences between methods due to compounding frequency. In addition, daily compounding can be affected over long periods of time due to leap years.

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Provision 6.A.23.c

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- c. For periods ending on or after 1 January 2011, **FIRMS MUST** present the **NET-OF-FEES SI-IRR** through the **COMPOSITE FINAL LIQUIDATION DATE**.

Discussion

Most real estate closed-end funds have a finite life, which varies from five to ten years. It is also common practice to have multiple extensions whereby some of the funds may extend their lives in increments of one to two years. On a since inception basis, the returns do not vary much during those extension periods unless the remaining investments have some major events that cause significant revaluation. In the end, the investments are liquidated by some means and the fund

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eventually is also liquidated. A firm must report a net-of-fees SI-IRR through that composite's final liquidation date in order to capture the residual value, either good or bad, in the last stages of the composite's existence.

Provision 6.A.24

If the GROSS-OF-FEES SI-IRR of the COMPOSITE is presented in the COMPLIANT PRESENTATION, FIRMS MUST present the GROSS-OF-FEES SI-IRR of the COMPOSITE for the same periods as the NET-OF-FEES SI-IRR is presented.

Discussion

When presenting performance for closed-end real estate fund composites, firms are required to present a net-of-fees SI-IRR. If the firm chooses to also present the gross-of-fees SI-IRR, then the firm must present both gross-of-fees and net-of-fees SI-IRR for the same periods.

Deriving SI-IRR gross-of-fees returns from SI-IRR net-of-fees returns and vice versa is not as straight forward as it might seem. There is no uniform method nor standardized formula to derive gross-of-fees SI-IRR returns directly from net-of-fees SI-IRR returns or vice versa. However, it is possible to calculate gross-of-fees SI-IRR and net-of-fees SI-IRR independently. The calculations would be based on the specific facts and circumstances regarding the timing and the terms of the fees, and independent and distinct cash flow streams for gross-of-fees SI-IRR and net-of-fees SI-IRR would be utilized.

The gross-of-fees SI-IRR is the return on investments reduced by any transaction expenses but before deducting investment management fees. The calculation of a net-of-fees SI-IRR as required by the GIPS standards must further be reduced by investment management fees including performance-based fees. Administrative costs and other expenses are not required to be deducted from gross-of-fees or net-of-fees returns. In many jurisdictions, however, it is common practice to deduct such items when computing gross-of-fees SI-IRR and net-of-fees SI-IRR. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses

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Provision 6.A.25

FIRMS MUST present, as of each annual period end:

- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL.
- b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS.
- c. COMPOSITE cumulative COMMITTED CAPITAL.
- d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI).
- e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI).
- f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE).
- g. RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).

Discussion

Because the firm controls the cash flows in a closed-end fund, the SI-IRR is an important performance return. Therefore, in addition to the TWRR, closed-end real estate fund composites must also present the SI-IRR. In addition to the SI-IRR, there are other metrics (described later in this section) that can provide insight into the composite's performance. The IRR by its nature is sensitive to early cash flow events, and the IRR calculation assumes that the residual value of a composite is totally liquid, whereas in reality, the residual value is the unrealized (and often illiquid) portion of the composite. As a result, other metrics have been developed that allow a prospective client to examine aspects of performance other than simply a rate of return. The performance metrics and the SI-IRR must be calculated on a net-of-fees basis.

a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL.

Discussion

The composite since inception paid-in capital consists of all capital inflows to an investment vehicle by the investors (e.g., limited partners). These inflows are also referred to as contributions to an investment vehicle by the investors. Paid-in capital also includes distributions that are subsequently recalled and reinvested into the investment vehicle.

b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS.

Discussion

The composite since inception distributions include all cash and stock distributed from an investment vehicle to the investors (e.g., limited partners).

c. COMPOSITE cumulative COMMITTED CAPITAL.

Discussion

The composite cumulative committed capital represents the total pledges of capital to an investment vehicle by the investors (e.g., limited partners).

d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI).

3 Explanation of the Provisions of the GIPS Standards

Discussion

The investment multiple, or TVPI, provides investors with a multiple that indicates how many times more the investment is worth compared with the original investment without taking into account the time value of money. It is equal to the sum of the composite since inception distributions and its residual value divided by the composite since inception paid-in capital (or contributions). The investment multiple is calculated as

$$\text{TVPI} = \text{DPI} + \text{RVPI or (Cumulative distributions since inception + Period-ending residual value)/Cumulative paid-in capital since inception),}$$

where,

DPI = realization multiple

RVPI = unrealized multiple

e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI).

Discussion

The DPI, or realization multiple, measures how much capital has actually been returned to investors. It is the amount of capital that has been “realized” by investors and is often viewed as the amount of the TVPI that is “realized.” It is equal to the sum of the since inception distributions divided by the since inception paid-in capital (or contributions). It is calculated as

$$\text{DPI} = (\text{Cumulative distributions since inception})/(\text{Cumulative paid-in capital since inception}).$$

f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE).

Discussion

The paid-in capital multiple (also known as the PIC multiple or PIC ratio) gives prospective investors information regarding how much committed capital has actually been drawn down. In industry terminology, it is also known as the “dry-powder ratio” because it measures how much capital is left to invest. It is equal to the since inception paid-in capital (or contributions) divided by total capital commitments. It is calculated as

$$\text{PIC} = (\text{Cumulative paid-in capital since inception})/(\text{Cumulative committed capital}).$$

Recycling/Reinvestment and Recalable Cash Flows Closed-end real estate funds are usually characterized by the prohibition (unless stipulated by agreement) to reinvest proceeds or allow redemptions. This means that unless otherwise agreed to, these funds must distribute proceeds from investments to investors (e.g., limited partners) and cannot reinvest that capital. In some cases,

distributions are “recallable”; that is, after the fund distributes proceeds to its investors, it can draw down the same capital again, which makes it possible for the fund to draw capital in excess of its total committed capital.

Distributions can be either recallable or non-recallable. This means that a recallable distribution must be treated as an actual distribution and if and when that distribution is recalled, it must be treated as additional paid-in capital. The treatment of recallable distributions with respect to committed capital should be disclosed in the compliant presentation.

Please note that recallable distributions have an impact on the performance metric calculations and the firm may wish to consider additional disclosure when there is material distortion to the PIC or realization multiples. If a recallable distribution is re-contributed and reflected as paid-in capital a second time, the result will be cumulative paid-in capital since inception being higher than total committed capital. It also means that the DPI, RVPI, and TVPI multiples will be lower, all other things being equal, for investment vehicles that have had recallable distributions because the denominator will be increased. In addition, the PIC ratio will be higher for investment vehicles that have had recallable distributions, all other things being equal.

g. RESIDUAL VALUE TO SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE OR RVPI).

Discussion

The unrealized multiple, or RVPI, is the converse of the realization multiple. It is equal to the residual value at the end of the period divided by since inception paid-in capital (or contributions). It is calculated as

$$\text{RVPI} = (\text{Residual value at period end}) / (\text{Cumulative paid-in capital since inception}).$$

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Provision 6.A.26

FIRMS MUST present the SI-IRR of the BENCHMARK through each annual period end. The BENCHMARK MUST:

- a. Reflect the investment mandate, objective, or strategy of the COMPOSITE;
- b. Be presented for the same time period as presented for the COMPOSITE; and
- c. Be the same VINTAGE YEAR as the COMPOSITE.

Discussion

Firms are required to present the annualized SI-IRR of a benchmark that reflects the same investment mandate, objective, or strategy of the composite, that corresponds to the same time periods as presented for the composite, and that has the same vintage year as the composite. Firms must disclose the calculation methodology of the benchmark and, if a custom benchmark or multiple benchmarks is used, how that benchmark is constructed, including the benchmark components, weights, and rebalancing process. If the firm determines no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.

Real Estate—Recommendations

Input Data—Recommendations (the following provision does not apply: 1.B.1)

Provision 6.B.1

For periods prior to 1 January 2012, REAL ESTATE investments SHOULD be valued by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser at least once every 12 months.

Discussion

For periods prior to 1 January 2012, each real estate investment must have an external valuation at least every 36 months. However, it is recommended that for periods prior to 1 January 2012, real estate investments be valued by an independent external professionally designated, certified, or licensed commercial property valuer/appraiser at least once every 12 months. Investors typically prefer external valuation because it is independent and unbiased and an “expert” estimate of value that is perceived by the marketplace to be more reliable than internal valuation.

3-6

Provision 6.B.2

REAL ESTATE investments SHOULD be valued as of the annual period end by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser.

Discussion

The GIPS standards recommend that the external valuation be conducted as of the annual period-end by an independent external professional to help real estate investors compare investment performance between investment management firms. In some jurisdictions, obtaining all appraisals as of the annual period-end is not feasible due to the limited availability of well-qualified property valuers or appraisers as of the firm’s annual period-end. Investors may also request that appraisals be performed as of a specific date, such as the fiscal year-end or on the anniversary after the property purchase date.

Disclosure—Recommendations

Provision 6.B.3

FIRMS SHOULD disclose the basis of accounting for the PORTFOLIOS in the COMPOSITE (e.g., U.S. GAAP, IFRS).

Discussion

The GIPS real estate provisions provide a minimum level of performance reporting to prospective investors. Disclosure of the accounting standards utilized may provide prospective investors insight into the firm's investment performance and will assist in the comparison of investment performance between different firms.

Sample Disclosures:

Sample 1: "All assets and liabilities are reported on a fair value basis using U.S. Generally Accepted Accounting Principles for non-operating companies."

Sample 2: "All funds in the composite report their assets and liabilities on a fair value basis using International Financial Reporting Standards (IFRS)."

Provision 6.B.4

FIRMS SHOULD explain and disclose material differences between the valuation used in performance reporting and the valuation used in financial reporting as of each annual period end.

3-6

Discussion

Normally, the valuations used for financial reporting and performance reporting should not differ significantly. If they do, the material differences as of each annual period-end should be explained and disclosed.

Provision 6.B.5

For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

Discussion

A firm must disclose material changes to valuation policies and/or methodologies used to value real estate investments for periods ending on or after 1 January 2011. Firms are recommended to disclose material changes to valuation policies and/or methodologies for periods ending prior to 1 January 2011.

Presentation and Reporting—Recommendations (the following provisions do not apply: 5.B.3, 5.B.4, and 5.B.5)

Provision 6.B.6

FIRMS SHOULD present both GROSS-OF-FEES and NET-OF-FEES returns.

Discussion

The difference between gross-of-fees and net-of-fees returns should reflect only investment management fees that the firm charges for providing investment management/advisory services. By presenting both gross-of-fees and net-of-fees returns, clients can typically estimate the effect on investment returns from investment management fees.

Provision 6.B.7

FIRMS SHOULD present the percentage of the total value of COMPOSITE assets that are not REAL ESTATE as of each annual period end.

Discussion

To provide additional clarity for the investor, the firm is recommended to present the percentage of the total value of composite assets as of each annual period-end that do not meet the definition of real estate according to the GIPS standards. Presenting statistics showing the amount of non-real-estate assets in the composite will provide insight into the types of investment instruments utilized and how the investment allocation has been implemented. Non-real-estate investments have different risk and return characteristics than real estate investments. It is useful to disclose the extent to which the composite includes investments other than real estate because the overall performance of the composite is influenced by all the investments utilized within each portfolio.

Provision 6.B.8

FIRMS SHOULD present the component returns of the BENCHMARK, if available.

Discussion

One of the primary goals of the GIPS standards is to provide information for investors and investment managers to evaluate performance relative to other third-party performance metrics. Benchmarks are important tools to aid in the planning, implementation, and review of investment policy. The benchmark serves as an objective point of reference for which the composite performance can be compared. Because component returns are required to be presented in addition to total returns, firms should present the component returns of the benchmark if available.

An Additional Recommendation for Real Estate Closed-End Fund Composites

Calculation Methodology—Recommendations

Provision 6.B.9

The SI-IRR SHOULD be calculated using daily cash flows.

Discussion

Although real estate investment managers generally calculate the SI-IRR using quarterly rather than daily cash flows, using daily cash flows to calculate SI-IRR results in a more accurate return calculation than using quarterly cash flows, and so the use of daily cash flows is recommended. The SI-IRR must be calculated using quarterly cash flows at a minimum.

Using daily cash flows means that the cash flows are dated on the date the cash flows occur—for example, the date of the capital call or the date of the distribution. The date of the incoming cash flow (paid-in capital) is intended to reflect the date the firm obtains control of the capital from the investor, which is not necessarily the date the capital is invested in underlying real estate. For practical purposes, this should be the date of the capital call because there may be a day or so lag in between the date of the capital call and the date the investor actually delivers the capital. Similarly, the date of the distribution is the date the distribution is returned to the investor which is not necessarily the date the firm receives the proceeds from the underlying investment because there may be a lag between the date of the distribution notice to investors and the date the investor actually receives the proceeds.

A firm can choose to move to a daily cash flow stream with legacy cash flows dated quarterly for prior periods. While it may not be as accurate as reconstruction of a daily cash flow stream historically, the administrative burden and cost of reconstruction would be difficult to justify given the benefit gained. When constructing such a stream historically, the firm must assume that all cash flows occurred on a particular date in the quarter regardless of the actual date of the cash flow. If quarterly cash flows are used with daily cash flows in the same cash flow stream, the IRR formula must use a daily compounding convention for the entire cash flow stream. For example, a firm that uses a quarter-end convention for cash flows prior to 1 January 2011 and then uses the exact date of daily cash flows for all cash flows after 1 January 2011 would compound the entire stream daily to meet the recommended SI-IRR calculation for using daily cash flows. While the resultant SI-IRR is not as precise as retroactively reconstructing the daily cash flows, the difficulty of daily cash flow reconstruction means that combining the quarterly and daily cash flow streams is a reasonable accommodation.

Time-Weighted Component Returns for Real Estate Portfolios

The GIPS standards require that compliant presentations for real estate composites include time-weighted total returns and component returns. The two components of real estate total returns are income returns and capital returns. Component returns provide information about the source of the total return. Generally, “core” real estate strategies derive most of their total return through income returns, “opportunistic” strategies derive most of their total return through capital returns, and “value-added” strategies derive their total return through both income and capital returns.

A firm may choose to present in compliant presentations total returns that are gross-of-fees, net-of-fees, or both. Likewise, a firm may choose to present in compliant presentations component returns that are gross-of-fees, net-of-fees, or both. If a firm chooses to present only gross-of-fees total returns in the compliant presentation, then the firm should also present gross-of-fees component returns. If a firm chooses to present only net-of-fees total returns in the compliant presentation, then the firm should also present net-of-fees component returns. If a firm chooses to present both gross-of-fees and net-of-fees total returns in the compliant presentation, the firm at a minimum should present gross-of-fees component returns.

Component returns are typically calculated utilizing information from the accounting records that tracks income/expense and capital gain/loss (realized and unrealized appreciation/depreciation) amounts separately. The sum of the income and capital amounts is reflected in the numerator of the total return calculation as described below.

Real estate portfolio accounting, including valuation, is usually performed internally on a quarterly basis, and, therefore, both portfolio and composite returns are typically calculated quarterly. For any given quarter, the sum of the income and capital component returns will equal the total return, with any differences solely due to rounding. The GIPS standards require that firms must calculate real estate portfolio returns at least quarterly. However, some firms calculate portfolio returns monthly for some or all of their real estate composites. In these instances, the sum of the monthly income and capital component returns will equal the monthly total return, but this relationship will not hold for the quarterly returns calculated using three geometrically linked monthly returns. See further discussion later. The typical return formulas utilized by real estate firms to calculate component and total returns are depicted later in this section for informational purposes. The GIPS standards allow flexibility in choosing the calculation methodology, which means that firms may use alternative formulas provided the calculation method chosen represents returns fairly, is not misleading, and is applied consistently. The calculation of component returns should be the same for all real estate portfolios within a composite.

The denominator is the same in all three formulas and is commonly referred to as either “capital employed,” “weighted average capital,” or “weighted average equity.” Capital employed does not include any income or capital return earned during the measurement period. Beginning capital is adjusted by weighting the external cash flows that occurred during the period. External cash flows are defined as capital (cash or investments) that enters or exits a portfolio.

The term “net investment income” is intended to reflect the impact of ownership and financing structures and includes all underlying property-level activity. Investment-level returns are distinct from property-level returns because property-level returns exclude all of the non-property (investment-level) balance sheet as well as income and expense items. Property-level returns are not used for reporting performance in compliance with the GIPS standards, although they may be shown as supplemental information provided all applicable requirements are adhered to. Please see the Guidance Statement on the Use of Supplemental Information for additional guidance.

Investment-level administrative costs are not required to be deducted from gross-of-fees or net-of-fees returns. However, in many jurisdictions, it is common practice in the real estate industry to deduct such items when computing gross-of-fees and net-of-fees total returns and income component returns. The formulas below assume that these items have been deducted when computing net investment income.

Acquisition, disposition, and financing services performed by the firm, an affiliate of the firm, or a third party on a particular transaction are considered “transaction expenses” and must be deducted from both gross-of-fees and net-of-fees total returns. It is recommended that these transaction expenses be accounted for through the capital return. Please note, however, that it is common practice in the real estate industry that investment management agreements separate the investment management fee into one or more fee components. For example, an investment management agreement might include the following components: base investment management, acquisition, and disposition. The acquisition and disposition fee components are typically considered to be part of the investment management fee rather than transaction expenses. When computing component returns, it is recommended that when the fees for such items are broken out separately, the base management fee be applied to the net-of-fees income return, with the remaining portion of the management fee applied to the net-of-fees capital return. Please note, however, that some firms account for the entire investment management fee, including the non-base management fee portions, through the income return.

The following are used in one or more of the items described later:

r_t^{GFI} = gross-of-fees income return for period t ; r_t^{NEI} = net-of-fees income return for period t

r_t^{GFC} = gross-of-fees capital return for period t ; r_t^{NFC} = net-of-fees capital return for period t

r_t^{GFT} = gross-of-fees total return for period t ; r_t^{NET} = net-of-fees total return for period t

NII_t = net investment income (after interest expense, advisory fees, and any performance-based fees allocated to the income component for performance calculation purposes) for period t

AF_t = advisory fee (asset-based portion of investment management fee expensed including any acquisition and disposition fees that are included as an advisory fee and excluding any performance-based fees) for period t

PF_t^C = performance-based fees allocated to the capital component (for performance calculation purposes) for period t

PF_t^I = performance-based fees allocated to the income component (for performance calculation purposes) for period t

V_t^B = the beginning value of the portfolio for period t

V_t^E = the ending value of the portfolio for period t

FC_t = fees charged by the investment manager and capitalized for accounting purposes but treated as an investment management fee for performance purposes for the period t (including acquisition and disposition costs)

j = the number of external cash flows (1, 2, 3, . . . , J) in period t

$CF_{j,t}$ = the value of cash flow j in period t

$W_{j,t}$ = the weight of cash flow j in period t (assuming the cash flow occurred at the end of the day) as calculated according to the following formula:

$$w_{j,t} = \frac{D_t - D_{j,t}}{D_t},$$

3 Explanation of the Provisions of the GIPS Standards

where

$w_{j,t}$ = the weight of cash flow j in period t , assuming the cash flow occurred at the end of the day

D_t = the total number of calendar days in period t

$D_{j,t}$ = the number of calendar days from the beginning of period t to cash flow j

Please note that other assumptions regarding the timing of cash flows are acceptable. For example, some real estate firms assume that all capital contributions occur at the beginning of the day and all capital distributions occur at the end of the day.

Income Return

Definition

The investment income earned on all investments (including cash and cash equivalents) during the measurement period, net of all non-recoverable expenditures, interest expense on debt, and property taxes. The income return is computed as a percentage of the capital employed.

Discussion

The numerator in the gross-of-fees income return represents the investment income for the portfolio during the period, including any income earned during the period at the investment level, and also reflects all income, fees, and expenses at the property level.

The formula for gross-of-fees income return is as follows:

$$r_j^{GFI} = \frac{NII_t + AF_t + PF_t^I}{V_t^B + \sum_{j=1}^J (CF_{j,t} \times W_{j,t})}$$

The numerator in the net-of-fees income return represents the net investment income for the portfolio during the period. This figure would include any income earned and expenses and fees deducted at the investment level and all income, fees, and expenses at the property level.

The formula for net-of-fees income return is as follows:

$$r_j^{NFI} = \frac{NII_t}{V_t^B + \sum_{j=1}^J (CF_{j,t} \times W_{j,t})}$$

Capital Return

Definition

The change in value of the real estate investments and cash and/or cash equivalent assets held throughout the measurement period, adjusted for all capital expenditures (subtracted) and net proceeds from sales (added). The capital return is computed as a percentage of the capital employed. Capital return is also known as “capital appreciation return” or “appreciation return.”

Discussion

The capital return numerator reflects the change (increase or decrease) in investment value adjusted for capital improvements, sales, refinancing, and net investment income activity. The numerator includes both realized gains/losses and the change in unrealized gains/losses from the prior period.

The net-of-fees capital return reflects the deduction of any performance-based (incentive) fees attributable to the capital component for performance calculation purposes. This figure would exclude any performance-based fees attributable to the income component for performance calculation purposes.

The formula for gross-of-fees capital return is as follows:

$$r_j^{GFC} = \frac{V_t^E - V_t^B - \sum_{j=1}^J (CF_{j,t} - NII_t + PF_t^C + FC_t)}{V_t^B + \sum_{j=1}^J (CF_{j,t} \times W_{j,t})}$$

The formula for net-of-fees capital return is as follows:

$$r_j^{NFC} = \frac{V_t^E - V_t^B - \sum_{j=1}^J (CF_{j,t} - NII_t)}{V_t^B + \sum_{j=1}^J (CF_{j,t} \times W_{j,t})}$$

Total Return

Definition

The percentage change in value of real estate investments, including all capital return and income return components, expressed as a percentage of the capital employed over the measurement period.

Discussion

The total return numerator measures the change (increase or decrease) in investment value from both income (loss) and realized and unrealized gains and losses.

The formula for total return gross-of-fees is as follows:

$$r_j^{GFT} = \frac{V_t^E - V_t^B - \sum_{j=1}^J (CF_{j,t} + AF_t + PF_t^I + PF_t^C + FC_t)}{V_t^B + \sum_{j=1}^J (CF_{j,t} \times W_{j,t})}$$

The formula for total return net-of-fees is as follows:

$$r_j^{NFT} = \frac{V_t^E - V_t^B - \sum_{j=1}^J CF_{j,t}}{V_t^B + \sum_{j=1}^J (CF_{j,t} \times W_{j,t})}$$

Performance-Based Fees

The structure of performance-based fees, also known as incentive fees, can vary widely, as can the treatment of performance-based fees for financial reporting purposes. However, for purposes of the GIPS standards, performance-based fees are considered investment management fees and must be deducted when calculating net-of-fees total returns even if such fees are characterized as

3 Explanation of the Provisions of the GIPS Standards

carried interest (promote) and treated as a capital reallocation for financial reporting purposes. Performance-based fees, which are typically earned when the total return of the portfolio exceeds a specified hurdle rate, are most often entirely allocated to the capital component return because the fee is generally earned primarily due to capital appreciation. However, it is also acceptable to allocate the entire performance-based fee to the income return component or to allocate the fee to both the income and capital return components based on a methodology deemed appropriate by the firm. The GIPS standards require that firms document their policies and procedures used in establishing and maintaining compliance with the GIPS standards and disclose that their policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. With respect to real estate composites, such policies and procedures must include documentation as to how component returns are calculated, including the treatment of performance-based fees, if applicable. These policies must be applied on a consistent basis.

Disclosure

When presenting net-of-fees returns, the GIPS standards require disclosure if returns are net of any performance-based fees. Because the treatment of performance-based fees when calculating component returns varies, it is recommended that firms disclose the method used to account for performance-based fees, including calculating net-of-fees component returns. It is also recommended that the rationale for the treatment of performance-based fees with respect to the calculation of net-of-fees component returns be disclosed.

Sample Disclosure:

“The net-of-fees returns are calculated net of the incentive fee as described above. The incentive fee is accrued quarterly and is allocated to the capital component return because the incentive fee is typically due to changes in the value of real estate investments.”

When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses.

Composite Component Returns

There is typically no added complexity for calculating real estate composite component returns. Real estate composite time-weighted rates of return, including component returns, must be calculated by asset weighting the individual portfolio returns at least quarterly. Please see the Guidance Statement on Calculation Methodology for additional information.

Linking Component Returns

For periods beginning on or after 1 January 2011, annual income and capital component returns must be calculated separately by geometrically linking either monthly or quarterly component returns. For example, if composite component returns are calculated quarterly, when calculating the income component return for the year, the four quarterly income component returns are geometrically linked to calculate the income component return for the annual period. Similarly, capital component returns and total returns are each geometrically linked in the same fashion. As a result of linking, cross-product/interaction terms are created, which result in annual income and capital component returns, which typically will not sum to the total return. For periods prior to 1

January 2011, some firms adjusted either the income or capital component returns (or both) such that the income and capital returns equaled the total return. This adjustment is no longer allowed for periods beginning on or after 1 January 2011.

As an example, the geometric linking of two quarterly component returns can be calculated as follows:

$$\text{Linked income return} = (1 + \text{INC}_1) \times (1 + \text{INC}_2) - 1 = \text{INC}_1 + \text{INC}_2 + (\text{INC}_1 \times \text{INC}_2).$$

$$\text{Linked capital return} = (1 + \text{CAP}_1) \times (1 + \text{CAP}_2) - 1 = \text{CAP}_1 + \text{CAP}_2 + (\text{CAP}_1 \times \text{CAP}_2).$$

Notice that both the income and capital component returns have interaction terms for the two quarters that reflect the compounding effect of each component over the two periods. Totaling the linked income return and linked capital return equals

$$\begin{aligned} \text{Linked income return} + \text{Linked capital return} &= \text{INC}_1 + \text{CAP}_1 + \text{INC}_2 + \text{CAP}_2 + (\text{INC}_1 \times \\ &\quad \text{INC}_2) + (\text{CAP}_1 \times \text{CAP}_2). \end{aligned}$$

Similarly, the geometrically linked total return has the same kind of interaction terms:

$$\text{Linked total return} = (1 + \text{TOT}_1) \times (1 + \text{TOT}_2) - 1 = \text{TOT}_1 + \text{TOT}_2 + (\text{TOT}_1 \times \text{TOT}_2).$$

Substituting $\text{INC}_1 + \text{CAP}_1$ for TOT_1 and $\text{INC}_2 + \text{CAP}_2$ for TOT_2 , we have

$$\begin{aligned} \text{Linked total return} &= (1 + \text{INC}_1 + \text{CAP}_1) \times (1 + \text{INC}_2 + \text{CAP}_2) - 1 = \text{INC}_1 + \text{CAP}_1 + \text{INC}_2 \\ &\quad + \text{CAP}_2 + (\text{INC}_1 \times \text{INC}_2) + (\text{CAP}_1 \times \text{CAP}_2) + (\text{INC}_1 \times \text{CAP}_2) + (\text{CAP}_1 \times \\ &\quad \text{INC}_2). \end{aligned}$$

Notice that this expression has two extra interaction terms, $\text{INC}_1 \times \text{CAP}_2$ and $\text{CAP}_1 \times \text{INC}_2$, that are not present in the sum of the linked income component return and linked capital component return. As a result, the linked total return for this two-quarter period will not equal the sum of the linked income return and linked capital return for the same two-quarter period unless the sum of the interaction terms is zero, which is typically not the case. In other words, the income return plus the capital return typically not equal the total return for a multi-period geometrically linked return. Please note that the interaction amounts are usually not presented in the compliant presentation.

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Disclosure

For periods prior to 1 January 2011, firms must disclose if component returns are adjusted to make the sum of the annual income and capital component returns equal the annual total return.

Sample Disclosure:

“For periods prior to 1 January 2011, [insert “income” and/or “capital”] component returns were adjusted such that the sum of the annual income and capital component returns equals the annual total return.”

Firms must disclose when component returns are calculated separately using geometrically linked time-weighted rates of return.

Sample Disclosure:

“The sum of the annual income and capital component returns does not equal the annual total return due to the geometric linking of quarterly component returns that are calculated separately.”

3 Explanation of the Provisions of the GIPS Standards

The following solution uses the Modified Dietz method to calculate time-weighted returns. A quarterly numerator and denominator are calculated in order to derive each quarterly return. The numerator represents the amount earned for the period. The denominator represents the weighted average equity for the period: the amount on which the return is earned. In order to calculate the denominator, the Modified Dietz method day-weights external cash flows during the period in order to derive the weighted average equity for the period. In this example, the quarterly income return plus capital return will equal the quarterly total return because composite returns are assumed to be calculated quarterly. In other words, there is no mathematical (geometric) linking of the component returns within the quarter. When component returns are mathematically linked to derive a multi-period return, the two component returns will no longer sum to the total return. For example, the annual income return and capital return will not sum to the annual total return. The information below is a suggested solution to calculate the component returns. Please note that additional methods (formulas) exist that could also be used to calculate the answers presented below.

The following calculations are presented below for illustrative purposes: (1) day-weighted contributions, (2) day-weighted distributions, (3) capital employed (weighted average equity), (4) gross-of-fees income return, (5) gross-of-fees capital return, (6) gross-of-fees total return, (7) net-of-fees income return, (8) net-of-fees capital return, and (9) net-of-fees total return.

(1) Day-Weighted Contributions	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Description Reference from Problem
Contribution Amount	1A	300,000,000	150,000,000			Contributions from investors
Date Contributions Received		1 January 20XX	10 April 20XX			Date contributions received
Days Contributions Are in the Fund for the Quarter	1B	90	82			
Days in Quarter	1C	90	91			
Pro-Rated Factor	1D = 1B/1C	1.00	0.90			
Day-Weighted Contributions	1E = 1A × 1D	300,000,000	135,164,835			
(2) Day-Weighted Distributions	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Description Reference From Problem
Distribution Amount	2A		10,000,000	55,000,000		Distributions to investors
Date Distributions Paid			12 July 20XX	3 November 20XX		Date distributions paid
Days Distributions Are out of the Fund for the Quarter	2B		80	58		
Days in Quarter	2C		92	92		
Pro-Rated Factor	2D = 2B/2C		0.87	0.63		
Day-Weighted Distributions	2E = 2A × 2D		8,695,652	34,673,913		
(3) Capital Employed (denominator)	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Description Reference From Problem
Beginning Net Assets	3A	—	296,789,375	472,915,375	509,969,250	Net assets
Plus Day-Weighted Contributions	1E	300,000,000	135,164,835			
Less Day-Weighted Distributions	2E		(8,695,652)	(34,673,913)		
Capital Employed (denominator)	3D = 3A + 1E + 2E	300,000,000	431,954,210	464,219,723	475,295,337	

(continued)

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(4) Gross-of-Fees Income Return	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Description Reference From Problem	Annual Return Year Ended 31 December 20XX
Net Investment Income, after Fees	4A	5,264,375	8,001,000	8,703,875	7,512,000	Net investment income, after fees and expenses	
Add Back Investment Management Fees	4B	750,000	1,125,000	1,125,000	1,125,000	Investment manage- ment fees	
Net Investment Income, before Fees	4C = 4A + 4B	6,014,375	9,126,000	9,828,875	8,637,000		
Capital Employed (denominator)	3D	300,000,000	431,954,210	464,219,723	475,295,337		
Gross-of-Fees Income Return	4C/3D	2.00%	2.11%	2.12%	1.82%		Annual gross-of-fees income return calculation: [(1 + .0200) × (1 + .0211) × (1 + .0212) × (1 + .0182)] – 1 = 8.30%

(5) Gross-of-Fees Capital Return	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Description Reference From Problem	Annual Return Year Ended 31 December 20XX
Net Realized and Unrealized Gain (loss), after Fees	5A	(8,475,000)	18,125,000	38,350,000	15,950,000	Net realized and unrealized gain (loss), after fees	
Add Back Unrealized Incentive Fees	5B	—	—	8,400,000	2,800,000	Unrealized incentive fees	
Net Realized and Unrealized Gain (loss), before Fees	5C = 5A + 5B	(8,475,000)	18,125,000	46,750,000	18,750,000		
Capital Employed (denominator)	3D	300,000,000	431,954,210	464,219,723	475,295,337		
Gross-of-Fees Capital Return	5C/3D	-2.83%	4.20%	10.07%	3.94%		Annual gross-of-fees capi- tal return calculation: [(1 + -.0283) × (1 + .0420) × (1 + .1007) × (1 + .0394)] – 1 = 15.84%

(continued)

(6) Gross-of-Fees Total Return	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Annual Return Year Ended 31 December 20XX
Increase (decrease) in Net Assets Resulting from Operations, after Fees	6A = 5A + 4A	(3,210,625)	26,126,000	47,053,875	23,462,000	
Add Back All Investment Management Fees, including Incentive Fees	6B = 5B + 4B	750,000	1,125,000	9,525,000	3,925,000	
Increase (decrease) in Net Assets Resulting from Operations, before Fees	6C = 6A + 6B	(2,460,625)	27,251,000	56,578,875	27,387,000	
Capital Employed (denominator)	3D	300,000,000	431,954,210	464,219,723	475,295,337	
Gross-of-Fees Total Return	6C/3D	-0.82%	6.31%	12.19%	5.76%	Annual gross-of-fees total return calculation: $[(1 + -.0082) \times (1 + .0631) \times (1 + .1219) \times (1 + .0576)] - 1 = 25.10\%$
Check: Gross-of-Fees Income Return + Gross-of-Fees Capital Return	(4C/3D) + (5C/3D)	-0.83%	6.31%	12.19%	5.76%	

(7) Net-of-Fees Income Return	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Annual Return Year Ended 31 December 20XX
Net Investment Income, after Fees	4A	5,264,375	8,001,000	8,703,875	7,512,000	
Capital Employed (denominator)	3D	300,000,000	431,954,210	464,219,723	475,295,337	
Net-of-Fees Income Return	4A/3D	1.75%	1.85%	1.87%	1.58%	Annual net-of-fees income return calculation: $[(1 + .0175) \times (1 + .0185) \times (1 + .0187) \times (1 + .0158)] - 1 = 7.24\%$

(continued)



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(8) Net-of-Fees Capital Return	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Annual Return Year Ended 31 December 20XX
Net Realized and Unrealized Gain (loss), after Fees	5A	(8,475,000)	18,125,000	38,350,000	15,950,000	
Capital Employed (denominator)	3D	300,000,000	431,954,210	464,219,723	475,295,337	
Net-of-Fees Capital Return	5A/3D	-2.83%	4.20%	8.26%	3.36%	Annual net-of-fees capital return calculation: [(1 + -.0283) × (1 + .0420) × (1 + .0826) × (1 + .0336)] - 1 = 13.30%
(9) Net-of-Fees Total Return	Formula	Quarter Ended 31 March 20XX	Quarter Ended 30 June 20XX	Quarter Ended 30 September 20XX	Quarter Ended 31 December 20XX	Annual Return Year Ended 31 December 20XX
Increase (decrease) in Net Assets Resulting from Operations, after Fees	6A	(3,210,625)	26,126,000	47,053,875	23,462,000	
Capital Employed (denominator)	3D	300,000,000	431,954,210	464,219,723	475,295,337	
Net-of-Fees Total Return	6A/3D	-1.07%	6.05%	10.14%	4.94%	Annual net-of-fees total return calculation: [(1 + -.0107) × (1 + .0605) × (1 + .1014) × (1 + .0494)] - 1 = 21.26%
Check: Net-of-Fees Income Return + Net-of-Fees Capital Return	(4A/3D) + (5A/3D)	-1.08%	6.05%	10.13%	4.94%	

Please note that the gross-of-fees income return plus the gross-of-fees capital return does not equal the gross-of-fees total return for the quarter ended 31 March 20XX. Similarly, the net-of-fees income return plus the net-of-fees capital return does not equal the net-of-fees total return for the quarters ended 31 March 20XX and 30 June 20XX. The 1 basis point difference is solely due to rounding.

3-7 PRIVATE EQUITY

Introduction

For purposes of compliance with the GIPS standards, private equity encompasses investment in nonpublic companies at various stages of development and includes venture capital, buyout, mezzanine, and some distressed securities investing. Private equity also includes investments in public companies with the intent of taking them private or investments directly in public companies through structures known as PIPEs (private investment in public equity).

Private equity investments can be made in virtually any industry or geographic sector. Venture capital investments normally take a minority equity position in a company, while buyout funds will take a controlling position in or total ownership of a company. As the industry has evolved, it has become more specialized, providing prospective clients with investment opportunities outside of the investment categories popular even in the recent past.

The private equity industry has evolved from being principally composed of primary fund vehicles investing in individual companies to a complex mix of primary fund vehicles, secondary fund vehicles, funds of funds, direct investments, co-investments, and sponsored primaries, among others. The industry has evolved to the extent that some investment strategies that were novel some years ago are now common. For example, historically, investors in funds invested only in the funds themselves. It is now common for investors to invest directly in companies rather than only in funds. Private equity investments may overlap investments in sectors also invested in by other asset classes, such as real estate. As a result, there has been increasing interest in how the overlap creates issues for harmonizing the provisions among the various asset classes.

Investments by private equity vehicles may include investments in individual companies, in other funds, in debt securities, and in infrastructure projects, among others. Technically, all of those investments are ultimately investments in securities because the investor takes some ownership position; therefore, these collectively will be termed “underlying investments” for purposes of this guidance.

3-7

Investment Vehicles

Investments in private equity are made through a variety of investment vehicles. This is generally done through fund vehicles that are referred to in these provisions as “primary funds” or through a fund of funds.

Primary Funds

Primary funds are investment vehicles that make investments in individual companies, which are typically termed “portfolio companies.” The strategy of the fund may be broad or may have a specific investment stage and/or geographic focus.

Funds of Funds

Funds of funds invest in primary funds rather than directly in portfolio companies (also see the section on co-investment later in this section) with the fund of funds taking a position as an investor in the underlying primary funds.

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Secondary Funds

Secondary investment funds, which themselves may be structured either as a primary fund or a fund of funds, acquire an interest in a private equity fund from one or more of the original investors before the end of the fund's fixed life.

There are also specialized secondary funds that focus on acquiring portfolio companies from other private equity funds. These are typically seen as another type of primary fund and are not synonymous with secondary funds that acquire interests in private equity funds and thus must be considered a primary fund for compliance purposes.

There is often confusion as to the difference between a secondary fund and a fund of funds because both have interests in other primary funds. The difference is that a fund of funds is typically an original investor in an underlying fund while a secondary fund acquires the interest from another investor. There are exceptions because a fund of funds may make an opportunistic secondary investment, but its primary focus is to be an original investor.

Co-Investment

In some instances, an investor in a primary fund may invest directly into portfolio companies alongside the primary fund. A fund of funds may also invest directly in portfolio companies alongside its underlying funds. These are termed "co-investments." To take advantage of this particular investment, there are now specialized funds that focus on co-investments.

Investment Flows

When investing in private equity through a closed-end primary fund or closed-end fund of funds, an investor makes an initial commitment of capital that is then "called" or drawn down as the investment manager of the primary fund or the investment managers of the underlying funds in a fund of funds find investment opportunities. Capital is returned to the investor via distributions on the sale or recapitalization of individual portfolio companies by the private equity funds, although in some cases, investors may also receive earnings-derived distributions.

Private equity investment vehicles typically have a limited life (i.e., they are not open ended) and are generally illiquid. The ultimate return of the private equity investment vehicle is not known until the fund or partnership is finally liquidated. Because of the unique characteristics of this asset class, additional performance reporting requirements are needed. The GIPS standards, which are based on the principles of fair representation and full disclosure, seek to provide prospective clients with the critical pieces of information needed to evaluate the firm's performance.

Compliance

Compliance with the GIPS standards can only be achieved on a firm-wide basis and requires adherence to not only the private equity provisions but also all provisions in Sections 0-5 in Chapter I of the GIPS standards, unless otherwise noted.

Valuations

Accounting standards up through the 1990s were driven in part by an overriding principle of prudence, seeking to protect investors and creditors from overstatements of asset values and profits. Traditional valuation methodologies, such as the use of historical cost, were easy to justify, thus placing a burden of proof on those seeking to deviate from conservative valuations. However,

there are a number of shortcomings in historical cost methods, which led to pressure for change. Although the precise tipping point for change from a historical cost basis differed by jurisdiction, it became apparent over various market cycles that in some cases conservatism can operate against the interests of some stakeholders.

For example, the historical cost approach has an outward appearance of being conservative and thus in the best interest of stakeholders. However, the use of historical cost can become a defense against the proper write-down of impaired investments. Conversely, the true value of a company's assets may be materially understated, leading to a potentially undervalued takeover bid. Furthermore, as valuation methodologies in public markets became more sophisticated by incorporating cash flows, brand values, the value of intellectual property, and earnings growth, traditional balance sheet conservatism became a less compelling approach.

Fair Value

It has been the position of the GIPS Executive Committee (and previously the Investment Performance Council) for some time that fair value is the most appropriate way to view private equity valuations. It was recommended that a fair value basis be used to value private equity investments in the 2005 edition of the GIPS standards. As fair value is progressively adopted as the preferred industry practice, and is mandated by various accounting standards, the GIPS standards require the use of fair value for all investments, including private equity investments, as of 1 January 2011.

Scope

The following are provisions that apply to the calculation and presentation of private equity investments made by fixed-life, fixed-commitment private equity investment vehicles, including primary funds and funds of funds. These provisions also apply to fixed-life, fixed-commitment secondary funds, which must apply either the provisions applicable to primary funds or the provisions applicable to funds of funds, depending on which form the secondary fund uses to make investments. Private equity open-end and evergreen funds must follow Sections 0–5 in Chapter I of the GIPS standards. Real estate closed-end funds must follow Section 6 in Chapter I of the GIPS standards.

3-7

Investment Structures

Closed-End Fund Vehicles (GIPS private equity provisions are applicable)

The predominant vehicle in the global private equity industry is the independent, private, fixed-life, closed-end fund. These vehicles may be organized in a variety of legal forms (e.g., limited partnership, trust, unit trust) depending on the jurisdiction. A firm may have several funds in existence at any one time, each of which is independent from the others. These funds by and large have a defined “start date” and most often have a fixed life (typically ten years) that can be extended by a pre-set number of defined periods (e.g., two one-year periods) upon agreement of the investors. This is termed a closed-end fund because the number of investors/shares is fixed for the life of the fund and closed to new investors, although ownership interest may be transferred (sold) to another investor under certain circumstances. This also means that the capital available for investment (capital commitments) is also fixed for the life of the fund.

An example of a closed-end fund vehicle is the limited partnership. A limited partnership is the most common structure used in the United States and is a fund of pooled interests managed by a general partner (generally an affiliated entity of the firm) who raises capital (i.e., committed capital)

3 Explanation of the Provisions of the GIPS Standards

from outside investors (limited partners). The general partner charges an investment management fee, typically from 1% to 3% per annum, on the total committed capital. Most funds require at least a nominal 1% investment by the general partner. In addition, the general partner will take a profit split (known as the “carried interest” or simply the “carry”) of usually 20% of profits.

The general partner will “call” the capital from the limited partners in tranches as needed for investment in underlying companies. These capital calls are also termed “drawdowns” or “take-downs.” The cumulative capital calls are known as paid-in capital. Another unique feature of this type of vehicle is that any proceeds from investments must be distributed to the limited partners; reinvestment is only permitted if allowed in the contract (known as a limited partnership agreement [LPA] or partnership agreement) between the general partner and the limited partners. In recent years, there has been an increasing number of cases where (by agreement) distributions may be recalled for subsequent investment. In addition, committed capital in these vehicles cannot be withdrawn (“redeemed”), as is the case in other pooled investment vehicles, such as hedge funds. In a typical private equity limited partnership, the cash flows are easy to enumerate because return is calculated on the basis of the cash flows between the partners (general and limited) and the fund. The investment management fee is generally charged on the total assets committed to the fund by the limited partners rather than on the value of the invested capital of the fund.

Funds of Funds (GIPS private equity provisions are applicable)

A fund of funds is a special type of fund vehicle that makes investments in primary private equity funds rather than in individual portfolio companies. The private equity fund of funds operates much like a primary fund vehicle except that the underlying investments are funds rather than companies. Recognizing that funds of funds do not necessarily control the underlying funds in which they invest, it is not necessary for each underlying fund in a fund of funds to be in compliance with the GIPS standards in order for the fund of funds firm to be compliant. A closed-end fund of funds that invests in open-ended vehicles would be required to follow the private equity provisions. Funds of funds must meet all relevant private equity requirements at the fund of funds level. Unless otherwise noted, each private equity provision applies to fund of funds vehicles.

Direct Investments and Co-Investments (GIPS private equity provisions are applicable)

Although an investment by a primary fund into a portfolio company is technically a “direct investment,” because the investment is made directly into the company, the term is generally applied to separate investments in companies by investors outside of a primary fund. For example, an investor who invests directly in a company is said to be making a direct investment, rather than investing through a fund. Co-investments are a special case of direct investments where an investor in a fund makes a direct investment in a portfolio company along with the fund. This is generally allowed in a pre-established co-investment agreement. In many cases the direct investment or co-investment will have a different fee structure than a comparable investment in a fund. It is not uncommon for these co-investments to be “no-fee, no-carry” transactions. If a composite includes any non-fee-paying portfolios, the firm must present, as of each period-end, the percentage of the composite that is represented by non-fee-paying portfolios.

Side-by-Side Vehicles (GIPS private equity provisions are applicable)

There are instances in which parallel vehicles are created that invest alongside a primary fund for reasons such as individual client accommodation, jurisdictional considerations, or tax considerations. The vehicle itself usually invests on a pro-rata basis with its affiliated primary fund. Best practice is for firms to disclose if there is a side-by-side vehicle associated with a fund. While the terms and conditions for the side-by-side vehicle may be significantly different from those of the primary fund, if the side-by-side vehicle has a similar strategy and the same vintage year as the primary fund, the side-by-side vehicle must be included in the same composite as the primary fund. In the case that a side-by-side vehicle is materially different in strategy or other characteristic from the primary fund, then the side-by-side vehicle should be included in a separate composite.

Evergreen Funds (GIPS private equity provisions are not applicable)

In contrast to the typical closed-end, fixed-life limited partnership (described earlier) there are investment vehicles that are neither fixed life nor fixed commitment. They are often called “open-end funds” or “evergreen funds.” While they do not have the same structure as a limited partnership, they may make the same type of investments into venture capital, buyouts, distressed debt, and similar investments and are usually also classified as private equity funds. However, the GIPS standards have excluded these from application of the private equity provisions, even though they may make the same type of investments. The investment structure typically doesn’t lend itself to the same type of treatment as the closed-end, fixed-life fund.

To understand why the private equity provisions do not apply, it should be understood that the basic metric and industry practice used in measuring performance in the private equity industry is the since inception internal rate of return (SI-IRR). In the typical open-ended vehicle without a fixed amount of committed capital, an investment manager does not have control over the timing of the cash flows. While an SI-IRR can technically be calculated for such a cash flow stream, a time-weighted return is more appropriate given the cash flow stream and the decision process being measured. For this reason, evergreen vehicles are not good candidates for using the SI-IRR but, rather, are best treated using a time-weighted rate of return (TWRR) calculation.

As a result, the private equity provisions exclude funds that have an evergreen structure and require that they instead comply with the provisions in Sections 0-5 in Chapter I of the GIPS standards. The exception is the special case of evergreen funds of funds where the GIPS private equity provisions can be applied (see discussion later in this section).

Captive and Semi-Captive Funds (GIPS private equity provisions are applicable if funds are closed end)

Some private equity vehicles are organized as captive vehicles or semi-captive vehicles. Captive refers to a fund that only invests for the interest of its owner organization (e.g., corporation, university, foundation). The salient feature is that the fund only invests its parent’s capital; there are no outside investors. Corporate venture groups of technology companies are examples of this type of vehicle, although several insurance companies and investment banks also have similar vehicles. A captive or semi-captive vehicle that is closed end would qualify for private equity provisions application.

A semi-captive vehicle is a vehicle that invests both parent entity capital as well as outside capital. These funds normally charge an asset-based investment management fee and/or carried interest to the outside investors, and are usually closed end because the number of investors is fixed, although a number of evergreen semi-captive funds also exist. If a captive or semi-captive vehicle is a closed end vehicle, then the GIPS private equity provisions apply. If the vehicle is evergreen, the GIPS private equity provisions do not apply.

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Open-End Funds (GIPS private equity provisions are not applicable)

Another investment structure is an open-end investment vehicle that acts much like a publicly quoted mutual fund. The fund is an investment vehicle that is traded on an exchange and priced daily. In addition, there are open-ended vehicles that, although not traded on an exchange, may be “priced” monthly. In these open-end investment vehicles, where the investment manager does not have control of the timing of cash flows from its investors, the IRR calculation is not appropriate. These types of open-end investment vehicle must adhere to the provisions in Sections 0-5 in Chapter I of the GIPS standards, rather than the private equity provisions.

Special Case of Evergreen Funds of Funds (GIPS private equity provisions can be applied)

The private equity provisions generally exclude evergreen open-ended vehicles. While not explicit in the provisions, there is one exception to the applicability of the private equity provisions. The private equity provisions of the 2010 edition of the GIPS standards provide funds of funds with the ability to define composites by vintage year of the funds of funds or by strategy. This flexibility accommodates a common type of structure used by funds of funds that have characteristics of an evergreen vehicle but the terms and structure resemble a typical private equity investment. This particular vehicle has the following characteristics:

- It is an open-end fund of funds vehicle that is neither publicly traded nor available to the general public.
- It does not have a finite life and is in essence evergreen.
- It invests in private equity funds as is typical for a fund of funds as either a limited partner or external investor. The fund of funds manager has full discretion regarding selection of the underlying funds. The underlying funds are managed by independent third-party managers/general partners. The fund of funds manager does not influence the investment decisions taken by those third-party managers. The fund of funds may also have other co-investments with the underlying funds.
- The fund of funds typically invests by strategy rather than by vintage year.
- The manager of the fund of funds charges a management fee to the investors.
- The timing and size of external cash flows into/from the fund of funds are determined by the third-party managers managing the underlying funds as they call the capital to make use of the investment opportunities or make distributions.

A vehicle of this structure may, but is not required to, comply with the private equity provisions that apply to funds of funds. If an evergreen fund of funds vehicle meets the above criteria and chooses to apply the private equity provisions, it must also comply with all of the private equity requirements in Section 7 of Chapter I of the GIPS standards. Alternatively, these vehicles can apply the provisions in Sections 0-5 of Chapter I of the GIPS standards.

Determining the Non-GIPS-Compliant SI-IRR Performance Period for Private Equity Composites

The private equity provisions require that private equity composites present the since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm’s inception or the composite inception date if the

firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The measurement period for an SI-IRR is the period from the inception date of the investment vehicle and/or composite through the end of the period that is being reported. Please note that the term “since inception” is independent of the calculation method used. For example, it is possible to calculate a “since inception time-weighted rate of return.” Although it is not required or recommended in the GIPS standards, it is also possible to calculate an IRR between any two points in time within an investment period that is not necessarily since inception.

In a “since inception” IRR calculation, the beginning date remains constant and does not change. The measurement period for an SI-IRR becomes increasingly longer as the ending date is extended, whereas the beginning date is constant. A TWRR, as typically disclosed in a compliant presentation, does not have a constant beginning date like an SI-IRR but, rather, is a mathematical linking of several interim independent sub-periods. Conversely, an SI-IRR has only one measurement period—from inception to the end of the period being measured, with no linking of interim independent sub-periods.

It is necessary to use the period-end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period-end, starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Private Equity—Requirements

Input Data—Requirements

Provision 7.A.1

For periods ending on or after 1 January 2011, PRIVATE EQUITY investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II of the GIPS standards.

Discussion

Performance reporting is of little value unless the underlying valuations are based on sound valuation principles. The GIPS Valuation Principles, including requirements and recommendations specific to private equity, establish a broad foundation for valuing investments. In order to create comparable valuations for consistent performance calculation, private equity investments must be

3 Explanation of the Provisions of the GIPS Standards

valued in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II of the GIPS standards. For periods ending prior to 1 January 2011, private equity investments must be valued according to either the GIPS Private Equity Valuation Principles in Appendix D of the 2005 edition of the GIPS standards or the GIPS Valuation Principles in Chapter II of the 2010 edition of the GIPS standards.

These broad principles can be supplemented with more detailed valuation guidelines, such as the standardized methods used for valuing private equity investments presented in the International Private Equity and Venture Capital Valuation (IPEV) Guidelines.

Fund Reporting and Valuation Considerations In some instances, the concept of fair value is misunderstood as being the same as “market value.” However, although related, they are not the same. At any point in time, a private equity portfolio’s valuation may be different from market prices due to an inherent lag effect in the industry. In private equity reporting, there is typically a lag effect in valuation reporting because a private equity fund has to apply the firm’s valuation methodology to portfolio investments, accumulate its total portfolio valuations, and report this information to its investors. The reporting lag inherent in this process means that there can be a valuation lag of a quarter or, in some cases, even longer. Thus, a 31 March valuation may be what is termed a roll-forward valuation (i.e., a valuation based on 31 December of the prior year adjusted by interim cash flows between 1 January and 31 March). This has the added effect that valuations of private equity holdings may not be contemporaneous with marketable securities that can truly be “marked to market.”

If these roll-forward valuations are used, firms must assess to what extent the estimated values represent the current fair value (and can be used for GIPS compliance purposes), or if the final values should be used, and how they will fit within the composite-specific valuation policies and procedures. Two possible scenarios include, but are not limited to, the following:

1. 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.
2. The firm uses estimated values to determine fair value and produce the compliant presentation on a timely basis. If using estimated values provided by third parties, the firm should obtain an understanding of the process for determining estimated values and determine whether reliance can be placed on this process. After the final values have been determined, the firm must assess the differences between the estimated and final 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 the compliant presentation for that composite must be adjusted on a prospective basis and whether any additional disclosure of this adjustment may be required. Firms must also consider if the compliant presentation should be revised retroactively according to the composite-specific valuation policies and procedures. If composite valuations are revised retroactively, firms must consider the Guidance Statement on Error Correction and the firm’s error correction policies.

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 should consider disclosing this fact in compliant presentations to provide enough information for a prospective client to interpret the performance record. The GIPS standards state that firms must not present performance or performance-related information that is false or misleading.

Portfolio Company Reporting Considerations Given the subjective methods used in private equity valuation, it should be noted that two funds invested in the same company may agree on a valuation on the date of initial or subsequent investment but at other times it may be possible, and is likely, that valuations may diverge because there is no market price and each firm invested in the portfolio company can use its own valuation methodologies to value those investments.

Provision 7.A.2

PRIVATE EQUITY investments MUST be valued at least annually.

Discussion

In Sections 0-5 in Chapter I of the GIPS standards, portfolios are required to be valued monthly for periods beginning on or after 1 January 2001 and portfolios must be valued at the time of all large cash flows for periods beginning on or after 1 January 2010. In a calculation where time-weighted returns are used, valuations at key cash flow events and at period-end are needed because those valuations become terminal values in the time-weighted return. In a true time-weighted return calculation, sub-period returns are calculated between each valuation and geometrically linked together to derive a return for the period.

The GIPS standards require an SI-IRR rather than a TWRR for private equity portfolios. In an SI-IRR, valuations are only needed at the end of the period being measured. Valuations in private equity investments are generally performed on a less frequent basis because they are not liquid securities. Typically, valuations are reported on a quarterly basis rather than monthly or daily. The GIPS standards require private equity investments to be valued at least annually in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II of the GIPS standards. Quarterly valuations are recommended. In addition, firms must value portfolios as of the calendar year-end or the last business day of the year for periods ending on or after 1 January 2006.

The practical implication of this is that private equity portfolios typically have quarterly valuations but must be valued at least once in a 12-month period. Most private equity firms have annual audits for their funds, meaning that this year-end valuation will most likely be the valuation used for compliance with the GIPS standards. More frequent valuations are generally required for client reporting purposes and are considered good business practice; thus, the GIPS standards recommend quarterly valuation for private equity.

3-7

Calculation Methodology—Requirements

Provision 7.A.3

FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).

3 Explanation of the Provisions of the GIPS Standards

Discussion

An investment manager should not be rewarded or penalized for investment decisions outside of his or her control. In an open-end fund, the timing of cash flows into and out of the fund is usually not at the discretion of the investment manager. As a result, the time-weighted rate of return, which adjusts for the effect of the timing of the cash flows in the portfolio, is required for open-end funds.

On the other hand, in a fixed-life private equity fund, the decisions to raise capital, draw down capital in the form of capital calls, and distribute proceeds are all at the discretion of the private equity manager. The timing of cash flows is part of the investment decision process. The private equity firm's performance must reflect the results of those timing decisions; and thus, the IRR is required.

In general, the IRR is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. The SI-IRR is a specific version of the IRR where the measurement period covers the entire investment period since inception.

The IRR is the return for which the net present value of a cash flow series is equated to zero and is calculated as follows:

$$0 = \sum_{i=0}^I CF_i (1 + r_{IRR})^{-\left(\frac{t_i}{365}\right)},$$

where

CF_i = cash flow i [negative values for inflows (paid-in capital) and positive values for outflows (distributions)]

i = number of cash flows (1, 2, ..., I) during the measurement period

r_{IRR} = annualized internal rate of return

t_i = number of calendar days between the beginning of the measurement period and the date of cash flow i

The since inception internal rate of return (SI-IRR) is a special version of the IRR where the period-end value of the investment is treated as a synthetic terminal cash outflow and is calculated as follows:

$$0 = \left[\sum_{i=0}^I CF_i (1 + r_{SI-IRR})^{-\left(\frac{t_i}{365}\right)} \right] + \left[V_E (1 + r_{SI-IRR})^{-\left(\frac{TD}{365}\right)} \right],$$

where

CF_i = cash flow i [negative values for inflows (paid-in capital) and positive values for outflows (distributions)]

i = number of cash flows (1, 2, ..., I) during the measurement period

r_{SI-IRR} = annualized since inception internal rate of return

t_i = number of calendar days between the beginning of the measurement period and the date of cash flow i

TD = total number of calendar days in the measurement period

V_E = value of the investment at the end of the measurement period. In the case of closed-end funds, this is typically the net asset value at the end of the measurement period

Note: the above annualized formula assumes a 365 day per year convention and may have slight inaccuracies when the measurement period contains a leap year(s).

Firms must calculate and present the annualized SI-IRR. If the period is less than a full year, firms must present the non-annualized SI-IRR. The non-annualized SI-IRR is calculated as follows:

$$R_{SI-IRR} = \left[\left(1 + r_{SI-IRR} \right)^{\frac{TD}{365}} \right] - 1,$$

where

R_{SI-IRR} = non-annualized since inception internal rate of return

r_{SI-IRR} = annualized since inception internal rate of return

TD = total number of calendar days in the measurement period

Note: the above formula assumes a 365 day per year convention and may have slight inaccuracies when the measurement period contains a leap year(s).

Provision 7.A.4

For periods ending on or after 1 January 2011, the SI-IRR MUST be calculated using daily cash flows. Stock DISTRIBUTIONS MUST be included as cash flows and MUST be valued at the time of DISTRIBUTION.

Discussion

Using daily cash flows to calculate the SI-IRR results in a more accurate return. For private equity investments, the GIPS standards require daily cash flows for periods after 1 January 2011 and recommend daily cash flows for periods prior to 1 January 2011. For periods prior to 1 January 2011, the SI-IRR must be calculated using either daily or monthly cash flows.

The date of the incoming cash flow (paid-in capital) is intended to reflect the date the firm obtains control of the capital from the investor, which is not necessarily the date the capital is invested in underlying companies (in the case of a primary fund) or funds (in the case of a fund of funds). For practical purposes, this should be the date of the capital call because there may be a day or so lag in between the date of the capital call and the date the investor actually delivers the capital. Similarly, the date of the distribution is the date the distribution is returned to the investor, which is not necessarily the date the firm receives the proceeds from the underlying investment because there may be a lag between the date of the distribution notice to investors and the date the investor actually receives the proceeds.

There has been confusion as to what daily cash flows mean and how to reconcile daily cash flows with historical results based on cash flows with a different frequency. Using daily cash flows means that the cash flows are dated on the date the cash flows occur—for example, the date of the capital call or the date of the distribution. Due to the administrative burden, historically, cash flows have been accounted for on a less frequent basis. For some funds in the 1980s, cash flow data were aggregated on a quarterly basis or even, in some cases, on an annual basis. (The same is still true in some emerging markets today.) Since cash flows were usually reported on a quarterly basis (or, in some cases, on an annual basis), there was little reason to calculate returns with cash flows on a more frequent basis, even if available.

There were practical reasons for this practice aside from the administrative burden. Before the advent of the modern financial calculator, it was very difficult to calculate an SI-IRR. There were approximations and formulas for calculating both the TWRR and the IRR, such as the Dietz and

3 Explanation of the Provisions of the GIPS Standards

the Modified Dietz methods. Some methods attempted to approximate daily cash flows. However, these methods were still not as accurate as a daily cash flows stream incorporating the actual dates of the cash flows.

Even with the introduction of spreadsheets, the ability to create a spreadsheet that used daily cash flows meant creating extremely large and cumbersome spreadsheets because these tools typically needed an entry for every date from beginning to end even if the date didn't have a cash flow.

Software products addressed this issue, and certain spreadsheets and performance systems only require dates on which cash flows actually occurred. However, monthly cash flow streams are still often used. In some cases, whole businesses have been created to consolidate cash flows into monthly streams in order to accommodate legacy performance measurement systems. Daily cash flow conventions are now the norm and are not difficult to produce with systems now available.

The principal issue is dealing with legacy cash flows streams that might be dated monthly for periods prior to 1 January 2011. While it may not be as accurate as requiring reconstruction of a daily cash flow stream historically, the administrative burden and cost of reconstruction would be difficult to justify given the benefit gained. When constructing such a stream historically, the firm must assume that all cash flows occurred on a particular date in the month regardless of the actual date of the cash flow. If monthly cash flows are used with daily cash flows in the same cash flow stream, the IRR formula must use a daily compounding convention for the entire cash flow stream. Thus, a firm that dates cash flows at month-end prior to 1 January 2011 and then uses daily cash flows after 1 January 2011 would compound the entire stream daily to be in compliance with the GIPS standards. While the resultant SI-IRR is not as precise as retroactively reconstructing the daily cash flows, the difficulty of daily cash flow reconstruction means that combining the monthly and daily cash flow streams is a reasonable accommodation.

Provision 7.A.5

All returns **MUST** be calculated after the deduction of actual **TRANSACTION EXPENSES** incurred during the period.

Discussion

Fees and expenses must be evaluated to determine their proper treatment when calculating returns. Firms are required to deduct actual transaction expenses incurred during the period when calculating both gross-of-fees and net-of-fees returns. Transaction expenses include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing portfolio investments as well as trading expenses, if any.

Provision 7.A.6

NET-OF-FEES returns **MUST** be net of actual **INVESTMENT MANAGEMENT FEES** (including **CARRIED INTEREST**).

Discussion

For both primary funds and funds of funds, private equity investment management fees usually include two components: an asset-based management fee (based on either invested or committed capital) that is paid on an ongoing basis and/or a performance-based fee, known as carried interest, which is accrued and paid as typically agreed in the limited partnership agreement. Collectively, these fees are referred to as investment management fees. Firms are required to deduct these actual investment management fees when calculating net-of-fees returns. Carried interest can often have a greater impact than the asset-based management fee.

When calculating net-of-fees returns, the terminal value should be net of investment management fees (which include carried interest) that have been accrued but not yet paid. The intent is to provide an estimate of what the limited partner would receive if the portfolio were liquidated, unrealized gains and losses were realized, and the fund's assets were distributed at the date of the performance calculation.

When calculating both gross-of-fees and net-of-fees returns, a firm may reflect the deduction of other expenses incurred at the primary fund or fund of funds level, such as administrative expenses, but it is not required to do so. In the case of an investment management firm that manages a fund of funds, the firm must calculate all returns that reflect the deduction of all of the underlying funds' investment management fees and other expenses. The firm must also deduct the fund of funds' investment management fees when calculating the net-of-fees return. The firm may also deduct other expenses from the fund of funds' net-of-fees return to arrive at what is generally referred to as a "net-net" return. Deducting this added layer of fees reflects the true return to the ultimate investor.

In practice, investment management fees can be paid either inside or outside of the investment vehicle, which can have an effect on returns. Firms should disclose how such fees are paid.

Provision 7.A.7

For FUNDS OF FUNDS, all returns MUST be net of all underlying partnership and/or fund fees and expenses, including CARRIED INTEREST.

3-7

Discussion

For funds of funds, all returns must be calculated after the deduction of actual transaction expenses incurred during the period. In addition, all expenses related to investments in underlying funds, whether or not they are reflected in the valuations of the underlying funds, must reduce both the gross-of-fees and net-of-fees SI-IRR. Note that this requirement also applies to the carried interest and investment management fees of the underlying funds. Such expenses might include management fees billed in addition to or outside of the limited partners' capital commitment or limited partner clawback expenses (e.g., portfolio company litigation) charged directly to the fund of funds. It is typically not possible to allocate the fund of funds level fees to the underlying portfolio investments individually because those fees are a joint cost and it would be arbitrary to allocate them down to the individual portfolio investments.

In addition to investment management fees and transaction expenses, fund of funds expenses used in calculating "net-net" returns to investors may include, but are not limited to, legal, auditing, consulting, accounting, and custodian fees and expenses; out-of-pocket expenses incurred in connection with transactions not consummated; expenses of the advisory board and annual meetings; premiums for insurance obtained by the fund of funds to protect it; taxes, fees, or other

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governmental charges levied against the fund of funds; organizational expenses up to a specified limit; expenses incurred in connection with the distribution of marketable securities; advertising and public notice costs; and costs of dissolving and liquidating the partnership.

Composite Construction—Requirements

The GIPS standards are structured around the concept of composites. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. In addition, primary funds must be grouped by vintage year such that funds with different vintage years are in different composites.

Firms must remember that the GIPS standards have requirements and recommendations regarding composite construction, which can be found in Section 3 in Chapter I of the GIPS standards as well as the Guidance Statement on Composite Definition. Most importantly, firms are required to include *all* fee-paying discretionary portfolios, including funds and partnerships, in at least one composite that is managed according to a particular investment mandate, objective, or strategy. Creating meaningful composites is critical to the fair presentation, consistency, and comparability of performance results over time and among firms. Firms must understand that the GIPS standards require a firm-wide level of compliance and are not for just selected composites or funds.

Firms should realize that all provisions and guidance related to composites apply to funds and partnerships if the fund or partnership is a single portfolio composite. For example, when the GIPS standards state that the annualized SI-IRR (since inception internal rate of return) must be presented for the composite, because each composite will typically contain only one fund or partnership, this will be the same as the annualized SI-IRR for the fund or partnership.

The following hierarchy may be helpful as firms consider how to define private equity composites:

Vintage Year

Strategy (e.g., venture, buyout, generalist, mezzanine, fund of funds, other private equity)

Sub-Strategy (e.g., size of fund, stage, geography)

3-7

Provision 7.A.8

COMPOSITE DEFINITIONS MUST remain consistent throughout the life of the COMPOSITE.

Discussion

The GIPS standards require that vintage year and investment mandate, objective, or strategy remain consistent through the life of the composite. Thus, a composite cannot change from being classified as a generalist private equity composite to a venture-focused composite, even though it may have invested in more venture deals as the strategy evolved. The vintage year selected for the composite must be consistent through the life of the fund to avoid gaming. There are two methods of classifying funds by vintage year: the year of the investment vehicle's first drawdown or capital call from its investors or the year when the first committed capital from outside investors is closed and legally binding. In most cases, a composite will contain only one fund/partnership. If a firm has multiple funds/partnerships (including side-by-side vehicles) with the same vintage year and strategy, they must be combined into a single composite. Side-by-side investment vehicles and

co-investments in underlying portfolio companies must be included in the same composite as the related primary fund if the side-by-side investment vehicle or co-investment meets the primary fund's composite definition.

Provision 7.A.9

PRIMARY FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR and investment mandate, objective, or strategy.

Discussion

The introduction outlined the features of the three most prevalent fund structures: the primary fund, the secondary fund, and the fund of funds. To review, a primary fund invests directly in portfolio companies or other underlying private equity investments. A fund of funds invests in primary fund vehicles rather than making direct investments in portfolio companies. A secondary fund buys partnership interests from other investors and may be organized as a primary fund or as a fund of funds. The private equity provisions apply to all of the above structures as long as they are fixed-life, fixed-commitment vehicles or evergreen fund of funds structures. Composite construction may be impacted by the investment vehicles' structure so it is important to note which composite construction requirements apply. A primary fund's composite definition will be a combination of vintage year and investment mandate, objective, or strategy. A secondary fund's composite inclusion will depend on whether it has structured itself as a primary fund (Provision 7.A.9 applies) or as a fund of funds (Provision 7.A.9 does not apply).

Provision 7.A.10

FUNDS OF FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR of the FUND OF FUNDS and/or investment mandate, objective, or strategy.

3-7

Discussion

A fund of funds is a vehicle that invests in private equity funds as an external investor. These underlying fund investments are not typically in the same vintage year and do not necessarily share the same investment mandate, objective, or strategy. Thus, a fund of funds might include investments in a 1998 venture fund, a 2003 buyout fund, a 2004 buyout fund, and a 2006 distressed fund. In addition, a fund of funds firm may have separately managed accounts that follow this same investment style but with different vintage years and strategies.

Requiring a firm to create fund of funds composites based on both vintage year and investment mandate, objective, or strategy was found to be impractical and not consistent with the information that prospective clients require for their fund of funds investments. Therefore, a firm may create fund of funds composites based on either vintage year of the fund of funds or investment mandate, objective, or strategy, or may choose to create a composite that considers both. In either case, all discretionary funds of funds must be included in at least one of the composites as discussed earlier. For examples of how a fund of funds firm could present composite performance, refer to Appendix A: Sample Compliant Presentations in the GIPS standards.

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Funds of funds have to be careful in their use of the term “vintage year.” In a fund of funds context, the generic term “vintage year” can refer to the vintage year of the fund of funds itself or the vintage year of the underlying fund vehicles in which it invests. In addition, a firm may have separately managed accounts that have a “subscription year,” which denotes the year an investor signed the investment agreement with the fund of funds. This is often also termed “vintage year.”

When the term “vintage year” is used to create a fund of funds composite, the term refers to the vintage year of the fund of funds vehicle itself. It does not refer to the vintage year of the underlying fund investments. However, Provision 7.A.22 does require that if a fund of funds composite is defined by strategy only, the firm must also provide performance of the underlying fund investments aggregated by the vintage year of the underlying investments. It is only in this context that the underlying fund investments’ vintage year is considered.

Disclosures—Requirements

Provision 7.A.11

FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.

Discussion

The disclosure of the vintage year increases transparency and comparability by allowing prospective clients to understand the time frame when the fund was initiated or first closed to investment.

The concept of the vintage year is to set a starting date so that funds started in the same year can be compared on an equal basis. While there may be several ways that start date could be determined, for compliance with the GIPS standards, the relevant start date is the vintage year of the fund. The GIPS standards require that the vintage year be determined by one of two methods: based on the year of the investment vehicle’s first drawdown or capital call from its investors or based on the year when the first committed capital from outside investors is closed and legally binding.

Historically, the vintage year was determined by the date of the first closing of a fund. This date typically also coincided with the fund’s first capital call for investments. As the industry evolved, there were more and more cases where the first close did not coincide with actual capital calls but instead were “dry closes,” where the fund closed its first commitments but drew no capital because it had no investments to make. Thus, another method evolved in which vintage year was defined by the date of the first capital call, whether for investment or management fees, rather than the first close.

These two methods are both legitimate methods of defining vintage year. The GIPS standards require disclosure of the vintage year and how the vintage year is defined for the composite. The vintage year chosen must be the same for the entire life of the composite.

It is important to note that the calculation of the SI-IRR relies on the first cash flow. The definition of vintage year does not impact the SI-IRR calculation, but it will have an impact on the benchmark that is chosen. The benchmark chosen to compare performance of the composite must reflect the same vintage year used for the composite.

Sample Disclosure:

“The vintage year of the Venture Capital Composite is 2001 and was determined by the year of the first drawdown of capital.”

Provision 7.A.12

FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.

Discussion

While most private equity funds generally have a 10-year life, it is common to have multiple extensions whereby some funds may have lives as long as 17 or 18 years. The residual value of the investments may be *de minimis* at that final liquidation date, but the longer the life, the lower the fund's SI-IRR will be, all other things being equal. At some point, the fund is finally liquidated either by disposing of the remaining investments or by writing off any remaining investments. The final liquidation date is the date when the last portfolio in a composite is fully distributed or written off.

Provision 7.A.13

FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period.

Discussion

Given the subjective nature of the judgments that are required in valuing private equity investments, it is important that the latest valuation methodologies used be disclosed. Portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles as of 1 January 2011. Any key assumptions and subjective judgments made should be disclosed.

Sample Disclosure:

“Accounting convention is U.S. GAAP. Partnership fund investments are carried at fair value as determined by the General Partner at its discretion. The Partnership's fund investments are generally carried at the valuations provided by the general partners or managers of such investments. The valuations provided by the general partners or managers of the underlying funds reflect the fair value of the Partnership's capital account balance of each fund investment, including unrealized gains and losses, and reflect the values as reported in the audited financial statements of the respective fund at the fund's fiscal year-end. The valuations used were based upon the fund managers' valuations as of [date] or at the latest available date. In reviewing these underlying valuations, the General Partner is advised by the Investment Advisor, who reviews the capital account balances and may adjust the value of each fund investment. The General Partner uses the market approach to estimate the fair value of private equity investments. The market approach utilizes prices and other relevant information generated by market transactions, including the type of security, size of the position, degree of liquidity, restrictions on the disposition, data from the latest round of financing, and current financial position and operating results, among other factors. In circumstances where fair values are not provided in respect of any of the partnership's fund investments,

3 Explanation of the Provisions of the GIPS Standards

the Investment Advisor will seek to determine the fair value of such investments based upon information provided by the general partners or managers of such funds or from other sources. Notwithstanding the above, the variety of valuation bases adopted and quality of management data of the ultimate underlying Investee companies means that there are inherent difficulties in determining the value of these investments. Amounts realized on the sale of these investments may differ from the values used to calculate returns and other fund measures used to prepare this composite presentation and the difference could be significant.”

Provision 7.A.14

For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies.

Discussion

Consistent with the recognition that valuations are a significant input into the performance equation and that the valuation of private equity investments involves the use of subjective estimates, for periods ending on or after 1 January 2011, firms are required to disclose material changes to valuation policies and/or methodologies that might affect performance results or make historical comparability of performance results difficult. This includes any changes to international guidelines that have had a material impact on valuation practices or adoption of different accounting principles, valuation policies or industry guidelines. Some examples of a material change include, but are not limited to, the following:

- new valuation principles adopted by a local accounting standards board,
- adoption of new international standards in lieu of local standards,
- change of economic criteria used to value investments, and/or
- change from discounted cash flows basis to a comparables basis.

Sample Disclosure:

“Effective [date], our valuation policy was changed from a discounted cash flow methodology to a market comparable basis. The reason for this change is that market comparables are more reflective of the value of the investments given the changes in the sectors we have invested in over the last few years. The new methodology is consistent with the definition of fair value and the GIPS Valuation Principles and the International Private Equity Valuation principles, policies, and recommended methodologies.”

Provision 7.A.15

If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied.

Discussion

Since the early 1990s, there have been several local, national, and international valuation principles adopted that have specifically addressed private equity. Almost every major national industry association has developed its own valuation guidelines. Many of the valuation standards across the globe have been subsumed into the International Private Equity and Venture Capital (IPEV) Valuation Guidelines which have broad global representation. The U.S. industry's attempt to codify standards has been subsumed into FAS 157/ASC Topic 820. It is not uncommon for the GIPS Valuation Principles to be supplemented by other local or international standards because other standards may be more stringent in their requirements.

The disclosure of which jurisdiction's valuation guidelines have been used in addition to the GIPS Valuation Principles will help prospective clients to determine the comparability of compliant presentations from different firms and/or jurisdictions.

Sample Disclosure:

"The Global Diversified Distressed Composite adheres to the XYZ Venture Capital Association's valuation guidelines as well as the GIPS Valuation Principles. The XYZ valuation standards are based on fair value but provide more prescriptive advice in terms of how to value specific investments, such as secondary investments and distressed debt investments."

Provision 7.A.16

FIRMS MUST disclose the calculation methodology used for the BENCHMARK. If FIRMS present the PUBLIC MARKET EQUIVALENT of a COMPOSITE as a BENCHMARK, FIRMS MUST disclose the index used to calculate the PUBLIC MARKET EQUIVALENT.

3-7

Discussion

The benchmark selected must be appropriate for comparing the performance of the composite. However, unlike those for publicly traded securities, industry benchmarks for private equity are not as widely available or are only available through certain commercial vendors. Firms may use public market indices as a benchmark, but the public market indices by themselves are not directly comparable to the SI-IRR because the market indices typically use a time-weighted return. The public market equivalent (PME) is a method where a public market index is used to create a comparable SI-IRR from a series of cash flows that replicate those of the composite and that can be compared with the SI-IRR of the private equity composite.

The GIPS standards require that the calculation methodology for the benchmark be disclosed. This provides transparency as to the comparability of the performance of the composite and the benchmark. The disclosure includes the calculation method itself (e.g., Is the benchmark a net IRR? On what basis is it compounded? What method is used to determine the vintage year for the benchmark? What metric or statistic is being used for comparison?) For example, the metric for a benchmark could be an average, median, upper quartile, or other percentile. It is expected that the benchmark description includes the name or source of the benchmark as well as the metric being used. If a PME is used as a benchmark, the firm must disclose which public market index is used to create the PME.

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Sample Disclosure:

“The benchmark is the 2008 vintage year (determined by the date of first capital call) pooled SI-IRR for U.S. venture capital funds, published by ACME advisory.”

Provision 7.A.17

FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.

Discussion

The SI-IRR calculation is sensitive to the relative timing of cash flows. In some cases, especially early in the life of a fund, using a quarterly cash flow dating convention (only allowed for periods prior to 1 January 2006) can have a very different outcome from using a monthly or daily convention due to the compounding effect of the SI-IRR. Accordingly, firms are required to disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011. Daily cash flows must be used for periods after 1 January 2011.

Sample Disclosure:

“The SI-IRR calculation incorporates monthly cash flows for periods prior to 31 December 2009 and daily cash flows thereafter.”

Provision 7.A.18

For GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.

Discussion

In order to help prospective clients better understand the gross-of-fees return calculation, firms must disclose if any other fees are deducted in addition to actual transaction expenses. For example, a closed-end fund's gross-of-fees return might reflect the deduction of administrative expenses, such as custodian and fund accounting fees. The same is true for a fund of funds. While fund of funds gross-of-fees returns must be reduced by all fees and expenses of the underlying funds, including carried interest, such returns could also reflect the deduction of other expenses at the fund of funds level. Firms are required to disclose if other fees have been deducted to derive the gross-of-fees return.

Sample Disclosure:

“Gross returns reflect the deduction of administrative expenses at the fund of funds level but do not reflect the deduction of ABC Fund of Funds Manager's investment management fees.”

Provision 7.A.19

For NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.

Discussion

When presenting private equity performance, firms are required to present both gross-of-fees and net-of-fees returns. Net-of-fees returns must be net of actual investment management fees and transaction expenses. Net returns may reflect the deduction of other expenses, such as administrative expenses. Expenses in addition to the investment management fees and transaction expenses that are reflected in net returns must be disclosed. Investment management fees typically include a recurring asset-based management fee (most often based on committed capital), a performance-based management fee (most commonly based on the performance of the portfolio above a pre-determined hurdle rate), and certain types of transaction-based investment management fees.

Sample Disclosure:

“Net returns are net of transaction expenses, administrative expenses, management fees, and carried interest.”

Provision 7.A.20

For any performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

3-7

Discussion

Firms may link non-GIPS compliant performance to their GIPS-compliant history, provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. If the firm chooses to present non-compliant performance for periods prior to 1 January 2006, the firm must disclose which periods are not in compliance. Prospective clients and existing clients are encouraged to inquire about the reasons why the periods prior to 1 January 2006 are not compliant and consider the effects of non-compliance on the historical performance. Note that the SI-IRR and other private equity performance measures are “since inception” measures. The measurement period for an SI-IRR is the period from the inception date of a fund or composite through the end of the period that is being reported. Please also refer to the earlier section on determining the non-GIPS-compliant SI-IRR performance period for private equity composites.

It is necessary to use the period-end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity fund composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

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Sample Disclosure:

“Fund IV was formed in 1996. During 1996 and 1997, cash flows were dated to the end of the quarter. Cash flows beginning 1 January 1997 are all dated as of the end of the month, while cash flows beginning 1 January 2003 are all dated as of the actual cash flow date. Therefore, performance for periods ended 31 December 1996 and 31 December 1997 is not in compliance with the GIPS standards.”

Presentations and Reporting—Requirements

Provision 7.A.21

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- a. **FIRMS MUST** present both the **NET-OF-FEES** and **GROSS-OF-FEES SI-IRR** of the **COMPOSITE** through each annual period end. **FIRMS MUST** initially present at least five years of performance (or for the period since the **FIRM’S** inception or the **COMPOSITE INCEPTION DATE** if the **FIRM** or the **COMPOSITE** has been in existence less than five years) that meets the **REQUIREMENTS** of the GIPS standards. Each subsequent year, **FIRMS MUST** present an additional year of performance. **COMPOSITE** returns **MUST** be clearly identified as **GROSS-OF-FEES** or **NET-OF-FEES**.

Discussion

The intent of this provision is to provide investors with a reasonably accurate estimate of the effect of investment management fees on performance. Deriving SI-IRR gross-of-fees returns from SI-IRR net-of-fees returns and vice versa is not as straight forward as it might seem. There is no uniform method nor standardized formula to derive gross-of-fees SI-IRR returns directly from net-of-fees SI-IRR returns or vice versa. However, it is possible to calculate gross-of-fees SI-IRR and net-of-fees SI-IRR independently. The calculations would be based on the specific facts and circumstances regarding the timing and the terms of the fees, and independent and distinct cash flow streams for gross-of-fees SI-IRR and net-of-fees SI-IRR would be utilized.

The gross-of-fees SI-IRR is the return on investments reduced by any transaction expenses but before deducting investment management fees.

The calculation of a net-of-fees SI-IRR as required by the GIPS standards must reflect the deduction of investment management fees including performance-based fees. Administrative costs and other expenses are not required to be deducted from gross-of-fees or net-of-fees returns. In many jurisdictions, however, it is common practice to deduct such items when computing gross-of-fees SI-IRR and net-of-fees SI-IRR. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses.

The five-year reporting requirement is most relevant for asset classes reporting performance on a periodic time-weighted basis. For example, a non-private-equity investment firm that is first coming into compliance with the GIPS standards and has a ten-year track record can report performance on the last five years of its track record. These results will be independent of any performance

preceding those five years. In the case of private equity returns that are based on since inception, the current performance is dependent on all transactions historically. If a fund has been in existence less than five years, it must present the SI-IRR through each annual period-end from inception.

Most investors will want to see the entire track record of annual SI-IRRs. It is typical that returns will be negative in the early years and will then likely turn positive. The plot of the cumulative since inception net cash flows or since inception returns of a fund is typically referred to as the “J-curve.” The early negative results are the result of the fact that in some funds, like venture funds, it will take time before the fund’s value exceeds paid-in capital. In addition, in the early cash flows, the cash flows called for management fees may be larger than the cash flows made for investment purposes. As a result, it is recognized that the early years of a fund are not indicative of long-term performance. This is especially true for venture capital funds because the early capital calls for management fees and length of time for investment development and growth mean that early returns will usually be highly negative until the fund recovers from the J-curve effect. However, the J-curve effect should be minimized with respect to the gross-of-fees return because management fees are not deducted in the gross-of-fees calculation.

Provision 7.A.21

The following items **MUST** be presented in each COMPLIANT PRESENTATION:

- b. For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS **MUST** present the non-annualized NET-OF-FEES and GROSS-OF-FEES SI-IRR through the initial annual period end.

Discussion

Firms are required to present any partial-year performance for the initial reporting period on a non-annualized basis for composites that begin on or after 1 January 2011. For example, a fund that began on 30 November 2011 and has a one-month initial return through 31 December 2011 of 3% would be required to present that 3% as the partial year’s performance. The annualized return of 42.6% must not be presented. Many spreadsheet and software applications automatically annualize all returns, and firms are reminded that for periods of less than a year, the firm must “de-annualize” any annualized returns that are calculated.

The method chosen to de-annualize is at the discretion of the firm. For example, the firm may de-annualize the return from the bottom up by compounding daily cash flows for the investment period or by taking the implied annual return and calculating the equivalent return for the investment period. In the situation just presented, the 42.6% implied annualized return could be de-annualized by the following formulas:

$$\left\{ \left(1 + 0.426 \right)^{\left(\frac{1}{12} \right)} - 1 \right\} \times 100 = 3\% \text{ or } \left\{ \left(1 + 0.426 \right)^{\left(\frac{30.42}{365} \right)} - 1 \right\} \times 100 = 3\%,$$

both resulting in a de-annualized one-month return of 3%.

Please note there may be some minor differences between methods due to compounding frequency. In addition, daily compounding can be affected over long periods of time due to leap years.

Provision 7.A.21

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- c. For periods ending on or after 1 January 2011, **FIRMS MUST** present the **NET-OF-FEES** and **GROSS-OF-FEES SI-IRR** through the **COMPOSITE FINAL LIQUIDATION DATE**.

Discussion

Funds typically have an initial 10-year life that can be extended through either prior or current agreement for a stipulated number of years. Many times, a fund may have one or two portfolio companies that have not been liquidated and continue to be held in the fund. On a since inception basis, the returns do not vary much during those extension periods unless the remaining investments have some major events that cause significant revaluation. In the end, the investments are liquidated by some means and the fund eventually is also liquidated. A firm must report performance through that composite's final liquidation date in order to capture the residual value, either good or bad, in the last stages of the composite's existence.

Provision 7.A.22

For periods ending on or after 1 January 2011, for **FUND OF FUNDS COMPOSITES**, if the **COMPOSITE** is defined only by investment mandate, objective, or strategy, **FIRMS MUST** also present the **SI-IRR** of the underlying investments aggregated by **VINTAGE YEAR** as well as other measures as **REQUIRED** in 7.A.23. These measures **MUST** be presented gross of the **FUND OF FUNDS INVESTMENT MANAGEMENT FEES** and **MUST** be presented as of the most recent annual period end.

Discussion

Each fund of funds manager determines the strategies to invest in and the vintage years over which to invest. These distinguishing characteristics are routinely described in detail in the limited partnership agreement. Fund of funds firms differentiate themselves from each other by offering narrow or broad strategies, offering regional or global geographical focuses, investing in primary or secondary markets, and the usage of direct investments or co-investments. These investment mandates are generally employed over two to five consecutive vintage years, although this can vary widely.

One of the significant changes in the 2010 edition of the GIPS standards is in how fund of funds composites can be defined. In the 2005 edition of the GIPS standards, all private equity funds, including funds of funds, were required to be included in composites that were defined by vintage year and investment mandate, objective, or strategy. Given how funds of funds structure their investment portfolios, this often led to a tremendous number of composites, many of which were irrelevant to prospective clients. The 2010 edition of the GIPS standards allows fund of funds firms to create composites that are defined by vintage year and/or investment mandate, objective, or strategy. Following the 2005 edition of the GIPS standards, a fund of funds firm with five funds, each

of which had the same strategy but different vintage year, would create five composites. Following the 2010 edition of the GIPS standards, the same firm could choose to define composites either by vintage year (five composites) or investment mandate, objective, or strategy (one composite).

If the firm chooses to create a fund of funds composite defined only by investment mandate, objective, or strategy, the firm is required to present the SI-IRR of the underlying investments that have been aggregated by vintage year as of the most recent annual period-end. The firm must also present, as of the most recent annual period-end, all of the metrics required by Provision 7.A.23 by vintage year as well. See Appendix A of the GIPS standards for examples.

Presenting the underlying investments by vintage years has the added benefit of increased comparability with benchmarks. Because of the numerous variations and structures of funds of funds, fund of funds composites may have underlying investments that span a number of vintage years. Since the number of vintage years of the underlying investments varies significantly, fund of funds composites are not usually comparable with vintage year benchmarks or with other funds of funds. By stratifying the fund of funds composites by the vintage year of the underlying investments, additional analysis of the composite can be performed. This allows for analysis by vintage year of all investments made by the fund of funds by comparing them directly to an appropriate vintage year benchmark.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL.
- b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS.
- c. COMPOSITE cumulative COMMITTED CAPITAL.
- d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI).
- e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI).
- f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE).
- g. RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).

3-7

Discussion

While the since inception IRR is the basic metric used to report performance for private equity investments, it is not the only useful metric used to gauge performance. Other measures are also useful to provide additional insight. The IRR by its nature is sensitive to early cash flow events, and the IRR calculation assumes that the residual value of a composite is totally liquid, whereas in reality, the residual value is the unrealized (and often illiquid) portion of the composite. As a result, other metrics have been developed that allow a prospective client to examine aspects of performance other than simply a rate of return.

3 Explanation of the Provisions of the GIPS Standards

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL.

Discussion

The composite since inception paid-in capital consists of all capital inflows to an investment vehicle by the investors (e.g., limited partners). These inflows are also referred to as contributions to an investment vehicle by the investors. Paid-in capital also includes distributions that are subsequently recalled and reinvested into the investment vehicle.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS.

Discussion

The composite since inception distributions include all cash and stock distributed from an investment vehicle to the investors (e.g., limited partners).

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- c. COMPOSITE cumulative COMMITTED CAPITAL.

Discussion

The composite cumulative committed capital represents the total pledges of capital to an investment vehicle by the investors (e.g., limited partners).

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI).

Discussion

The investment multiple, or TVPI, provides investors with a multiple that indicates how many times more the investment is worth compared with the original investment without taking into account the time value of money. It is equal to the sum of the composite since inception distributions and its residual value divided by the composite since inception paid-in capital (or contributions). The investment multiple is calculated as

$$\text{TVPI} = \text{DPI} + \text{RVPI or (Cumulative distributions since inception + Period-end residual value)/Cumulative paid-in capital since inception),}$$

where

DPI = realization multiple

RVPI = unrealized multiple

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE OR DPI).

Discussion

The DPI, or realization multiple, measures how much capital has actually been returned to investors. It is the amount of capital that has been “realized” by investors and is often viewed as the amount of the TVPI that is “realized.” It is equal to the sum of the since inception distributions divided by the since inception paid-in capital (or contributions). It is calculated as

$$\text{DPI} = (\text{Cumulative distributions since inception})/(\text{Cumulative paid-in capital since inception}).$$

3-7

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE).

Discussion

The paid-in capital multiple (also known as the PIC multiple or PIC ratio) gives prospective investors information regarding how much committed capital has actually been drawn down. In industry terminology, it is also known as the “dry-powder ratio” because it measures how much capital is left to invest. It is equal to the since inception paid-in capital (or contributions) divided by total capital commitments. It is calculated as

$$\text{PIC} = (\text{Cumulative paid-in capital since inception})/(\text{Cumulative committed capital}).$$

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Recycling/Reinvestment and Recalable Cash Flows Private equity vehicles are usually characterized by the prohibition (unless stipulated by agreement) to reinvest proceeds or allow redemptions. This means that unless otherwise agreed to, private equity investment vehicles must distribute proceeds from investments to investors (e.g., limited partners) and cannot reinvest that capital. In some cases, distributions are “recalable”, that is, after the investment vehicle distributes proceeds to its investors, it can draw down the same capital again, which makes it possible for the investment vehicle to draw capital in excess of its total committed capital.

Distributions can be either recalable or non-recalable. This means that a recalable distribution must be treated as an actual distribution and if and when that distribution is recalled, it must be treated as additional paid-in capital. The treatment of recalable distributions with respect to committed capital should be disclosed in the compliant presentation.

Please note that recalable distributions have an impact on the performance metric calculations and the firm may wish to consider additional disclosure when there is material distortion to the PIC or realization multiples. If a recalable distribution is re-contributed and reflected as paid-in capital a second time, the result will be cumulative paid-in capital since inception being higher than total committed capital. It also means that the DPI, RVPI, and TVPI multiples will be lower, all other things being equal, for investment vehicles that have had recalable distributions because the denominator will be increased. In addition, the PIC ratio will be higher for investment vehicles that have had recalable distributions, all other things being equal.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- g.** RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE OR RVPI).

3-7

Discussion

The unrealized multiple, or RVPI, is the converse of the realization multiple. It is equal to the residual value at the end of the period divided by since inception paid-in capital (or contributions). It is calculated as

$$\text{RVPI} = (\text{Residual value at period-end}) / (\text{Cumulative paid-in capital since inception}).$$

Provision 7.A.24

FIRMS MUST present the SI-IRR for the BENCHMARK through each annual period end. The BENCHMARK MUST:

- a.** Reflect the investment mandate, objective, or strategy of the COMPOSITE;
- b.** Be presented for the same time periods as presented for the COMPOSITE; and
- c.** Be the same VINTAGE YEAR as the COMPOSITE.

Discussion

Firms are required to present the annualized SI-IRR of a benchmark that reflects the same investment mandate, objective, or strategy of the composite that corresponds to the same time periods as presented for the composite and has the same vintage year as the composite. Firms must disclose the calculation methodology of the benchmark and, if a custom benchmark or multiple benchmarks are used, how each benchmark is constructed, including the benchmark components, weights, and rebalancing process. If the firm determines no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.

Provision 7.A.25

For FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy and a BENCHMARK is presented for the underlying investments, the BENCHMARK MUST be the same VINTAGE YEAR and investment mandate, objective, or strategy as the underlying investments.

Discussion

A variety of appropriate benchmarks can be used for direct comparison or opportunity cost comparison. A fund of funds is composed of underlying funds of various vintage years. If a firm chooses to present a benchmark for the underlying investments, an appropriate benchmark is one that mirrors the exact vintage year of the underlying funds for direct comparison. If the benchmark is presented for the underlying investments that span a number of vintage years, a corresponding benchmark including multiple vintage years should be used. For example, for a fund of funds composite with underlying buyout funds with 2004, 2006, and 2008 vintage years, the benchmark should be composed of buyout funds with 2004, 2006, and 2008 vintage years because this is the direct peer comparison for those that invested in the same years.

3-7

Provision 7.A.26

For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.

Discussion

Direct investments (or co-investments) by a fund of funds may augment the strategy used in the investment in underlying fund vehicles. Direct investments may have different terms and conditions that might change the return characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the returns of the fund of funds composite. If no assets are invested in direct investments, no disclosure is required.

Provision 7.A.27

For periods ending on or after 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.

Discussion

Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending on or after 1 January 2011, firms must disclose, for primary fund composites, the percentage of the composite that is invested in other funds as of each annual period-end, if any. If no assets are invested in other funds, no disclosure is required.

Provision 7.A.28

FIRMS MUST NOT present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, FIRMS may present non-GIPS-compliant performance.

Discussion

As previously discussed, there may be legitimate reasons for which reported performance may not be compliant prior to 1 January 2006. Given the fact that performance for private equity is always reported on a since inception basis, the past is always incorporated into the IRR in contrast to a TWRR, which does not necessarily incorporate since inception results. It could be argued that the since inception basis of private equity reporting would mean that any period of historical non-compliance could make the current period also non-compliant because the current calculation may depend on inputs that were not in compliance with the GIPS standards. However, this is not the case—a firm may present prior non-GIPS-compliant performance while claiming compliance even if the prior non-compliant period's inputs are used in current period reporting. The early use of quarterly cash flows or the inability to value portfolios in accordance with private equity valuation standards for investments prior to 1 January 2006 does not invalidate current compliance with the GIPS standards.

Private Equity—Recommendations

Provision 7.B.1

PRIVATE EQUITY investments SHOULD be valued at least quarterly.

Discussion

There was a time when private equity valuations were only available annually, but the industry has evolved to the point where quarterly valuation reporting is a standard industry practice. The use of quarterly valuations is recommended because it provides prospective clients with earlier notification of any significant movements and allows more effective tracking and comparative analysis of investments.

Provision 7.B.2

For periods ending prior to 1 January 2011, the SI-IRR SHOULD be calculated using daily cash flows.

Discussion

Daily cash flows improve the accuracy of the return calculations, including the SI-IRR required by the GIPS standards for private equity investments. Firms should, therefore, use daily cash flows for periods prior to 1 January 2011 and are required to use daily cash flows for periods after 1 January 2011.

Provision 7.B.3

FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end.

Discussion

Normally, the valuations used for financial reporting and performance reporting do not differ significantly. If they do, the material differences as of each annual period-end should be explained and disclosed.

Sample Disclosure:

“There was a material change in the value of Fund XX caused by a significant write-down of an investment in the portfolio in the fourth quarter of 2012. Due to a time lag in reporting, this valuation is not reflected in the 2012 year-end financial report but was recognized in the

3 Explanation of the Provisions of the GIPS Standards

2013 report. However, our compliant presentations reflect this decrease in valuation as of 31 December 2012. In the opinion of the GP, this represents a material difference between the valuations used in financial reporting versus performance reporting.”

Provision 7.B.4

For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

Discussion

A firm must disclose material changes to valuation policies and/or methodologies used to value private equity investments for periods ending on or after 1 January 2011. Firms are recommended to disclose material changes to valuation policies and/or methodologies for periods ending prior to 1 January 2011.

Provision 7.B.5

For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by VINTAGE YEAR of the FUND OF FUNDS, FIRMS SHOULD also present the SI-IRR of the underlying investments aggregated by investment mandate, objective, or strategy and other measures as listed in 7.A.23. These measures SHOULD be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES.

3-7

Discussion

As a corollary to Provision 7.A.22, where a fund of funds firm is required to provide summary statistics by vintage year if the firm chooses to create composites by investment mandate, objective, or strategy, Provision 7.B.5 recommends that if a fund of funds composite is defined by vintage year, the firm should also provide summary statistics by strategy.

Provision 7.B.6

For periods ending prior to 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.

Discussion

Direct investments (or co-investments) by a fund of funds may augment the strategy used in the investment in underlying fund vehicles. Direct investments may have different terms and conditions that might change the performance characteristics of the fund of funds. By providing the

percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the performance of the fund of funds composite.

Provision 7.B.7

For periods ending prior to 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.

Discussion

Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending prior to 1 January 2011, firms should disclose, for primary fund composites, the percentage of the composites that is invested in other funds as of each annual period-end.

3-8 WRAP FEE/SEPARATELY MANAGED ACCOUNT (SMA) PORTFOLIOS

Introduction

In order to provide prospective clients with a variety of investment options, firms offer different types of investment products/services as well as fee structures. One of these structures offers clients the ability to “bundle” multiple fees incurred during the management of a portfolio. Bundled fees can include any combination of management, trading, custody, and other administrative fees. One specific example of a bundled fee portfolio is a wrap fee portfolio. A wrap fee is defined as a type of bundled fee and is specific to a particular type of investment product. The wrap fee is charged by a wrap fee sponsor for investment management services and typically includes associated trading expenses that cannot be separately identified. Wrap fees can be all-inclusive, asset-based fees and may include a combination of investment management fees, trading expenses, custody fees, and/or administrative fees. A wrap fee portfolio is sometimes referred to as a “separately managed account” or “managed account.”

Wrap fee/SMA portfolios are unique and significantly different from traditional brokerage or investment management relationships, and as a result, additional guidance is necessary for firms managing wrap fee/SMA portfolios on how to apply the GIPS standards. Additional guidance for applying the GIPS standards to wrap fee/SMA portfolios is included in the Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios.

The following provisions are applicable to those GIPS-compliant firms that have discretionary portfolio management responsibility for wrap fee/SMA portfolios. The wrap fee/SMA provisions and related guidance apply to the calculation and presentation of performance when presenting a compliant presentation to a wrap fee/SMA prospective client (which includes prospective wrap fee/SMA sponsors, prospective wrap fee/SMA clients, and existing wrap fee/SMA sponsors). Unless otherwise noted, this section supplements all the required and recommended provisions in Sections 0–5 of the GIPS standards.

Although there are different types of wrap fee/SMA structures, these provisions apply to all wrap fee/SMA portfolios where there are bundled fees and the wrap fee/SMA sponsor serves as an intermediary between the firm and the end user of the investment services. The wrap fee/SMA provisions and the Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios are not applicable to portfolios defined as other types of bundled fee portfolios. These provisions are also not applicable to model portfolios that are provided by a firm to a wrap fee/SMA sponsor if the firm does not have discretionary portfolio management responsibility for the individual wrap fee/SMA portfolios. Similarly, a firm or overlay manager in a multiple strategy portfolio or similar program is also excluded from applying the wrap fee/SMA provisions and this guidance to such portfolios if they do not have discretion. In some cases, discretion may be shared between the firm and the wrap fee/SMA sponsor. In these instances, it is up to the firm to determine if portfolios for which the firm has shared discretion are considered to be discretionary.

Firms must have records to support performance presented to satisfy laws and regulations as well as the requirements of the GIPS standards. However, due to the structure of wrap fee/SMA relationships, lack of records is a common reason that firms managing wrap fee/SMA portfolios

are unable to comply with the GIPS standards. Wrap fee/SMA sponsors typically maintain the underlying portfolio records, and firms may not have access to records to support portfolio-level performance.

It is important to note that firms have options for satisfying the GIPS requirement that all data and information necessary to support all items included in a compliant presentation must be captured and maintained. In order to satisfy the recordkeeping requirements of the GIPS standards, firms may choose to:

- place reliance on the performance calculated and reported by the wrap fee/SMA sponsor. This can be done on either the aggregate level, effectively viewing the wrap fee/SMA sponsor as a single portfolio, or on the underlying wrap fee/SMA portfolio level. When relying on information provided by a third party (in this instance, the wrap fee/SMA sponsor), the firm claiming compliance with the GIPS standards must take the necessary steps to be satisfied that the information provided by the wrap fee/SMA sponsor can be relied on to meet the requirements of the GIPS standards;
- utilize “shadow accounting” to track the wrap fee/SMA portfolios on their in-house performance measurement systems. “Shadow accounting” is the process of maintaining investment performance records for each portfolio that enables an investment management firm to determine beginning and end of reporting period values and cash flows; or
- exclude the wrap fee/SMA division from the definition of the firm.

A firm claiming compliance with the GIPS standards is responsible for its claim of compliance and is responsible, as well, for reporting information in compliance with the GIPS standards to prospective clients. The firm must be sure that the performance provided by the wrap fee/SMA sponsor can be used by the firm to satisfy the requirements of the GIPS standards, or the firm must maintain separate/duplicate records that meet the requirements of the GIPS standards. Furthermore, if the firm undertakes the verification process, the wrap fee/SMA portfolios are subject to the same level of testing as all other portfolios within the firm.

All wrap fee/SMA compliant presentations that include performance results for periods beginning on or after 1 January 2006 must meet all the requirements and the related guidance.

Wrap Fee/Separately Managed Account (SMA) Portfolios—Requirements

Composite Construction—Requirements

Provision 8.A.1

FIRMS MUST include the performance record of actual WRAP FEE/SMA PORTFOLIOS in appropriate COMPOSITES in accordance with the FIRM’S established PORTFOLIO inclusion policies. Once established, these COMPOSITES (containing actual WRAP FEE/SMA PORTFOLIOS) MUST be used in the FIRM’S COMPLIANT PRESENTATIONS presented to WRAP FEE/SMA PROSPECTIVE CLIENTS.

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Discussion

While the same investment strategy can be employed by the firm for wrap fee/SMA and non-wrap-fee/SMA portfolios, the delivery of information about the strategy to the end user is what distinguishes wrap fee/SMA portfolios and necessitates additional guidance for creating and maintaining composites that include wrap fee/SMA portfolios. Once a firm obtains and manages wrap fee/SMA portfolios, the firm must include the wrap fee/SMA portfolios in an appropriate composite and present the performance of the composite containing wrap fee/SMA portfolios when marketing to prospective wrap fee/SMA clients. A firm may not present a non-wrap fee/SMA track record to a prospective wrap fee/SMA client in lieu of a wrap fee/SMA track record if the firm has an appropriate composite that includes actual wrap fee/SMA portfolios. The firm must not exclude the performance of *actual* wrap fee/SMA portfolios from the appropriate composite(s).

Prior to managing wrap fee/SMA portfolios In order for a firm claiming compliance with the GIPS standards to present performance for a specific strategy to wrap fee/SMA prospective clients that the firm historically managed for only non-wrap-fee/SMA portfolios, the firm must satisfy the following:

1. The firm definition must include both the wrap fee/SMA and non-wrap-fee/SMA assets.
2. There were no wrap fee/SMA portfolios under management for the particular strategy during the time periods for which the firm compiles the wrap fee/SMA performance using only non-wrap-fee/SMA portfolios.
3. For all wrap fee/SMA composite presentations that include periods prior to the composite containing an actual wrap fee/SMA portfolio, the firm must disclose, for each period presented, that the composite does not contain actual wrap fee/SMA portfolios (i.e., that 0% or none of the composite portfolios/assets are wrap fee/SMA portfolios). This disclosure will be used by the firm prior to the implementation of the GIPS provision requiring firms with composites that include portfolios with bundled fees to present the percentage of composite assets represented by portfolios with bundled fees as of each annual period-end (see Requirement 4.A.24 for more information. For an example, please refer to Sample 8 of Appendix A: Sample Compliant Presentations of the GIPS standards).

The firm may calculate a wrap fee/SMA performance history for a specific strategy by using that strategy's gross-of-fees non-wrap-fee/SMA composite history reduced by the highest total wrap fee charged to the client (end user) by the wrap fee/SMA sponsor for the strategy (product), resulting in net-of-fees wrap fee/SMA performance.

Once a firm acquires one or more wrap fee/SMA portfolios Beyond building an initial track record for presentation to wrap fee/SMA prospective clients, the firm must consider whether it will revise its wrap fee/SMA composite history as it accumulates an actual wrap fee/SMA performance record. Once a firm acquires one or more wrap fee/SMA portfolios for management, the firm must include the performance of the actual wrap fee/SMA portfolio(s) in an appropriate composite in accordance with the firm's established portfolio inclusion policies. The firm must determine if it will combine wrap fee/SMA portfolios in a composite with non-wrap-fee/SMA portfolios with the same strategy or if it will have separate composites for non-wrap-fee/SMA portfolios.

The firm has three options to consider:

1. keep the calculated history, redefine the composite to include only actual wrap fee/SMA portfolios going forward, and include relevant disclosures related to the redefinition;

2. continue to include the ongoing performance of the non-wrap-fee/SMA portfolios and combine it with performance of actual wrap fee/SMA portfolios; or
3. create a new composite to represent only actual wrap fee/SMA portfolios. The new composite will reflect a recent composite creation date.

When presenting wrap fee/SMA performance to wrap fee/SMA prospective clients, the firm must choose one of the three options listed above.

Firms must not redefine a composite on a retroactive basis, according to the Guidance Statement on Composite Definition. Once the firm includes non-wrap-fee/SMA portfolios in the wrap fee/SMA composite history, the firm must not retroactively strip those portfolios out of the composite in order to create a “wrap fee/SMA only” composite history.

Disclosure—Requirements (the following provision does not apply: 4.A.15)

Provision 8.A.2

For all WRAP FEE/SMA COMPLIANT PRESENTATIONS that include periods prior to the inclusion of an actual WRAP FEE/SMA PORTFOLIO in the COMPOSITE, the FIRM MUST disclose, for each period presented, that the COMPOSITE does not contain actual WRAP FEE/SMA PORTFOLIOS.

Discussion

Recognizing that firms may choose to use their non-wrap-fee/SMA composite history to generate new wrap fee/SMA business, this provision ensures both wrap fee/SMA prospective clients and wrap fee/SMA sponsors are informed about the firm’s experience managing wrap fee/SMA portfolios.

In order for a firm claiming compliance with the GIPS standards to present performance for a specific strategy to wrap fee/SMA prospective clients that the firm historically managed for *only* non-wrap-fee/SMA portfolios, the firm must satisfy the following:

1. The firm definition must include both the wrap fee/SMA and non-wrap fee/SMA assets.
2. There were no wrap fee/SMA portfolios under management for the particular strategy during the time periods for which the firm compiles the wrap fee/SMA performance using *only* non-wrap-fee/SMA portfolios.
3. For all wrap fee/SMA composite presentations that include periods prior to the composite containing an actual wrap fee/SMA portfolio, the firm must disclose, for each period presented, that the composite does not contain actual wrap fee/SMA portfolios (i.e., that 0% or none of the composite portfolios/assets are wrap fee/SMA portfolios). This disclosure will be used by the firm prior to the implementation of the GIPS provision requiring firms with composites that include portfolios with bundled fees to present the percentage of composite assets represented by portfolios with bundled fees as of each annual period-end (for an example, please refer to Sample 8 of Appendix A in the GIPS standards).

3 Explanation of the Provisions of the GIPS Standards

The firm may calculate a wrap fee/SMA performance history for a specific strategy by using that strategy's gross-of-fees non-wrap-fee/SMA composite history reduced by the highest total wrap fee charged to the client (end user) by the wrap fee/SMA sponsor for the strategy (product), resulting in net-of-fees wrap fee/SMA performance.

Provision 8.A.3

For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

Discussion

The GIPS standards allow firms to link non-GIPS-compliant performance to their GIPS-compliant history provided that only GIPS-compliant wrap fee/SMA performance is presented for periods beginning on or after 1 January 2006. If the firm chooses to present non-compliant wrap fee/SMA performance for periods prior to 1 January 2006, the firm must disclose which periods are not in compliance. This disclosure will allow prospective clients to make valid comparisons among compliant presentations and consider the effects of non-compliance on the historical performance.

Provision 8.A.4

When FIRMS present COMPOSITE performance to an existing WRAP FEE/SMA sponsor that includes only that sponsor's WRAP FEE/SMA PORTFOLIOS (resulting in a "sponsor-specific COMPOSITE"):

- a. FIRMS MUST disclose the name of the WRAP FEE/SMA sponsor represented by the sponsor-specific COMPOSITE; and
- b. If the sponsor-specific COMPOSITE COMPLIANT PRESENTATION is intended for the purpose of generating WRAP FEE/SMA business and does not include performance net of the entire WRAP FEE, the COMPLIANT PRESENTATION MUST disclose that the named sponsor-specific COMPLIANT PRESENTATION is only for the use of the named WRAP FEE/SMA sponsor.

Discussion

When a firm is reporting the performance of a wrap fee/SMA program to an existing wrap fee/SMA sponsor for the sponsor's internal use, there is a need to report how the firm has performed managing a particular program or "product" for that individual wrap fee/SMA sponsor. The firm may report the performance of the composite that includes only the portfolios managed for that wrap fee/SMA sponsor. Similar to the concept of existing client reporting, a firm may choose to create a smaller composite consisting only of the portfolios managed for the wrap fee/SMA sponsor in order to present to that sponsor the performance of their own wrap fee/SMA product. Provided all the requirements of the GIPS standards are met on a firm-wide basis, the sponsor-specific composite presentation may include the claim of compliance. The firm must reflect the name of the existing wrap fee/SMA sponsor in the sponsor-specific compliant presentation. Furthermore, if the

presentation does not include net-of-fees returns, the firm must include a prominent disclosure stating that the sponsor-specific compliant presentation is only for the internal use of the named wrap fee/SMA sponsor.

Q&A

1. *When reporting performance to a specific wrap fee/SMA sponsor with whom our firm has entered into a sponsor agreement, we report the performance of that sponsor's portfolios (managed to the same strategy) since the inception of our relationship with the sponsor in a composite. May we link the performance of the sponsor-specific results to our historical, style-defined wrap fee/SMA composite track record, which includes the combined historical performance of all wrap fee/SMA portfolios managed in the same style, regardless of sponsor?*

Yes. Sponsor-specific wrap fee/SMA composite results may be linked to the historical performance of a style-defined composite (which could also include the performance of non-wrap fee/SMA portfolios managed in the same style reduced by the highest total wrap fee).

2. *Are we required to control how a wrap fee/SMA sponsor uses our firm's presentations? What if the sponsor delivers our sponsor-specific wrap fee/SMA gross-of-fees composite performance to a wrap fee/SMA prospective client?*

The GIPS standards do not impose any specific, additional requirements for a firm to monitor the use of its performance information once it has been provided to the wrap fee/SMA sponsor; however, as in all situations where the performance information of the firm is distributed by a third party, the firm should take appropriate measures to ensure that its performance is not misrepresented or used in a misleading fashion.

Presentation and Reporting—Requirements (the following provision does not apply: 5.A.3)

Provision 8.A.5

When FIRMS present performance to a WRAP FEE/SMA PROSPECTIVE CLIENT, the COMPOSITE presented MUST include the performance of all actual WRAP FEE/SMA PORTFOLIOS, if any, managed according to the COMPOSITE investment mandate, objective, or strategy, regardless of the WRAP FEE/SMA sponsor (resulting in a “style-defined COMPOSITE”).

Discussion

The GIPS standards require firms to define composites according to similar investment mandates, objectives, and/or strategies. In order to facilitate the comparability of performance results and prevent firms from cherry-picking their best performing portfolios for presentation, firms must group all appropriate wrap fee/SMA portfolios in a composite according to the same investment objective, mandate, or strategy (creating a style-defined composite) regardless of the wrap fee/SMA sponsor. If the firm has no actual wrap fee/SMA portfolios under management for the specified

3 Explanation of the Provisions of the GIPS Standards

strategy, this style-defined composite will be composed of only non-wrap-fee/SMA portfolios managed to the specified strategy, using the gross-of-fees performance results reduced by the highest wrap fee applicable to that strategy.

Once the firm has actual wrap fee/SMA portfolios under management, the firm has two options for composite construction:

1. If the firm chooses to define its composites to include only actual wrap fee/SMA portfolios going forward, the style-defined composite will consist of portfolios from all wrap fee/SMA sponsors that are managed to the specified strategy.
2. If the firm chooses to continue to combine the ongoing performance of the non-wrap-fee/SMA portfolios and actual wrap fee/SMA portfolios in the same composite, the style-defined composite will consist of the continuing non-wrap-fee/SMA portfolios as well as all wrap fee/SMA portfolios managed to the specified strategy, regardless of the wrap fee/SMA sponsor.

Regardless of the firm's composite construction choice, this style-defined composite must be presented to wrap fee/SMA prospective clients in order to demonstrate a full and fair picture of the firm's ability to manage wrap fee/SMA portfolios in the defined style. A firm may choose to present additional information and/or supplemental information demonstrating the firm's ability to manage portfolios for a specific wrap fee/SMA sponsor or group of wrap fee/SMA sponsors.

Q&A

1. *When reporting performance to a wrap fee/SMA prospective client, may we present sponsor-specific composite performance from an existing wrap fee/SMA sponsor?*

When presenting performance to a wrap fee/SMA prospective client, the firm must present a style-defined composite in order to demonstrate a full and fair picture of the firm's ability to manage all wrap fee/SMA portfolios in the defined style. Firms may choose to present additional and/or supplemental information demonstrating the firm's ability to manage portfolios for a specific wrap fee/SMA sponsor or group of wrap fee/SMA sponsors.

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Provision 8.A.6

When FIRMS present performance to a WRAP FEE/SMA PROSPECTIVE CLIENT, performance MUST be presented net of the entire WRAP FEE.

Discussion

When presenting performance to a wrap fee/SMA prospective client, performance must be shown net-of-fees (i.e., net of the entire wrap fee). Firms may also present gross-of-fees returns as additional information and/or "pure" gross-of-fees returns as supplemental information.

If a firm has not managed actual wrap fee/SMA portfolios in a specific strategy, the firm may create a history from that strategy's non-wrap-fee/SMA composite. The firm may calculate a wrap fee/SMA performance history for a specific strategy by using that strategy's gross-of-fees

non-wrap-fee/SMA composite history reduced by the highest total wrap fee charged to the client (end user) by the wrap fee/SMA sponsor for the strategy (product), resulting in net-of-fees wrap fee/SMA performance.

It is up to the firm to determine the appropriate highest wrap fee to deduct. This highest wrap fee should be obtained from the prospective wrap fee/SMA sponsor and should be comparable for the investment mandate, objective, or strategy of the wrap fee/SMA composite. “Pure” gross-of-fees performance (i.e., gross of all expenses, including trading expenses) is only permitted as supplemental information to a compliant presentation. It is recognized that when starting with the gross-of-fees non-wrap-fee/SMA composite history, the gross-of-fees performance already reflects the deduction of actual trading expenses incurred. By then reducing the composite performance by the highest total wrap fee, which includes a portion attributable to trading expenses, performance will reflect the deduction of trading expenses two times (actual and portion of highest wrap fee). If the firm can identify the portion of the highest total wrap fee attributable to trading expenses, the firm may first calculate performance reflecting the deduction of both actual trading expenses and the highest wrap fee; the firm may then increase this result by the identifiable portion of the wrap fee attributable to trading expenses in order to compute a net-of-fees return.

In order to assist prospective clients and their understanding of the fees charged in these situations, when presenting gross-of-fees returns, firms must disclose if other fees are deducted in addition to the trading expenses. 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.

For additional information on the calculation of gross-of-fees and net-of-fees returns, please review Exhibit C of the Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios.

Provision 8.A.7

FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.

3-8

Discussion

Performance for periods after 1 January 2006 that does not comply with the GIPS standards must not be linked to GIPS-compliant performance. For wrap fee/SMA composites, the GIPS standards allow firms to link non-GIPS-compliant performance to the composite’s GIPS-compliant history provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.

Q&A

1. *Our firm currently manages wrap fee/SMA accounts. We will not be able to comply with the GIPS standards for SMA portfolios as of 1 January 2006. We believe we will be able to comply with the GIPS standards for our SMA portfolios as of 1 January 2008. Can we begin to claim compliance with the GIPS standards for our SMA portfolios as of 1 January 2008?*

3 Explanation of the Provisions of the GIPS Standards

Firms that manage wrap fee/SMA portfolios and wish to claim compliance with the GIPS standards must comply with the GIPS standards for periods beginning on or after 1 January 2006, at a minimum. If the firm is not able to claim compliance as of this date, the firm must wait until it has a minimum five-year track record that complies with all the requirements of the GIPS standards before claiming compliance.

3-9 GIPS ADVERTISING GUIDELINES

Purpose of the GIPS Advertising Guidelines

The GIPS Advertising Guidelines provide firms with options for advertising performance when mentioning the firm's claim of compliance. The GIPS Advertising Guidelines do not replace the GIPS standards, nor do they absolve firms from presenting a compliant presentation as required by the GIPS standards. These guidelines only apply to firms that already satisfy all the requirements of the GIPS standards on a firm-wide basis and choose to include their claim of compliance with the GIPS standards in an advertisement. A firm that does not mention the GIPS standards in an advertisement is not required to meet the requirements of the GIPS Advertising Guidelines. However, all firms are encouraged to abide by these ethical guidelines. Firms that choose to claim compliance in an advertisement must follow either the GIPS Advertising Guidelines or include a compliant presentation in the advertisement.

The language of the claim of compliance that is included in a compliant presentation differs from the language of the claim of compliance for advertisements prepared in accordance with the GIPS Advertising Guidelines, but both are referred to as a claim of compliance. Although it is not required for firms to include a claim of compliance in any or all of its advertisements, firms claiming compliance with the GIPS standards must ensure that all performance or performance-related information in marketing materials, whether or not it contains a claim of compliance, is not false or misleading and adheres to the guiding principles of fair representation and full disclosure.

Definition of Advertisement

For the purposes of these guidelines, an advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, firm brochures, letters, media, websites, or any other written or electronic material addressed to more than one prospective client. Any written material, other than one-on-one presentations and individual client reporting, distributed to maintain existing clients or solicit new clients for a firm is considered an advertisement.

3-9

Relationship of GIPS Advertising Guidelines to Regulatory Requirements

Firms advertising performance must adhere to all applicable laws and regulations governing advertisements. Firms are encouraged to seek legal or regulatory counsel because additional disclosures may be required. In cases where applicable laws and/or regulations conflict with the requirements of the GIPS standards and/or the GIPS Advertising Guidelines, firms are required to comply with the laws and/or regulations.

3 Explanation of the Provisions of the GIPS Standards

The calculation and advertisement of performance of pooled unitized investment vehicles, such as mutual funds, investment trusts, and open-ended investment companies, are regulated in most markets. The GIPS Advertising Guidelines are not intended to replace applicable laws and/or regulations when a firm is advertising performance solely for a pooled unitized investment vehicle. However, should a GIPS-compliant firm choose to claim compliance in an advertisement for a pooled unitized investment vehicle, the firm must comply with all applicable laws and/or regulations as well as the GIPS Advertising Guidelines.

Other Information

The advertisement may include other information beyond what is required under the GIPS Advertising Guidelines provided the information is shown with equal or lesser prominence relative to the information required by the GIPS Advertising Guidelines and the information does not conflict with the requirements of the GIPS standards and/or the GIPS Advertising Guidelines. Firms must adhere to the principles of fair representation and full disclosure when advertising and must not present performance or performance-related information that is false or misleading.

GIPS Advertising Guidelines—Requirements

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines **MUST** disclose:

1. The definition of the **FIRM**.

Discussion

This disclosure must be consistent with the disclosure of the definition of the firm included in the corresponding compliant presentation (as required by Provision 4.A.2) unless the disclosure included in the advertisement is a more current definition of the firm that has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation. For more information on this disclosure, please refer to the guidance provided in this Handbook for Provision 4.A.2 as well as the Guidance Statement on Definition of the Firm.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines **MUST** disclose:

2. How a PROSPECTIVE CLIENT can obtain a COMPLIANT PRESENTATION and/or the FIRM's list of COMPOSITE DESCRIPTIONS.

Discussion

In order for the reader of the advertisement to know how to obtain more information about the firm and its products, contact information must be included in the firm's advertisements so that the reader can obtain a compliant presentation as well as the firm's list of composite descriptions.

Sample Disclosure:

"To receive a list of composite descriptions of Sample Four Investments and/or a compliant presentation, contact Jean Paul at +12 (034) 5678910 or write Sample Four Investments, One Plain Street, Resultland 12KJ4 or jpaul@sample4inv.com.re."

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines **MUST** disclose:

3. The GIPS compliance statement for advertisements:

[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®).

Discussion

The GIPS Advertising Guidelines only apply to firms that already claim compliance with the GIPS standards. Firms that claim compliance can choose to advertise that claim using the GIPS Advertising Guidelines or choose to include a compliant presentation in the advertisement. The claim of compliance required by the GIPS Advertising Guidelines is different from the claim of compliance required to be disclosed in compliant presentations. The following claim of compliance must be disclosed in an advertisement prepared in accordance with the GIPS Advertising Guidelines:

[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®).

Sample Disclosure:

"Sample Four Investments claims compliance with the Global Investment Performance Standards (GIPS®)."

3 Explanation of the Provisions of the GIPS Standards

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

4. The **COMPOSITE DESCRIPTION**.

Discussion

Advertisements that present any performance and include the GIPS compliance statement for advertisements must disclose the composite description. This disclosure must be consistent with the disclosure of the composite description included in a compliant presentation (as required by Provision 4.A.3) unless the disclosure included in the advertisement is a more current composite description that has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation. For more information on this disclosure, please refer to the guidance provided in this Handbook on Provision 4.A.3. Appendix C of the GIPS standards provides a Sample List of Composite Descriptions.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

5. **COMPOSITE TOTAL RETURNS** according to one of the following:
 - a. One-, three-, and five-year annualized **COMPOSITE** returns through the most recent period with the period-end date clearly identified. If the **COMPOSITE** has been in existence for less than five years, **FIRMS** **MUST** also present the annualized returns since the **COMPOSITE INCEPTION DATE**. (For example, if a **COMPOSITE** has been in existence for four years, firms must present one-, three-, and four-year annualized returns through the most recent period.) Returns for periods of less than one year **MUST NOT** be annualized.
 - b. Period-to-date **COMPOSITE** returns in addition to one-, three-, and five- year annualized **COMPOSITE** returns through the same period of time as presented in the corresponding **COMPLIANT PRESENTATION** with the period-end date clearly identified. If the **COMPOSITE** has been in existence for less than five years, **FIRMS** **MUST** also present the annualized returns since the **COMPOSITE INCEPTION DATE**. (For example, if a **COMPOSITE** has been in existence for four years, **FIRMS** **MUST** present one-, three-, and four-year annualized returns in addition to the period-to-date **COMPOSITE** return.) Returns for periods of less than one year **MUST NOT** be annualized.
 - c. Period-to-date **COMPOSITE** returns in addition to five years of annual **COMPOSITE** returns (or for each annual period since the **COMPOSITE INCEPTION DATE** if the **COMPOSITE** has been in existence for less than five years) with the period-end date clearly identified. The annual returns **MUST** be calculated through the same period of time as presented in the corresponding **COMPLIANT PRESENTATION**.

Discussion

Firms advertising performance results must also adhere to all applicable regulatory rules and requirements governing advertisements. Advertisements that present any performance and include the GIPS compliance statement for advertisements must present composite performance in accordance with one of the options as described.

Provisions 5.a and 5.b of the GIPS Advertising Guidelines require presentation of annualized composite returns, which represent the geometric average annual compound return achieved over the defined period of more than one year. Annualized performance is only permitted for periods of one year or more.

$$\text{Annualized Return (\%)} = \{[(1 + R)^{1/n}] - 1\} \times 100,$$

where R is the cumulative return for the period, which is calculated by geometrically linking the sub-period returns during the period, and n is the number of years in the period.

For example, a portfolio's cumulative return for a five-year period is 150.0%. It has a five-year average annual compound return, or annualized return, of 20.11%:

$$[(1 + 1.50)^{\frac{1}{5}}] - 1 = 0.2011 = 20.11\%.$$

If the 150% is earned over 12.5 years, its 12.5-year average annual compound return, or annualized return, is

$$[(1 + 1.50)^{\frac{1}{12.5}}] - 1 = 0.0761 = 7.61\%.$$

Advertising Guidelines Provision 5.a requires the firm to present one-, three-, and five-year annualized composite returns through the most recent period with the period-end date clearly identified. If the composite has been in existence for more than one year but less than five years, the firm must also present the annualized composite return from the composite inception date through the most recent period in addition to the most recent one-year return (and three-year annualized return, if appropriate). These returns must be derived from the performance included in or that *will be* included in the corresponding compliant presentation.

Advertising Guidelines Provision 5.b requires the firm to present period-to-date composite returns in addition to one-, three-, and five-year annualized composite returns through the same period of time as presented in the corresponding compliant presentation. If the composite has been in existence for more than one year but less than five years, the firm must also present the annualized composite return from the composite inception date through the most recent period in addition to the most recent one-year return (and three-year annualized return, if appropriate). These returns must be derived from the performance included in or that *will be* included in the corresponding compliant presentation.

Advertising Guidelines Provision 5.c requires the firm to present period-to-date composite returns in addition to five years of annual composite returns. The annual returns must be calculated through the same period of time and must be consistent with those presented in the corresponding compliant presentation. These returns must be the same as the performance included in or that will be included in the corresponding compliant presentation. If the composite has been in existence for less than five years, the firm must present the annual composite returns for each annual period since composite inception.

3 Explanation of the Provisions of the GIPS Standards

Example 1 Advertising Guidelines Provision 5.a—Sample Advertisement Including One-, Three-, and Five-Year Annualized Returns through the Most Recent Period

Generic Asset Management: Global Equity Growth Composite			
	Ending 31 March 2012		
	1-Year	3-Year Annualized	5-Year Annualized
Global Equity Growth Composite	−0.3%	13.7%	0.1%
XYZ World Index	−0.5%	13.8%	−0.6%

Note: Returns are measured in U.S. dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890 or write Generic Asset Management, One Plain Street, Returnsville 12345 or jpaul@genericassetmanagement.com.

Example 2 Advertising Guidelines Provision 5.b—Sample Advertisement Including Period-to-Date and One-, Three-, and Five-Year Annualized Returns through the Same Period of Time as Presented in the Corresponding Compliant Presentation

Generic Asset Management: Global Equity Growth Composite				
	Ending 31 Mar 2012	Ending 31 Dec 2011		
	Period to Date (3 months)	1-Year	3-Year Annualized	5-Year Annualized
Global Equity Growth Composite	−3.84%	1.3%	15.0%	−1.2%
XYZ World Index	−4.94%	1.5%	14.1%	−0.7%

Note: Returns are measured in U.S. dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890 or write Generic Asset Management, One Plain Street, Returnsville 12345 or jpaul@genericassetmanagement.com.

Example 3 Advertising Guidelines Provision 5.c—Sample Advertisement Including Five Years of Annual Returns

Generic Asset Management: Global Equity Growth Composite						
	Period to Date (3 months to 31 Mar 2012)	Annual Returns: Periods Ended 31 Dec				
		2011	2010	2009	2008	2007
Global Equity Growth Composite	-3.84%	1.3%	13.0%	33.0%	-40.6%	9.6%
XYZ World Index	-4.94%	1.5%	11.8%	30.8%	-40.3%	9.6%

Note: Returns are measured in U.S. dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890 or write Generic Asset Management, One Plain Street, Returnville 12345 or jpaul@genericassetmanagement.com.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

- Whether returns are presented **GROSS-OF-FEES** and/or **NET-OF-FEES**.

Discussion

The GIPS standards require that all performance must be calculated after the deduction of actual trading expenses and permit firms to present investment performance results gross-of-fees and/or net-of-fees. Firms advertising performance results must adhere to all applicable laws and regulations, including those governing advertisements. In some jurisdictions, laws and/or regulations require performance in an advertisement to be presented net-of-fees. Whether or not laws and/or regulations specify which returns must be presented in an advertisement, firms must clearly indicate in the advertisement whether returns are presented gross-of-fees or net-of-fees so that the reader of the advertisement can better understand the information presented.

3 Explanation of the Provisions of the GIPS Standards

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

7. The **TOTAL RETURN** for the **BENCHMARK** for the same periods for which the **COMPOSITE** return is presented. **FIRMS MUST** present **TOTAL RETURNS** for the same **BENCHMARK** as presented in the corresponding **COMPLIANT PRESENTATION**.

Discussion

Firms that present performance in an advertisement and include the GIPS compliance statement for advertisements have three options for presenting composite performance as described above in Advertising Guidelines Provisions 5.a, 5.b, and 5.c. Once an option is selected, firms must present the total return for the benchmark(s) for the same periods as the composite return in the advertisement. The benchmark presented in the advertisement must be consistent with the benchmark presented in the compliant presentation. If more than one benchmark is included in the compliant presentation, firms should consider whether multiple benchmarks should be presented in the advertisement. For more information on this requirement, please refer to the guidance provided in this Handbook for Provision 5.A.1.e.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

8. The **BENCHMARK DESCRIPTION**.

Discussion

In addition to presenting a total return for a benchmark, firms must also disclose the benchmark description. This disclosure must be consistent with the disclosure of the benchmark description included in the corresponding compliant presentation (as required by Provision 4.A.4) unless the disclosure included in the advertisement is a more current benchmark description that has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation. For more information on this disclosure, please refer to the guidance provided in this Handbook for Provision 4.A.4.

Sample Disclosure:

“The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market country-specific indices.”

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

9. If the **FIRM** determines no appropriate **BENCHMARK** for the **COMPOSITE** exists, the firm **MUST** disclose why no **BENCHMARK** is presented.

Discussion

The GIPS standards require firms to present total returns for a benchmark that reflects the investment mandate, objective, or strategy of the composite. In instances where no benchmark is provided because an appropriate benchmark does not exist, the firm must explain why no benchmark is presented.

This disclosure must be consistent with the disclosure required by Provision 4.A.29 in the corresponding compliant presentation unless the disclosure included in the advertisement is more current and has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation. For more information, please refer to the guidance provided in this Handbook on Provision 4.A.29.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

10. The currency used to express performance.

Discussion

Firms are required to disclose the currency used to express any performance in the advertisement. Firms must adhere to the guidance provided in this Handbook on Provision 4.A.7.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

11. 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.

3 Explanation of the Provisions of the GIPS Standards

Discussion

This disclosure must be consistent with the disclosure required by Provision 4.A.13 in the corresponding compliant presentation unless the disclosure included in the advertisement is more current and has not yet been reflected in the corresponding compliant presentation. It is not expected that this disclosure would differ from the disclosure required in the corresponding compliant presentation. For more information on this disclosure, please refer to the guidance provided in this Handbook on Provision 4.A.13.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

12. For any performance presented in an advertisement for periods prior to 1 January 2000 that does not comply with the GIPS standards, the period of non-compliance.

Discussion

The GIPS standards allow firms to link non-GIPS-compliant performance to their compliant history provided that no non-compliant performance is shown for periods beginning on or after 1 January 2000. If the firm chooses to present non-compliant performance for periods prior to 1 January 2000, the firm must disclose which periods are not in compliance. For more information on this disclosure, please refer to the guidance provided in this Handbook on Provision 4.A.15.

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance **MUST** include the first three items above and **MUST** also disclose the following information, which **MUST** be taken or derived from a **COMPLIANT PRESENTATION**:

13. If the advertisement conforms with laws and/or regulations that conflict with the **REQUIREMENTS** of the GIPS standards and/or the GIPS Advertising Guidelines, **FIRMS MUST** disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards and/or the GIPS Advertising Guidelines.

Discussion

Firms must comply with all applicable laws and regulations regarding the calculation and presentation of performance. Firms must also comply with all of the requirements of the GIPS standards. If the firm chooses to advertise its claim of compliance with the GIPS standards following the GIPS Advertising Guidelines, firms must also comply with all of the requirements of the GIPS Advertising Guidelines. Compliance with applicable laws and regulations does not necessarily result in compliance with the GIPS standards and/or the GIPS Advertising Guidelines.

Firms choosing to advertise their claim of compliance with the GIPS standards following the GIPS Advertising Guidelines must comply with the GIPS standards and the GIPS Advertising Guidelines as well as all applicable laws and regulations unless there is a conflict. In the rare cases where laws

and regulations conflict with the GIPS standards and/or the GIPS Advertising Guidelines, firms are required to comply with the laws and regulations and disclose the manner in which the laws and/or regulations conflict with the GIPS standards and/or GIPS Advertising Guidelines.

This disclosure will assist prospective clients in comparing performance information included in advertisements among firms where reporting requirements may differ due to local laws or regulations.

4 GUIDANCE STATEMENTS

4-1 GUIDANCE STATEMENT ON ALTERNATIVE INVESTMENT STRATEGIES AND STRUCTURES

Adoption Date: 18 May 2012
Effective Date: 1 October 2012
Retroactive Application: No
Public Comment Period: 15 March–15 June 2011

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.

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.

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.

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.

Areas of Concern with Applying the GIPS Standards to Alternative Investment Strategies and Structures

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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.

Fundamentals of Compliance

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.

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.

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.

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.

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.

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 of the GIPS standards. 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. In 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.

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

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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.

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:

1. 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.
2. 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.
3. 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

4-1 Guidance Statement on Alternative Investment Strategies and Structures

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.

Calculation Methodology

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.

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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.

Composite Construction

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

Unique Alternative Investment Strategies

Many alternative investment vehicles and hedge funds follow a unique investment strategy and are not necessarily comparable with 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) whether they can be grouped into new composites, or (3) whether separate single-portfolio (e.g., fund) composites should be created.

The last 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:

- 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.
- 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.
- 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.
- 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.

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.

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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.

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 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 pocket, 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.

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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 are 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.
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.

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.

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.

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

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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.

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.

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.

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

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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.

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 Frequency of Valuation of Portfolios). 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 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.

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.

Questions & Answers

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

Fundamentals of Compliance

1. *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?*

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.

2. *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 those funds in the definition of the firm and the relevant portfolio universe?*

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.

3. *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?*

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.

Input Data

4. *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, 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?*

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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.

Performance Measurement

5. *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.*

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 its 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	$10,000 \times 0.7 = 7,000$	$(360 - 300)/300 = 20\%$	$(360 - 300)/7,000 = 0.86\%$
Total	600	680			11,900	13.33%	0.67%

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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.”

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

	Option 1 Leveraged Return	Option 2 Unleveraged Return	Option 3 Removing Derivatives
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.

6. *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?*

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.

7. *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?*

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;

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- 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.

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

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 that double-counting of assets for the calculation of composite assets and total firm assets 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%
Composite	100+200=300	$5% \times (100/300) + 10% \times (200/300) = 8.33%$

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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%
Composite	100+200-50=250	0%×(50/250)+10%×(200/250)=8.00%

Composite Construction

9. *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?*

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.

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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.

10. *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 a 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?*

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.

11. *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?*

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.

12. *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?

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 implements 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 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."

Presentation and Disclosure

13. *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?*

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.

4-2 GUIDANCE STATEMENT ON CALCULATION METHODOLOGY

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

Achieving comparability among firms' compliant presentations requires as much uniformity as possible in the methodology used to calculate portfolio and composite returns. The uniformity of the return calculation methodology is dependent on accurate and consistent input data, a critical component to compliance with the GIPS standards. Although the GIPS standards allow flexibility in return calculation, the return must be calculated using a methodology that incorporates the time-weighted rate of return concept for all portfolios except for private equity. For information on calculating performance for private equity, see the private equity provisions and guidance.

The GIPS standards require a time-weighted rate of return because it removes the effects of external cash flows, which are generally client driven. Therefore, a time-weighted rate of return best reflects the firm's ability to manage the portfolios according to a specified mandate, objective, or strategy and is the basis for the comparability of composite returns among firms on a global basis.

In this Guidance Statement, the term "return" is used, rather than the more common term "performance," to emphasize the distinction between return and risk and to encourage the view of performance as a combination of risk and return. Risk measures are valuable tools for assessing the abilities of asset managers; however, this Guidance Statement focuses only on the return calculation.

Money- or dollar-weighted returns may add further value in understanding the impact to the client of the timing of external cash flows but are less useful for return comparisons and are, therefore, not covered by this Guidance Statement.

Guiding Principles

Valuation Principles

The following are guiding principles that firms must use when determining portfolio values as the basis for return calculations:

- 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 of the GIPS standards.
- For periods prior to 1 January 2011, portfolio valuations must be based on market values (not cost basis or book values).
- Firms must value portfolios in accordance with the composite-specific valuation policy.
 - For periods prior to 1 January 2001, portfolios must be valued at least quarterly.

- For periods beginning on or after 1 January 2001, portfolios must be valued at least monthly.
- For periods beginning on or after 1 January 2010, firms must value portfolios on the date of all large cash flows. Firms must define large cash flow for each composite to determine when portfolios in that composite must be valued.
- Portfolios must not be valued more frequently than required by the composite-specific valuation policy.
- For periods beginning on or after 1 January 2010, firms must value portfolios as of the calendar month end or the last business day of the month.
- Firms must use trade-date accounting for periods beginning on or after 1 January 2005. [Note: for purposes of the GIPS standards, trade date accounting recognizes the asset or liability on the date of the purchase or sale, not on the settlement date. Recognizing the asset or liability within three days of the date the transaction is entered into (trade date, T + 1, T + 2, or T + 3) satisfies the trade-date accounting requirement for purposes of the GIPS standards.]
- Accrual accounting must be used for fixed-income securities and all other investments that earn interest income. The value of fixed-income securities must include accrued income.
- Accrual accounting should be used for dividends (as of the ex-dividend date).

Calculation Principles for Portfolios

The following are guiding principles that firms must use when calculating *portfolio* returns:

- All returns must be calculated after the deduction of the actual trading expenses incurred during the period. Firms must not use estimated trading expenses.
- Total returns must be used. Total return is defined as the rate of the return that includes the realized and unrealized gains and losses plus income for the measurement period.
- The calculation method chosen must represent returns fairly, must not be misleading, and must be applied consistently.
- Firms must calculate time-weighted rates of return that adjust for external cash flows. External cash flow is defined as capital (cash or investments) that enters or exits a portfolio and is generally client driven. Income earned on a portfolio's investments is not considered an external cash flow unless it is paid out of the portfolio.
- For periods beginning on or after 1 January 2005, firms must calculate portfolio returns that adjust for daily-weighted external cash flows. An example of this methodology is the Modified Dietz method.
- For periods beginning on or after 1 January 2010, at the latest, firms must calculate performance for interim sub-periods between all large cash flows and geometrically link performance to calculate periodic returns. (Note: For periods beginning on or after 1 January 2010, firms must define prospectively, on a composite-specific basis, what constitutes a large cash flow.) For information on calculating a "true" time-weighted return, see the "Time-Weighted Rate of Return" section below.
- External cash flows must be treated in a manner consistent with the firm's documented composite-specific policy.

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- For periods beginning on or after 1 January 2001, firms must calculate portfolio returns at least monthly. For periods prior to 2001, portfolio returns must be calculated at least quarterly.
- Periodic and sub-period returns must be geometrically linked.

Calculation Principles for Composites

The following are guiding principles that firms must use when calculating *composite* returns:

- 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 aggregate return method, which combines all the composite assets and cash flows to calculate composite performance as if the composite were one portfolio, is acceptable as an asset-weighted approach.
- For periods beginning on or after 1 January 2006 and prior to 1 January 2010, firms must calculate composite returns by asset-weighting the individual portfolio returns at least quarterly. For periods beginning on or after 1 January 2010, composite returns must be calculated by asset-weighting the individual portfolio returns at least monthly.
- Periodic and sub-period returns must be geometrically linked.

Cash Flow Principles

The following are guiding principles that firms must consider when defining their composite-specific cash flow policies:

- An *external cash flow* is a flow of capital (cash or investments) that enters or exits a portfolio, which is generally client driven. When calculating approximated rates of return, where the calculation methodology requires an adjustment for the daily-weighting of cash flows, the formula reflects a weight for each external cash flow. The cash flow weight is determined by the amount of time the cash flow is held in the portfolio.
- When calculating a more accurate time-weighted return, a *large cash flow* must be defined by each firm for each composite to determine when the portfolios in that composite are to be valued for performance calculations. It is the level at which the firm determines that an external cash flow may distort performance if the portfolio is not valued. Firms must define the amount in terms of the value of the cash/asset flow or in terms of a percentage of the portfolio assets or the composite assets. The large cash flow determines when a portfolio is to be valued for performance calculations.
- A large cash flow is differentiated from a *significant cash flow*, which occurs in situations where the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy and the portfolio is temporarily removed from the composite or the external cash flow is placed in a temporary new account. Please see the Guidance Statement on the Treatment of Significant Cash Flows, which details the procedures and criteria that firms must adhere to and offers additional options for dealing with the impact of significant cash flows on portfolios.

Time-Weighted Rate of Return

Valuing the portfolio and calculating interim returns each time there is an external cash flow results in the most accurate method to calculate the time-weighted rates of return. The formula for calculating the time-weighted portfolio return when there are no external cash flows is:

$$r_i = \frac{V_i^E - V_i^B}{V_i^B},$$

where

r_i = the return for period i in which there are no external cash flows

V_i^E = the ending value of the portfolio for period i

V_i^B = the beginning value of the portfolio for period i

When a portfolio experiences external cash flows during a period, the most accurate return is calculated by valuing the portfolio at the time of the external cash flow, calculating the time-weighted return for each sub-period (defined as the period between external cash flows), and then geometrically linking the sub-period returns using the following formula:

$$r_t^{TWR} = [(1 + r_1) \times (1 + r_2) \times \cdots \times (1 + r_I)] - 1,$$

where r_t^{TWR} is the time-weighted return for period t and period t consists of I sub-periods.

Approximation of Time-Weighted Rate of Return

As mentioned in the introduction, the GIPS standards require firms to calculate a time-weighted rate of return, except for private equity. The GIPS standards allow flexibility in choosing the calculation methodology, which means that firms may use alternative formulas provided the calculation method chosen represents returns fairly, is not misleading, and is applied consistently.

Calculating a time-weighted rate of return is not an easy task and may be cost intensive. For these reasons, firms may use an approximation method to calculate the total return of the individual portfolios for the periods and sub-periods. The most common approximation methods combine specific rate of return methodologies (such as the original Dietz method, the Modified Dietz method, the original IRR [internal rate of return] method, and the Modified BAI [Bank Administration Institute] method) for sub-periods, and then geometrically links the sub-period returns.

Just as the GIPS standards transition to more frequent valuations, the GIPS standards also transition to more precise calculation methodologies. Therefore, the GIPS standards require firms to calculate approximated time-weighted rates of return that adjust for daily-weighted external cash flows (e.g., Modified Dietz method) for periods beginning on or after 1 January 2005. For periods beginning on or after 1 January 2010, firms are required to calculate a more accurate time-weighted rate of return and are required to value portfolios at the time of each large cash flow, as well as at calendar month-end or on the last business day of the month.

According to the *Modified Dietz* method the portfolio return can be calculated using the formula:

$$r_t^{MD} = \frac{V_t^E - V_t^B - \sum_{i=1}^I CF_{i,t}}{V_t^B + \sum_{i=1}^I (CF_{i,t} \times w_{i,t})},$$

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where

r_t^{MD} = the Modified Dietz return for the portfolio for period t

V_t^E = the ending value of the portfolio for period t

V_t^B = the beginning value of the portfolio for period t

i = the number of external cash flows (1, 2, 3... I) in period t

$CF_{i,t}$ = the value of cash flow i in period t

$w_{i,t}$ = the weight of cash flow i in period t (assuming the cash flow occurred at the end of the day), as calculated according to the following formula:

$$w_{i,t} = \frac{D_t - D_{i,t}}{D_t}$$

where

$w_{i,t}$ = the weight of cash flow i in period t , assuming the cash flow occurred at the end of the day

D_t = the total number of calendar days in period t

$D_{i,t}$ = the number of calendar days from the beginning of period t to cash flow i

While this Guidance Statement only contains details about the Modified Dietz method, other formulas for calculating approximate time-weighted rates of return are also permitted.

Composite Return Calculation

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 intention is to show a composite return that reflects the overall return of the set of the portfolios included in the composite.

To calculate composite returns, firms may use alternative formulas so long as the calculation method chosen represents returns fairly, is not misleading, and is applied consistently.

According to the *Beginning Assets Weighting* method, the composite return, R_t , can be calculated using the formula:

$$R_t = \frac{\sum_{k=1}^K (V_{k,t}^B \times r_{k,t})}{\sum_{k=1}^K V_{k,t}^B},$$

where

R_t = the Beginning Assets Weighted return for the composite for period t

k = number of portfolios (1, 2, 3,..., K) in the composite at the beginning of period t

$V_{k,t}^B$ = the beginning value of portfolio k for period t

$r_{k,t}$ = the return of portfolio k for period t

The *Beginning Assets Weighting* method can also be expressed as:

$$R_t = \sum_{k=1}^K \left(\frac{V_{k,t}^B}{\sum_{k=1}^K V_{k,t}^B} \times r_{k,t} \right) = \sum_{k=1}^K w_{k,t}^B \times r_{k,t},$$

where $w_{k,t}^B$ is the weight of the value of portfolio k as a fraction of total composite asset value based on beginning asset values for period t and can be calculated according to the following formula:

$$w_{k,t}^B = \frac{V_{k,t}^B}{\sum_{k=1}^K V_{k,t}^B}.$$

The *Beginning Assets Plus Weighted Cash Flow* method represents a refinement to the Beginning Assets weighting method. Consider the case in which one of two portfolios in a composite doubles in value as the result of a contribution on the third day of a performance period. Under the Beginning Assets weighting method, this portfolio will be weighted in the composite based solely on its beginning value (i.e., not including the contribution). The *Beginning Assets Plus Weighted Cash Flow* method resolves this problem by including the effect of external cash flows in the weighting calculation.

Assuming that external cash flows occur at the end of the day, the weighting factor for each cash flow is calculated as:

$$w_{i,k,t} = \frac{D_t - D_{i,k,t}}{D_t},$$

where

$w_{i,k,t}$ = the weight of cash flow i in portfolio k in period t , assuming the cash flow occurred at the end of the day

D_t = the total number of calendar days in period t

$D_{i,k,t}$ = the number of calendar days from the beginning of period t to cash flow i in portfolio k

The *Beginning Assets Plus Weighted Cash Flow* composite return can be calculated as follows:

$$R_t = \frac{\sum_{k=1}^K \left\{ \left[V_{k,t}^B + \sum_{i=1}^{I_k} (CF_{i,k,t} \times w_{i,k,t}) \right] \times r_{k,t} \right\}}{\sum_{k=1}^K \left[V_{k,t}^B + \sum_{i=1}^{I_k} (CF_{i,k,t} \times w_{i,k,t}) \right]},$$

where

R_t = the Beginning Assets Plus Weighted Cash Flow composite return for period t

$V_{k,t}^B$ = the beginning value of portfolio k for period t

i_k = the number of cash flows (1, 2, 3, ..., I_k) in portfolio k

$CF_{i,k,t}$ = the i th cash flow in portfolio k for period t

$w_{i,k,t}$ = the weight of cash flow i in portfolio k for period t

$r_{k,t}$ = the return for portfolio k for period t

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The *Beginning Assets Plus Weighted Cash Flow* composite return method can also be expressed by the following formula:

$$R_t = \sum_{k=1}^K \left(\frac{V_{k,t}}{\sum_{k=1}^K V_{k,t}} \times r_{k,t} \right),$$

where

R_t = the Beginning Asset Plus Weighted Cash Flow composite return for period t

$r_{k,t}$ = the return for portfolio k for period t

$V_{k,t}$ = the beginning value plus weighted cash flows of portfolio k for period t as calculated according to the following formula:

$$V_{k,t} = V_{k,t}^B + \sum_{i=1}^{I_k} (CF_{i,k,t} \times w_{i,k,t}),$$

where

$V_{k,t}$ = the value of portfolio k 's beginning assets plus weighted cash flows for period t

$V_{k,t}^B$ = the beginning value of portfolio k for period t

i_k = the number of cash flows (1, 2, 3, ..., I_k) in portfolio k

$CF_{i,k,t}$ = the i th cash flow in portfolio k for period t

$w_{i,k,t}$ = the weight of cash flow i in portfolio k for period t

The *Aggregate Return* method combines all the composite assets and external cash flows before any calculations occur to calculate returns as if the composite were one portfolio. The method is also acceptable as an asset-weighted approach.

Geometric Linking of the Periodic Composite Returns

To calculate the composite return over more than one period or sub-period, the composite return over the total period is calculated by geometrically link the individual composite periodic returns using the following formula:

$$R_t^{TWR} = [(1 + r_1) \times (1 + r_2) \times \dots \times (1 + r_I)] - 1,$$

where R_t^{TWR} is the time-weighted composite return for period t and period t consists of I sub-periods.

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Additional Considerations

Changes to the Methodology

Where appropriate, in the interest of fair representation and full disclosure, firms should disclose material changes to their calculation and valuation policies and/or methodologies.

Third-Party Performance Measurement

Firms may use portfolio returns calculated by a third-party performance measurer as long as the methodology adheres to the requirements of the GIPS standards.

Different Valuation and/or Calculation Method

Firms are permitted to include portfolios with different valuation and/or calculation methodologies within the same composite as long as the methodologies adhere to the requirements of the GIPS standards. Firms must be consistent in the methodology used for a portfolio (e.g., firms cannot change the methodology for a portfolio from month to month).

Month End Valuations

Firms must be consistent in defining the (monthly) valuation period. The valuation period must end on the same day as the reporting period. In other words, firms must value the portfolio/composite on the last day of the reporting period or the nearest business day. Including portfolios with different ending valuation dates in the same composite is not permitted for periods beginning on or after 1 January 2006. For periods beginning on or after 1 January 2010, firms must value portfolios as of the calendar month-end or the last business day of the month.

Trading Expenses

Returns must be calculated after the deduction of the actual trading expenses. Trading expenses are the actual costs of buying or selling investments. These costs typically take the form of brokerage commissions, exchange fees, taxes, bid–offer spreads from either internal or external brokers, and any other regulatory fee, duty, etc., associated with an individual transaction. Custodial fees charged per transaction should be considered custody fees, not trading expenses.

Trade-Date Accounting

Firms must use trade-date accounting for periods beginning on or after 1 January 2005. Trade-date accounting recognizes an asset or liability on the date of the purchase or sale, 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.

Taxes

Firms must disclose relevant details of the treatment of withholding taxes on dividends, interest income, and capital gains, if material. Returns should be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes should be accrued.

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Grossing Up or Netting Down of Investment Management Fees

Firms are allowed to include portfolios with different grossing-up methodologies within the same composite. Firms must be consistent in the methodology used for a portfolio (e.g., firms cannot change the methodology for a portfolio from month to month). Please see the Guidance Statement on Fees.

Large Cash Flows

The firm must have an established composite-specific policy on defining and valuing large cash flows and must apply this policy consistently. Actual valuation at the time of any large cash flow is required for periods beginning on or after 1 January 2010.

Disclosures

Firms must disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Effective Date

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

4-3 GUIDANCE STATEMENT ON COMPOSITE DEFINITION

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

Three of the most fundamental issues that a firm must consider when becoming compliant with the Global Investment Performance Standards are the definition of the firm, the firm's definition of discretion, and the firm's composite definitions. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. The firm's definition of discretion establishes criteria to judge which portfolios should be in a composite to accurately reflect the application of the firm's investment strategy. Once the firm and discretion have been defined, composites can be constructed based on the strategies implemented by the firm. Firms are reminded that, under the GIPS standards, they must comply with all applicable laws and regulations regarding the calculation and presentation of performance.

A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy and is the primary vehicle for presenting performance to prospective clients. The firm must include all actual, fee-paying, discretionary portfolios in at least one composite. Composites must include all portfolios that meet the composite definition. In this way, firms cannot "cherry-pick" their best performing portfolios to present to prospective clients. Non-fee-paying portfolios may be included in the firm's composites; however, firms must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period-end.

If the firm includes non-fee-paying portfolios in its composites, they are subject to the same rules as fee-paying portfolios (e.g., the firm must not move the non-fee-paying portfolio into and out of a composite without documented changes in client guidelines or the redefinition of the composite make it appropriate). Firms are permitted to include a portfolio in more than one composite provided it satisfies the definition of each composite. Non-discretionary portfolios must not be included in a firm's composites.

Before defining composites, the firm must establish reasonable criteria that support the fundamental principle of fair representation. A variety of criteria must be analyzed to identify whether portfolios are similar and should be grouped together into a composite.

Guiding Principles

The GIPS standards encourage firms to develop objective criteria for defining composites. The following are guiding principles that firms must consider when defining composites:

- Composites must be defined according to investment mandate, objective, or strategy. Composites should enable clients to compare the performance of one firm with another. The firm should also consider the definition and construction of similar products found within the competitive universe. Composites must be representative of the firm's products and be consistent with the firm's marketing strategy.
- Firms must apply the criteria for defining composites consistently (e.g., the firm may not select only certain, specific portfolios (i.e., cherry-picking) that meet the composite definition but must include all portfolios that satisfy the criteria for inclusion).
- Firms are not permitted to include portfolios with materially dissimilar investment mandates, objectives, or strategies in the same composite. The performance of such a composite is meaningless. In the case where there are many portfolios with unique, defining investment characteristics, it may be necessary for the firm to create numerous single-portfolio composites.
- Portfolios must not be switched from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes switching appropriate. The historical performance of the portfolio must remain with the original composite.

Discretion

Discretion is the ability of the firm to implement its intended strategy. If documented client-imposed restrictions significantly hinder the firm from fully implementing its intended strategy, the firm may determine that the portfolio is non-discretionary. Non-discretionary portfolios must not be included in a firm's composites. There are degrees of discretion and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy. For example, if a client requests that the firm not purchase any tobacco stocks in their portfolio, the firm should first consider if this restriction will hinder the implementation of the intended strategy. If so, the firm could either classify this portfolio as non-discretionary (and all other portfolios with this restriction) or could choose to classify it as discretionary and create a composite for portfolios with tobacco restrictions. Firms should, where possible, consider classifying these portfolios as discretionary and grouping them with portfolios with similar restrictions in a separate composite.

Firms must document their policies and procedures used in establishing and maintaining compliance with the GIPS standards. As such, each firm must document its definition of discretion and must apply the definition consistently. Ideally, discretion is defined at the firm level, but may be defined at the composite level or by asset class. Firms must maintain records to support why a portfolio was assigned to a specific composite or was excluded from all composites. It is the firm's responsibility to ensure that all of its actual, fee-paying discretionary portfolios are included in at least one composite. Accordingly, firms must review each of their portfolios (both discretionary

and non-discretionary) on a regular basis to determine whether any portfolios must be re-classified. According to the GIPS verification procedures, included in Chapter IV of the GIPS standards, a verifier must determine if the firm's definition of discretion has been applied consistently over time.

Examples of client-imposed restrictions that may cause a portfolio to be classified as non-discretionary include, but are not limited to:

- restrictions on trading activities due to conditional client approval,
- restrictions on asset allocation (i.e., the firm cannot alter asset allocation established by the client),
- tax considerations (e.g., low-cost-basis stocks),
- limits on the sale of certain securities (e.g., sentimental holdings),
- restrictions on the purchase of certain securities or types of securities (e.g., the firm cannot buy tobacco stocks, the firm cannot buy futures, the firm cannot buy securities below a specific quality),
- cash flow requirements (e.g., the client requires large cash distributions on a regular basis), or
- legal restrictions.

Few of these restrictions are reason to *automatically* classify a portfolio as non-discretionary, as the firm must determine if the restriction will significantly hinder the implementation of the intended strategy. In addition, the outsourcing of performance measurement or record keeping by a third party does not negate the firm's responsibility related to compliance and is not a sufficient reason to classify portfolios as non-discretionary.

In the case of client-restricted securities (e.g., low-cost-basis stocks, held to maturity securities), the firm may choose to classify the restricted portion of the portfolio as non-discretionary (also commonly referred to as "unmanaged" or "unsupervised") and keep the remaining discretionary portion of the portfolio in the composite, provided the remaining portion is representative of the composite's strategy. When considering if a portion of a portfolio should be classified as non-discretionary, firms should consider if the assets affect the management of the portfolio's investment strategy. All calculation and composite construction requirements would apply to the remaining discretionary portion of the portfolio.

Non-discretionary portfolios are not permitted to be included in the firm's composites (i.e., composites consisting of discretionary portfolios). Some firms, however, may group some or all of the firm's non-discretionary portfolios together to simplify composite administration. According to the GIPS standards, this is *not* a composite and must not be included on the firm's list of composite descriptions.

Minimum Asset Level

If the firm sets a minimum asset level for portfolios to be included in a composite, no portfolios below that asset level can be included in that composite. Firms must disclose the minimum asset level, if any, below which portfolios are not included in a composite. Firms must also disclose any changes to the minimum asset level. Firms should not present a compliant presentation of the composite to a prospective client who is known not to meet the composite's minimum asset level. Firms must disclose the minimum asset level of the composite, if one exists, in each respective

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compliant presentation and must consistently apply the minimum. Firms must document and disclose changes to the minimum asset level and must not retroactively apply the new limit. Portfolios below the minimum are not necessarily non-discretionary; however, asset level can affect discretion.

Portfolios may fall below the minimum due to client withdrawals or depreciation in value. Firms must determine, as part of their policies regarding minimum asset levels, which value will be used to evaluate composite portfolios against the minimum asset level (e.g., beginning value, ending value, beginning value plus cash flows). If a firm establishes a minimum asset level, it must document its policies regarding how portfolios will be treated if they fall below the minimum and must apply these policies consistently. Firms should consider establishing a threshold for the application of the minimum asset level and a minimum time period in order to minimize portfolio movement into or out of a composite. For example, the firm establishes a range of $\pm 5\%$ of the minimum asset level when determining when to remove a portfolio from the composite and/or the firm establishes that a portfolio must remain above/below the minimum for at least two periods prior to addition/removal. If a portfolio is removed from a composite, the prior history of the portfolio must remain in the composite. Like all policies, once the firm establishes a policy regarding the minimum asset level, it must be applied consistently. Once a portfolio is removed, the firm must determine if the portfolio meets any other composite definition and must include it in the appropriate composite(s) in a timely and consistent manner.

Firms should bear in mind that if all the portfolios in a composite fall below the minimum asset level and, according to the firm's policies, are removed from the composite, the performance record of the composite comes to an end. If after a period of time, portfolios move above the minimum asset level or new portfolios are added to the composite, the prior performance history of the composite must be shown but not be mathematically linked to the ongoing composite performance.

Composite Creation Date

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

Composite Definition

Creating meaningful composites is critical to fair presentation, consistency, and comparability of results over time and among firms. A composite's definition must include detailed criteria that determine the assignment of portfolios to composites and must be made available upon request. Firms must document policies and procedures related to composite definition.

While investment strategies can change over time, in most cases, firms should not change the definition of a composite. Generally, changes in strategy result in the creation of a new composite. In some very rare cases, however, it may be appropriate to redefine a composite. If a firm determines that it is appropriate to redefine a composite, it must disclose the date of, description of, and reason for the redefinition. Changes to composites must not be applied retroactively. It is required that firms disclose any changes to the name of a composite. Terminated composites must

continue to be listed on the firm's list of composite descriptions for five years after termination. When requested, firms must provide a compliant presentation for any composite on the firm's list of composite descriptions.

Firms are only permitted to move portfolios into and out of composites due to documented changes to a portfolio's investment mandate, objective, or strategy or in the case where the redefinition of the composite makes it appropriate. For purposes of the GIPS standards, documentation can include, but is not limited to, letters, faxes, e-mails, and/or internal memorandums documenting conversations with clients. The historical performance of the portfolio must remain with the original composite.

Composite Definition Criteria

In addition to the guiding principles above, firms may choose to define their composites according to relevant criteria and must document the definition of each composite, including any criteria or constraints. It is constructive to consider a hierarchical structure of criteria for composite definition that promotes primary and secondary strategy characteristics. It is also important to understand the defining characteristics commonly found in the marketplace for investment products. Comparability of similar strategies or products is a fundamental objective of the GIPS standards, and current and prospective clients benefit when firms define composites similarly, using clear and unambiguous terminology.

Suggested Hierarchy for Composite Definition

The following suggested hierarchy may be helpful as firms consider how to define composites. Firms are not required to define their composites according to each level of the hierarchy.

- **Investment Mandate**

Composites based on the summary of strategy or product description.

Example: Large-cap global equities

- **Asset Class**

Composites based on a broad asset class are the most basic and should be representative of the firm's products. Firms may further define asset classes by country or region.

Examples: Equity, fixed income, balanced, real estate, venture capital, U.S. fixed income, European equities

- **Style or Strategy**

Firms may further define a composite based on the style or strategy in order to provide investors with additional insight and allow for increased comparability.

Examples: Growth, value, active, indexed, asset class sector (e.g., telecommunications)

- **Benchmarks**

Firms may define composites on the basis of the portfolios' benchmark or index provided the benchmark reflects the investment objective or strategy and there are no other composites with the same characteristics. This is often the case if the benchmark also defines the investment universe.

Examples: Swiss Market Index, S&P 500 Index, Barclays Capital Aggregate Index

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■ *Risk/Return Characteristics*

Portfolios with different risk characteristics (e.g., targeted tracking error, beta, volatility, and information ratio) and return objectives may be grouped together into different composites.

Example: A Japanese equity composite with a targeted excess return of 1% and targeted tracking error of 2% would be in a separate composite from a Japanese equity composite with a targeted excess return of 3% and targeted maximum volatility of 6%.

Constraints/Guidelines

In addition to the fundamental criteria above, firms may choose to further define their composites based on relevant client constraints or guidelines. The following are example of constraints or guidelines that could result in materially different strategies and, therefore, justify separate composites.

■ *Extent of the Use of Derivatives, Hedging, and/or Leverage*

In general, portfolios that use derivatives, leverage, and/or hedging have a unique investment strategy from those portfolios that do not utilize these techniques or instruments. Accordingly, firms must consider whether portfolios that use leverage, derivatives, and/or hedging should be included in separate composites from portfolios that are restricted from using such instruments or strategies.

■ *Treatment of Taxes*

The firm should define separate composites for portfolios with specific tax treatments if the treatment of taxes hinders the firm's ability to implement a specific investment strategy as compared with similar portfolios without specific tax treatments. For example, the different tax situations of corporate or insurance clients and private clients may require different investment strategies in terms of emphasizing growth versus yield or dividend versus interest income. If so, firms are required to define separate composites appropriate to the different strategies.

■ *Type of Client* (e.g., pension fund, private client, endowment)

Client type alone must not be used as the primary criterion for defining a composite. In some cases, the client type determines the investment strategy because of characteristics that are unique to the client type. If portfolios of different client types have materially different investment strategies and/or styles that are specific to the type of client, the firm must create separate composites representing each of the different strategies.

■ *Instruments Used* (e.g., invest only in pooled vehicles versus individual securities)

If portfolios use specific instruments, the firm may define separate composites.

■ *Size of Portfolios*

Differences in portfolio size may result in meaningful, material differences in investment strategy and justify the creation of separate composites. For example, an index strategy may be implemented via sampling (i.e., holding a sample of the index securities) for smaller portfolios, while the strategy may be implemented via a full replication of the index for larger portfolios. In this case, the strategy is actually different based on the size of portfolio.

- **Client Characteristics** (e.g., cash flow needs, risk tolerances)
Firms may create composites based on multiple client characteristics. For example, a firm may choose to create a composite composed of growth equity, taxable clients that allow leverage and have a targeted tracking error of 4%.
- **Portfolio Types** (e.g., segregated [separate] portfolios, pooled portfolios [mutual funds])
Pooled funds, including mutual funds and unit trusts, may be treated as separate composites or combined with other portfolios into one or more composites of the same strategy, style, or objective.
- **Base Currency**
Base currency must *not* be a criterion used for composite definition unless it is specific to the investment strategy.

Additional Considerations

- **Multiple Asset Class Portfolios**
Multi-asset or balanced portfolios are portfolios that consist of more than one asset class. Composites should be constructed according to strategic ranges of asset mixes provided in the client investment guidelines, not according to the tactical percentage of assets invested in the different asset classes. Portfolios with varying but similar strategic asset allocations can be grouped together if they collectively have the same strategy or style. Firms often have discretion to tactically alter the asset allocation in an effort to add value. Portfolios must not be moved into or out of composites due to changes in the tactical asset allocation. Only in the case of client-documented strategic asset allocation changes can portfolios be moved into different composites.
- **Inception Date**
In general, firms are not permitted to create composites based solely on inception date. However, in very specific situations, it may be appropriate to group portfolios into composites according to inception date (e.g., private equity composites, after-tax composites, municipal bond composites).
- **Firms with Multiple Offices, Branches, or Investment Divisions**
Firms are only permitted to define different composites for offices, branches, or investment divisions of a firm *if* the portfolios are managed according to investment objectives, mandates, or strategies that are unique to each particular office, branch, or division. Thus, it is the investment objective, mandate, or strategy that determines the composite, not the location or group. Composite definition cannot span multiple firms. For additional guidance regarding how the firm can be defined, please refer to the Guidance Statement on Definition of the Firm.
- **Internal Dispersion of Portfolio Returns within a Composite**
While internal dispersion is one measure to determine how consistently the firm has implemented its strategy across the portfolios in the composite, it can only be measured on an ex-post basis and, therefore, must not be used as a criterion to define a composite. An internal dispersion figure may serve as a good indicator of whether the criteria for composite definition are suitable and whether or not to redefine the composite. There is no general rule for a maximum amount

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of composite dispersion. The firm should contemplate the definition of a broad, “inclusive” composite with a wide internal dispersion of portfolio returns versus a narrow, “exclusive” composite with a more narrow internal dispersion measure.

- ***Treatment of Fees***

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

Effective Date

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

4-4 GUIDANCE STATEMENT ON DEFINITION OF THE FIRM

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

Three of the most fundamental issues that a firm must consider when becoming compliant with the GIPS standards are the definition of the firm, the firm's definition of discretion, and the firm's composite definitions. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. The firm's definition of discretion establishes criteria to judge which portfolios should be in a composite to accurately reflect the application of the firm's investment strategy. Once the firm and discretion have been defined, composites can be constructed based on the strategies implemented by the firm.

The GIPS standards must be applied on a firm-wide basis. As the first step in complying with the GIPS standards, the firm must be defined fairly and appropriately. Compliance with the GIPS standards relies on a clear and consistent definition of the firm. The GIPS standards require that the definition of the firm be disclosed in compliant presentations, and the verification procedures require that verifiers perform sufficient procedures to determine that the firm is, and has been, appropriately defined.

In addition, 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 actual, fee-paying, discretionary portfolios must be included in at least one composite.

As merger and acquisition activity can affect the definition of the firm, the Guidance Statement on Performance Record Portability must also be considered.

Guiding Principles

When defining the firm, it is important to consider the following:

- How the firm holds itself out to the public.
- The firm definition must be appropriate, rational, and fair.
- Firms should adopt the broadest, most meaningful definition of the firm.
- Firms must not use the definition of the firm as a substitute for defining composites (e.g., defining the firm too narrowly, as to only encompass one product).

Defining the Firm

The GIPS standards require that a firm must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity. A distinct business entity is a unit, division, department, or office that (1) is organizationally and functionally segregated from other units, divisions, departments, or offices, (2) retains discretion over the assets it manages, and (3) should have autonomy over the investment decision-making process. Possible criteria that can be used to determine this include:

- being a legal entity,
- having a distinct market or client type (e.g., institutional, retail, private client), and
- using a separate and distinct investment process.

As previously stated, firms should adopt the broadest, most meaningful definition of the firm and consider how it is held out to the public. The scope of this definition should include all geographic (country, regional, etc.) offices operating under the same brand name regardless of the actual name of the individual investment management company. Factors to consider when defining the firm include, but are not limited to:

- all offices operating under the same brand name (e.g., XYZ Asset Management),
- other names resulting from mergers, acquisitions, and/or trading under a different name for branding purposes,
- financial service holding companies defined as one global firm with multiple brands, several legal entities, multiple offices, investment teams, and investment strategies,
- an investment management firm with one brand but multiple strategies and investment teams,
- all offices trading under a globally recognizable trading name with regional/country-specific additions (e.g., XYZ Asset Management Asia), and/or
- investment management firms in most countries must register with one or more governmental agencies or regulators. The GIPS standards recognize a regulatory registration as a possible definition of a firm for purposes of compliance but also require firms to consider the manner in which they are holding themselves out to the public when determining the firm definition.

Additional Considerations

In addition to the guiding principles listed above, firms should consider the following when defining the firm:

- The GIPS standards require that when the firm jointly markets with other firms, the firm claiming compliance with the GIPS standards must be sure that it is clearly defined and separate relative to other firms being marketed and that it is clear which firm is claiming compliance.
- The GIPS standards recommend that if a parent company contains multiple firms, each firm within the parent company should disclose a list of the other firms contained within the parent company.

- The use of a third party (e.g., custodian, broker/dealer) to perform recordkeeping or performance measurement is not a valid reason for excluding assets from the definition of the firm.
- System incompatibilities cannot be used as a reason for excluding assets from the definition of the firm (i.e., a firm cannot make the claim of compliance for only those assets that are measured and monitored on compatible systems).

Inception of the Firm/Redefinition of the Firm

In some cases, due to corporate restructuring and merger and acquisition activities, the changes within the firm may be so significant that it is held out to the public as a new firm. The new firm must determine if there is a continuation from the prior firm or if the restructuring is so substantial that it is essentially a new firm.

Changes in investment style or personnel are not valid reasons for redefining the firm, unless the changes are such that the firm is held out to the public in a significantly different way. A simple name change is not sufficient reason to redefine the firm and restart the performance record. In some cases, a firm definition may change without the firm losing its performance history. Please refer to the Guidance Statement on Performance Record Portability for related guidance. In all cases, the underlying principles of the GIPS standards must be considered: fair representation and full disclosure. If a firm is redefined, the firm must disclose the date of, description of, and reason for the redefinition. The GIPS standards require that changes in a firm's organization must not lead to alteration of historical composite performance.

Total Firm Assets

The definition of the firm also determines the boundaries for determining total firm assets. This includes all assets for which a firm has investment management responsibility and includes assets managed outside the firm (e.g., by sub-advisors) for which the firm has discretionary authority.

For periods beginning on or after 1 January 2011, total firm assets must be the aggregate fair value of all discretionary and non-discretionary assets managed by the firm. This includes both fee-paying and non-fee-paying portfolios.

The GIPS standards state that for periods prior to 1 January 2011, total firm assets must be the aggregate of the market value of all discretionary and non-discretionary assets under management within the defined firm. This includes both fee-paying and non-fee-paying assets. For periods prior to 1 January 2011, assets to which the GIPS standards cannot be applied are not to be considered by firms when claiming compliance and are not to be included in total firm assets. Such assets include investment vehicles that are based on cost or book values rather than market values.

Sub-advisors

Some firms utilize a sub-advisor to manage part or all of a particular strategy. For example, if a firm specializes in managing equities, it might hire a sub-advisor to manage the fixed income portion of its balanced portfolios. The GIPS standards require that firms must include the performance of assets assigned to a sub-advisor in a composite provided the firm has the authority to allocate the assets to a sub-advisor.

If a firm has discretion over the selection of the sub-advisor (i.e., can hire and/or fire), the firm must claim the sub-advisor's performance as part of its performance history and include the assets in total firm assets. Because the sub-advisor has discretion over the actual investment of the assets and the firm has discretion over the selection of the sub-advisor, both the firm and the sub-advisor are able to claim the performance of the assets as their own. The firm is able to claim this performance because the sub-advised portion of the portfolio is essentially viewed as an asset (similar to purchasing a mutual fund within the portfolio) and the firm must be held responsible for its decision to utilize a sub-advisor. The firm can only include the sub-advisor's performance record relevant to those assets assigned by the firm. If a firm does not have discretion over sub-advisor selection, it must not include the sub-advisor's performance in its performance history.

The GIPS standards require that for periods beginning on or after 1 January 2006, firms must disclose the use of a sub-advisor(s) and the periods a sub-advisor(s) was used.

Effective Date

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

4-5 GUIDANCE STATEMENT ON ERROR CORRECTION

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Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

Firms claiming compliance with the Global Investment Performance Standards are faced with situations in which errors are discovered that must be specifically addressed. Even with the tightest of controls, errors will occur. Errors can be quantitative and/or qualitative. This Guidance Statement only addresses errors related to compliant presentations. This Guidance Statement does not address errors discovered in advertisements prepared following the GIPS Advertising Guidelines.

Background

For a variety of reasons, an error might occur in a firm's processes that results in errors in, or directly related to, a composite's compliant presentation. An error is defined as any component of a compliant presentation that is missing or inaccurate.

Errors in compliant presentations can result from, but are not limited to, incorrect, incomplete, or missing:

- composite returns,
- benchmark returns,
- composite assets,
- firm assets,
- number of portfolios in a composite,
- measure of internal dispersion,
- three-year ex-post standard deviation, and
- disclosures.

Errors in compliant presentations can be caused by, but are not limited to:

- input data errors,
- prior-period adjustments,
- system/spreadsheet calculation errors,
- incorrect assignment of portfolios to composites,
- incorrect timing of inclusion and/or exclusion of portfolios to composites,
- missed trades,
- mishandling of corporate actions,
- software errors,
- incorrect treatment of cash flows,

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- pricing or exchange rate problems,
- incorrect benchmark returns supplied by the benchmark source,
- incorrectly calculated customized benchmark returns,
- inadequate creation or implementation of policies and procedures used in establishing and maintaining compliance with the GIPS standards, and
- poor internal communication.

Guiding Principles

Firms must remember that the fundamental principles of the GIPS standards are fair representation and full disclosure. Firms, therefore, must not present performance or performance-related information that is false or misleading. The objectives of the GIPS standards include presenting investment performance in a fair, comparable format that provides full disclosure. The GIPS standards were created to ensure accurate and consistent performance data for reporting, recordkeeping, marketing, and presentations. The GIPS standards require firms to make every reasonable effort to provide a compliant presentation to all prospective clients.

In addition, the GIPS standards state that firms must document their policies and procedures used in establishing and maintaining compliance with the GIPS standards. In that spirit, firms must establish error correction policies and procedures.

Additionally, firms must comply with all applicable laws and regulations regarding the calculation and presentation of performance, including error correction.

To deal with errors appropriately, firms must adhere to the following requirements:

- Error correction policies and procedures must be established and then implemented consistently.
- Materiality must be defined in the error correction policies.
- The lack of a required disclosure is considered an error and the compliant presentation must be corrected.

With respect to a material error:

- The error must be corrected and disclosed in a corrected compliant presentation.
- Disclosure of the change in the corrected compliant presentation must be included for a minimum of 12 months following the correction of the compliant presentation. Firms are not required to disclose the material error in a compliant presentation that is provided to prospective clients that did not receive the erroneous presentation. However, for a minimum of 12 months following the correction of the compliant presentation, if the firm is not able to determine if a particular prospective client has received the materially erroneous compliant presentation, then the prospective client must receive the corrected compliant presentation containing disclosure of the material error. This may result in the preparation of two versions of the corrected compliant presentation to be used for a minimum of 12 months following the correction of the compliant presentation.

- The corrected compliant presentation must be given to all existing clients that received the erroneous presentation.
- Every reasonable effort must be made to provide the corrected compliant presentation to all prospective clients and other parties that received the erroneous compliant presentation. However, a firm is not required to provide a corrected compliant presentation to former prospective clients that did not hire the firm and are no longer considered a prospective client. If a firm wishes to differentiate between current prospective clients and former prospective clients that no longer qualify as current prospective clients, the firm must establish procedures to determine when a prospective client no longer has an interest in or no longer qualifies to invest in the composite strategy in question and, therefore, no longer is considered a prospective client for that composite strategy. If a firm is not able to differentiate between prospective clients and former prospective clients, the firm must send the corrected compliant presentation to both groups.

The following recommendations have been introduced:

- Error correction policies and procedures should be unambiguous and should include specific steps to discover and correct errors.
- Error correction policies and procedures should include how the corrected compliant presentation will be distributed to all applicable parties.
- Error correction policies and procedures should include procedures for documenting the error and actions taken.

When an error is made, it is important that the firm assess the impact and determine whether the corrective action will meet the guiding principles as described above.

Error Correction Policies and Procedures

A firm's control procedures are critical to mitigating errors and then identifying errors that do occur. It is important that the firm identify the parties within the organization who are integral to compliance with the GIPS standards and ensure that these parties are in communication with each other so that all areas affecting the firm's compliance with the GIPS standards are addressed in the firm's error correction policy. There should be a framework within the organization by which material errors in compliant presentations are escalated.

Error correction policies and procedures must be established and then implemented consistently. A firm should strive to create an unambiguous process that includes specific steps to discover and correct errors.

A firm must define materiality within the scope of its error correction policies and procedures. Once materiality is defined, the firm can decide how to treat errors of varying degrees. The policy should indicate the appropriate course of action given the materiality and nature of the error that will be broad enough to capture various scenarios. Error correction policies and procedures should also include how the corrected compliant presentation will be distributed to all applicable parties as well as procedures for documenting the error and the actions taken. When determining error correction policies and procedures, a firm should consider the following factors:

- materiality of the error, in absolute and relative terms,
- whether the error is material relative to the benchmark,

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- whether returns are overstated or understated,
- significance of the missing or incorrect disclosures,
- whether the error affects returns over time and/or is a timing issue,
- period(s) affected by the error,
- if these policies will be applied firm-wide or on a composite-specific basis,
- whether erroneous compliant presentations have been provided to prospective clients,
- whether erroneous compliant presentations were provided to former prospective clients that are no longer considered prospective clients,
- whether clients have received erroneous compliant presentations,
- whether other parties have received erroneous compliant presentations, and
- whether the firm has any legal or regulatory obligations related to error correction.

Definition of Materiality

The size and impact of the error may vary for different asset types (e.g., equities, fixed income, emerging market equities), reporting periods (e.g., monthly, quarterly, or annual returns), and time periods (e.g., prior to a specific date, more than five years ago). Whether an error might affect a prospective client's decision to invest is a key determinant of materiality and the appropriate action necessary to resolve the issue.

Error Correction

Once the investment management firm becomes aware of an error that affects the compliant presentation, the firm must determine how to proceed based on its previously established error correction policies and procedures. The firm generally has four options for how errors might be handled:

1. Take no action.

According to the firm's pre-established error correction policies and procedures, the error is deemed to be immaterial and does not require a change to any data or disclosures in the compliant presentation.

2. Correct the compliant presentation with no disclosure of the change.

The correction of the error results in a change to one or more items in the compliant presentation, but according to the firm's pre-established error correction policies and procedures, these changes are not material and, therefore, do not require disclosure of the change or distribution of the corrected compliant presentation to parties that received the erroneous compliant presentation.

3. Correct the compliant presentation with disclosure of the change and no distribution of the corrected compliant presentation.

The correction of the error results in a change to one or more items in the compliant presentation, but according to the firm's pre-established error correction policies and procedures, it is not deemed to be a material error. Therefore, the firm does not distribute the corrected compliant presentation. The error does, however, require disclosure in a revised compliant presentation.

4. Correct the compliant presentation with disclosure of the change and make every reasonable effort to provide a corrected compliant presentation to all prospective clients and other parties that received the erroneous compliant presentation.

According to the firm's pre-established error correction policies and procedures, the error is material and, therefore, requires correction and disclosure in a revised compliant presentation. The firm must provide the corrected compliant presentation to all existing clients that received the erroneous compliant presentation. In addition, the firm must make every reasonable effort to provide the corrected compliant presentation to all prospective clients and other parties that received the erroneous compliant presentation, including consultants and verifiers. A firm is not required to provide a corrected compliant presentation to former prospective clients that did not hire the firm and are no longer considered prospective clients. Disclosure of the change must be included in the respective compliant presentation for a minimum of 12 months following the correction of the compliant presentation.

Firms are not required to disclose the material error in a compliant presentation that is provided to prospective clients that did not receive the erroneous presentation. However, for a minimum of 12 months following the correction of the presentation, if the firm is not able to determine if a particular prospective client has received the materially erroneous presentation, then the prospective client must receive the corrected presentation containing disclosure of the material error. This may result in the preparation of two versions of the corrected compliant presentation to be used for a minimum of 12 months following the correction of the presentation.

Examples

A basic error correction process involving an incorrect composite return within a compliant presentation may include the following steps:

1. Recalculate the returns and quantify the error.
2. Determine if the error is material based on previously established error correction policies and procedures.
3. Decide which action is the most appropriate based on previously established error correction policies and procedures.
4. Document the original return, the corrected return, and the action taken.

A basic error correction process involving an *incorrect or missing disclosure* may include the following steps:

1. Compare the composite's existing disclosures with those required in the GIPS standards.
2. Determine if an error has been made, including whether any disclosures are missing from the compliant presentation.
3. Determine if the error is material based on previously established error correction policies and procedures.
4. Decide which action is the most appropriate based on previously established error correction policies and procedures.
5. Document the original information, the corrected information, and the action taken.

Effective Date

The effective date for this Guidance Statement is 1 January 2011. The prior version of this Guidance Statement is available on the GIPS standards website (www.gipsstandards.org).

4-6 GUIDANCE STATEMENT ON FEES

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

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Introduction/Background

The purpose of the GIPS standards is to create compliant presentations that allow for greater comparability of returns and increased transparency of information provided to investors. While it is impossible to develop standards that cover 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.

In the global investment industry, fees are charged in many different ways and a variety of terms are used. In order to promote comparability, it is important that firms around the world treat fees consistently and in a comparable manner. The terms that are used can confuse the matter considerably. In some parts of the world the net-of-fees return is the starting point and investment management fees are added back to arrive at the gross-of-fees return. In other places the opposite is true and investment management fees are deducted from the gross-of-fees return to arrive at the net-of-fees return. In some regions, the terms “fee,” “duty,” “cost,” “charge,” and “expense” have different meanings, while in other regions, these terms are interchangeable. This highlights the need for common definitions, which are included in the GIPS standards Glossary.

There is a range of different types of costs and/or fees that a client incurs when maintaining an investment portfolio. In general, there are three main types of fees and/or costs: investment management fees, trading expenses, and administrative fees. Administrative fees are defined as all fees other than trading expenses and investment management fees and include custody fees, accounting fees, auditing fees, consulting fees, legal fees, performance measurement fees, and other related fees. In some situations, the only fees that the firm controls are the investment management fees and the trading expenses (i.e., the actual cost of buying or selling investments). Therefore, only the investment management fees and the trading expenses should impact the firm’s returns. Even though custody fees are a necessary additional cost of owning a portfolio, many investment managers are not involved in the selection of the custodian or in the negotiation of the custody fees. Accordingly, in order to promote comparability, custody fees should not be reflected in (i.e., should not reduce) the firm’s returns.

The GIPS standards are based on the concept of presenting composite performance to prospective clients rather than presenting individual portfolio returns to existing clients. Firms should, however, consider if existing clients will benefit from the presentation of their individual portfolio returns after the reduction of all fees associated with owning an investment portfolio (i.e., including administrative fees). This “client return” (the net-of-fees return reduced by all administrative fees) may be useful to prospective and existing clients to fully understand the actual return that has been earned and the total amount of fees incurred. The administrative fees, however, are typically outside the control of the firm and, as such, should not reduce gross-of-fees or net-of-fees returns.

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The gross-of-fees return is defined as the return on investments reduced by any trading expenses.¹ Returns should be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes should be accrued. Because the gross-of-fees return includes only the return on investments and the associated trading expenses, it is the best measure of the firm's investment management ability and can be thought of as the "investment return." In addition, because fees are sometimes negotiable, presenting gross-of-fees returns shows the firm's expertise in managing assets without the impact of the firm's or client's negotiating skills. Accordingly, firms are recommended to present gross-of-fees returns. A prospective client, however, must also consider the effect of fees on performance. As a prospective client evaluates and compares investment firms, the most universal point of comparison is the gross-of-fees return less the investment management fee that the prospective client expects to pay. Consequently, firms are required to disclose in each compliant presentation the fee schedule that is appropriate to the compliant presentation. When presenting gross-of-fees returns, firms must also disclose if any other fees are deducted in addition to the trading expenses.

The fee schedule must be current. While a current fee schedule may not assist a prospective client when interpreting historical performance, it is the most relevant to the prospective client. Firms should also disclose additional information related to the firm's fees (e.g., if performance-based fees are available, if other fees are charged by a sub-advisor or through a fund-of-funds structure).

The net-of-fees return is defined to be the gross-of-fees return reduced by the investment management fees incurred, which includes performance-based fees and carried interest. It is important to recognize that the net-of-fees return consists of two distinct components: the gross-of-fees return and the impact of the investment management fee (see Fees Example Scenario A). Firms are also encouraged to present net-of-fees returns. In order to reflect the most accurate net-of-fees return, fees and expenses should be accrued, when possible. 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.

The GIPS standards require that returns must be calculated after the deduction of actual trading expenses. Trading expenses can be:

- direct: as in the case of brokerage commissions and any other regulatory fee, duty, and/or tax (e.g., stamp duty, SEC fee, etc.) associated with an individual transaction or
- indirect: such as a bid-ask spread.

For purposes of the GIPS standards, firms must reduce both gross-of-fees and net-of-fees returns by the trading expenses incurred in the purchase or sale of investments. These costs must be included because they must be incurred in order to implement the investment strategy. Estimated trading expenses are not permitted.

In some cases (particularly when initially compiling a track record that complies with the GIPS standards), the actual fees charged to each discretionary portfolio under management are not available. Firms that wish to show net-of-fees performance results are permitted to use the highest investment management fee incurred by portfolios in the composite to reduce gross-of-fees performance.

¹ For real estate and private equity portfolios, all returns must be net of transaction expenses. Transaction expenses are defined as all actual legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing portfolio investments as well as trading expenses, if any. Please see the real estate and private equity provisions and guidance.

However, it is not permissible to use the highest investment management fee to add to the net-of-fees return in order to obtain a gross-of-fees return. Adding back the highest fee would result in overstating the gross-of-fees return. When adjusting from net-of-fees to gross-of-fees returns, firms must use either the actual fees or the weighted-average fee for the composite.

Many custodial banks charge part of the custody fee based on the number and type of transactions. These fees, even though they are charged on a per transaction basis, are still part of the custody fee and should not be included in trading expenses.

Bundled Fees

In some cases, firms combine multiple fees into one total or “bundled” fee. A bundled fee can include any combination of fees, including investment management fees, trading expenses, custody fees, and/or administrative fees. A bundled fee can be specific to a client, as is the case with “all-in” fees,² or can be specific to a particular product, as is the case with “wrap” fees.³ Some bundled fees can be segregated into the various underlying components (e.g., the firm can “un-bundle” the fee and identify each segment that composes the bundled fee—see Fees Example Scenario C). In other cases, only portions of the bundled fee can be segregated (e.g., investment management fee segment can be identified and separated, but the custody fee and trading expenses cannot—see Fees Example Scenario D). If a firm includes a portfolio with a bundled fee in a composite, it must disclose the types of fees that are included in the bundled fee and must present the percentage of composite assets represented by portfolios with bundled fees as of each annual period-end.

In cases where the actual trading expenses cannot be identified and segregated from a bundled fee, either the entire bundled fee or the portion of the bundled fee containing the trading expenses must be included in (i.e., reduce) the gross-of-fees returns and net-of-fees returns (see Fees Examples Scenarios B and D). In these cases, custody fees and other administrative fees might be included in the gross-of-fees returns and in the net-of-fees returns. Firms may also find that the gross-of-fees return is equal to the net-of-fees return. To assist prospective clients in understanding the fees included in the gross-of-fees return calculation, if a composite contains portfolios with bundled fees, firms must disclose the types of fees that are included in the bundled fees. 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.

Some investment product returns are typically calculated net of other fees (e.g., custody fees, other administrative fees). In order for these portfolios to be treated consistently with regard to the definitions of gross-of-fees returns and net-of-fees returns in the GIPS standards, when calculating gross-of-fees returns from net-of-fees returns, firms are allowed to add back all fees and expenses (e.g., investment management, custody, transfer agent, share registration, marketing, and regulatory fees) except for trading expenses. When calculating net-of-fees returns, firms are allowed to add back all fees and expenses except for trading expenses and the investment management fees, provided that the firm can identify all these fees. Estimated fees are not permitted.

² All-in fees are client specific and are typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.

³ Wrap fees are charged by a wrap fee sponsor for investment management services and typically include associated trading expenses that cannot be separately identified. Wrap fees can be all-inclusive, asset-based fees and may include a combination of investment management fees, trading expenses, custody fees, and /or administrative fees. A wrap fee portfolio is sometimes referred to as a “separately managed account” (SMA) or “managed account.”

Sub-Advisor, Pooled Investment Vehicles, and Funds of Funds

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In some situations, firms may invest a portion of a large portfolio in a pooled investment vehicle, utilize a sub-advisor, or create a fund-of-funds structure whereby additional fees are charged by the underlying fund or paid to the sub-advisor. In these situations, it is most appropriate to present the return net of all fees (e.g., including administrative fees) since all investors must pay these fees. However, net-of-fees returns must be net of transaction expenses and investment management fees and these fees (including the underlying fees) must not be added back to calculate net-of-fees returns.

Effective Date

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

Fees Examples

For the purpose of these examples, the trading expenses are stated as a percentage of the beginning value. In practice, trading expenses are typically accounted for in the book value of securities and are, therefore, reflected in the return on investments. These examples are presented to illustrate the concepts presented in this Guidance Statement, and the examples assume deduction of fees and trading expenses at the beginning of the period. These examples are simplified to illustrate the differences between fee structures and are not intended to provide guidance on the actual calculations. Actual return calculations may differ based on when the fee is deducted from the portfolio and the value used as a basis for the calculation (e.g., beginning-of-period assets, end-of-period assets, weighted average period assets).

Descriptions of Scenarios	
<i>Scenario A : A typical fee structure in which each fee can be clearly identified</i>	
Return on investments	8.00%
Trading expenses	0.20%
Investment management fees	1.00%
Administrative fees (including custody fees)	0.50%
 <i>Scenario B: Bundled Fee 1 (structure in which the bundled fee cannot be separated)</i>	
Return on investments	8.00%
Bundled fee: Trading expenses, investment management fees, and administrative fees (including custody fees)	1.70%

(continued)

Scenario C: Bundled Fee 2 (structure in which the bundled fee can be separated)

Return on investments	8.00%
Bundled fee: trading expenses, investment management fees, and administrative fees can be separated as follows:	1.70%
Trading expenses	0.20%
Investment management fees	1.00%
Administrative fees	0.50%

Scenario D: Bundled Fee 3 (structure in which only the investment management fee can be separated from the bundled fee)

Return on investments	8.00%
Bundled fee: Trading expenses, investment management fees, and administrative fees (including custody fees) can be separated as follows:	1.70%
Investment management fees	1.00%
Trading expenses and administrative fees	0.70%

Scenario E: Bundled Fee 4 (structure in which only the trading expenses can be separated from the bundled fee)

Return on investments	8.00%
Bundled fee: Trading expenses, investment management fees, and administrative fees (including custody fees) can be separated as follows:	1.70%
Trading expenses	0.20%
Investment management fees and administrative fees	1.50%

Calculation of Scenarios A-E

	Scenario A	Scenario B	Scenario C	Scenario D	Scenario E
Return on investments	8.00%	8.00%	8.00%	8.00%	8.00%
– Trading expenses	0.20%	1.70%	0.20%	0.70%	0.20%
= Gross-of-fees return	7.80%	6.30%	7.80%	7.30%	7.80%
– Investment management fees	1.00%	na	1.00%	1.00%	1.50%
= Net-of-fees return	6.80%	6.30%	6.80%	6.30%	6.30%
– Administrative fees	0.50%	na	0.50%	na	na
= Client return*	6.30%	6.30%	6.30%	6.30%	6.30%

na = not applicable

* The client return is not required by the GIPS standards and is presented here as additional information that may be helpful for existing clients.

4-7 GUIDANCE STATEMENT ON PERFORMANCE EXAMINATIONS

Adoption Date: 16 March 2012
Effective Date: 1 July 2012
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Public Comment Period: June 2011–August 2011

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Scope and Purpose of Performance Examination

The scope and purpose of verification is to assess whether a firm has complied with all the composite construction requirements of the Global Investment Performance Standards on a firm-wide basis and the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

A firm may choose to also have a performance examination of a specific composite presentation. The detailed testing of any of the firm's composites and their associated compliant presentations by an independent verifier is termed a "performance examination."

A performance examination may only be performed either concurrently with or subsequent to the completion of a verification. The verification and the performance examination need not be performed by the same verification firm. The performance examination must be performed by a verifier who is independent of the investment management firm. Please see the Guidance Statement on Verifier Independence for additional guidance.

Verifiers must follow currently accepted standards of practice within their industry (if applicable) when undertaking a performance examination pursuant to the GIPS standards. Please see the Guidance Statement on Verification for additional guidance on verifier qualification requirements.

A performance examination is not required for a firm to be verified and is neither recommended nor required under the GIPS standards. Performance examinations are unlikely to become a requirement of the GIPS standards. However, a firm may be asked or may choose to obtain a performance examination of one or more of the firm's composites.

A performance examination is the detailed testing of a specific composite and its associated compliant presentation by an independent verifier for a specific period. A performance examination tests, for a specific composite, the following:

1. whether the firm has constructed the composite and calculated the composite performance in compliance with the GIPS standards and
2. whether the firm has prepared and presented the composite presentation in compliance with the GIPS standards.

Fundamental Considerations for Performance Examinations

When conducting a performance examination of a specific composite and its associated compliant presentation, the verifier must consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to exceptions:

- Information obtained from independent sources outside the firm provides greater assurance than information secured solely from within the firm.
- Information obtained from the verifier's direct personal knowledge (such as through tangible documentation, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- The more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion.

The extent to which the performance examination procedures will be performed must, at a minimum, be based on the verifier's consideration of the following:

- the nature and materiality of the information to be tested;
- the effectiveness of the control environment (including the extent to which manual processes are employed);
- the likelihood of misstatements;
- knowledge obtained during current and previous engagements;
- the extent to which the information is affected by judgment; and
- inadequacies in the underlying data.

A principal verifier may accept the work of another verifier as part of the basis for satisfying that a firm has previously received a verification report and/or as part of the basis for the principal verifier's performance examination opinion. A principal verifier may also choose to rely on the audit and/or internal control work of a qualified and reputable independent third party with appropriate professional abilities and experience and a practical level of expertise regarding investment management practices, including performance calculation procedures and business processes. In addition, a principal verifier may choose to rely on the other audit and/or internal control work performed by the verification firm. If reliance on another party's work is planned, the scope of work (including the time period[s] covered), results of procedures performed, qualifications, competency, objectivity, and reputation of the other party must be assessed by the principal verifier when making the determination as to whether to place any reliance on such work. Reliance considerations and conclusions must be documented by the principal verifier. The verifier must use professional skepticism when deciding whether to place reliance on work performed by another independent third party.

Sampling

Verifiers must subject the entire composite to testing when conducting performance examination procedures unless reliance is placed on work performed by a qualified and reputable independent third party or appropriate alternative control procedures have been performed by the verifier.

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Verifiers may use a sampling methodology when performing such procedures. The size of the sample will vary based on the verifier's judgment when considering the criteria listed below. Not only must the verifier determine the appropriate sample size, but the verifier must also determine if the sample selected is reasonable considering the firm's specific circumstances.

Verifiers must consider the following criteria when selecting samples:

- number of portfolios in the composite;
- composite definition;
- total assets of individual portfolios relative to total composite assets;
- internal control structure at the firm;
- number of years being examined;
- use of computer applications, use of software in the construction and maintenance of composites, and use of external performance measurers and other external service providers; and
- performance calculation methodology.

This list is not all-inclusive and contains only the minimum criteria that must be considered in the selection and evaluation of a sample. For example, one potentially useful approach would be to include in the sample a portfolio that has the largest impact on composite performance because of its size or because of extremely good or bad performance. Missing or incomplete documents, or the presence of errors, would normally be expected to warrant the selection of a larger sample or the application of additional performance examination procedures.

Required Performance Examination Procedures

When conducting a performance examination, the verifier must accumulate sufficient evidence and perform sufficient procedures such that the risk of not detecting errors during the performance examination is mitigated to an acceptably low level.

The following are the minimum procedures verifiers must follow when conducting a performance examination. Verifiers must complete the performance examination in accordance with these procedures prior to issuing a performance examination report to the firm.

Pre-Performance Examination Procedures:

1. *Knowledge of the GIPS standards.* Verifiers conducting the performance examination must understand all the requirements and recommendations of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*.
2. *Knowledge of applicable laws and regulations.* Verifiers conducting the performance examination must be knowledgeable of applicable laws and regulations regarding the calculation and presentation of performance and must consider any differences between these laws and regulations and the GIPS standards.

3. *Knowledge of the firm.* Verifiers conducting the performance examination must obtain the relevant verification report(s) and the compliant presentation(s) to be examined. Verifiers must gain an understanding of the firm, including the corporate structure of the firm and how it operates.
4. *Knowledge of the firm's policies and procedures.* Verifiers conducting the performance examination must understand the firm's policies and procedures for establishing and maintaining compliance with all the applicable requirements and adopted recommendations of the GIPS standards. The verifier must obtain a copy of the firm's policies and procedures used in establishing and maintaining compliance with the GIPS standards and ensure that all applicable policies and procedures are properly included and adequately documented with respect to the composite and its associated compliant presentation(s) being examined. The verifier must also ensure that the policies and procedures are clear, unambiguous, and in accordance with the GIPS standards and meet any applicable requirements of the GIPS standards. For example, verifiers must understand the firm's policies and procedures with regard to, but not limited to, the following items with respect to the composite and its associated compliant presentation(s) to be examined:
 - investment discretion (the verifier must obtain a copy of the firm's definition of investment discretion and the firm's guidelines for determining whether portfolios are discretionary);
 - definition of composite according to investment mandate, objective, or strategy (the verifier must obtain the composite definition with criteria for assignment of portfolios to the composite);
 - timing of inclusion of new portfolios in the composite;
 - timing of exclusion of terminated portfolios from the composite;
 - accrual of interest and dividend income;
 - treatment of fees;
 - valuation of portfolio investments, including policies and procedures for the determination of fair value;
 - calculation of the rates of return for each portfolio;
 - treatment of cash flows (assumptions on the timing of capital inflows/outflows and treatment of large and, where applicable, significant cash flows);
 - calculation of composite returns;
 - error correction;
 - preparation of the composite's compliant presentation(s);
 - use of leverage, derivatives, and short positions;
 - maintenance of books and records supporting the calculation of portfolio and composite returns, including the existence and ownership of client assets;
 - selection, construction, and calculation of composite benchmarks; and
 - any other policies and procedures relevant to the composite and its associated compliant presentation(s).
5. *Knowledge of valuation basis and performance calculations.* Verifiers must understand the policies, procedures, and methodologies used to value portfolios and calculate investment performance.

Performance Examination Procedures

1. *Portfolio selection.* Objective: to determine that the proper portfolios are included in the examined composite. The verifier must obtain a list of all open (both new and existing) and terminated portfolios for the firm for the period(s) under examination, and sufficient procedures must be performed to determine for the examined composite that
- the timing of inclusion of portfolios in the composite is in accordance with the firm's policies and procedures;
 - the timing of exclusion of portfolios from the composite is in accordance with the firm's policies and procedures;
 - the firm's classification of portfolios as discretionary is appropriate (by referring to the portfolio's investment mandate, objective, or strategy as indicated by the portfolio's investment management agreement, investment guidelines, and/or other appropriate documentation);
 - portfolios are completely and accurately included in the composite by tracing selected portfolios from
 - a. the portfolio's investment management agreement and/or investment management guidelines to the composite and
 - b. the composite to the portfolio's investment management agreement and/or investment guidelines;
 - portfolios managed to a similar investment mandate, objective, or strategy are included in the same composite; and
 - movements of portfolios into and out of the composite are appropriate, in accordance with the firm's policies and procedures, and consistent with documented changes to the portfolios' investment mandates, objectives, or strategies or the redefinition of the composite.
2. *External cash flows.* Objective: to determine that external cash flows for portfolios in the examined composite are
- properly recorded in portfolios;
 - recorded at the correct amounts;
 - properly identified as large (as defined by the firm's policies and procedures); and
 - recorded on a timely basis in accordance with the firm's policies and procedures.
- Sufficient procedures must be performed to determine that
- external cash flows reflect appropriate supporting documentation, such as custody statements or internal records;
 - external cash flows reflect proper valuation and timely recording; and
 - the recording of external cash flows is appropriate and in accordance with the firm's policies and procedures.
3. *Income and expenses.* Objective: to determine that income and expenses for portfolios in the examined composite are
- recorded in the proper portfolios;
 - recorded at the correct amounts; and
 - recorded on a timely basis.

Sufficient procedures must be performed to determine that

- income and expenses reflect supporting documentation, such as custody statements or internal records;
- the methods used to record income and expenses, including investment management fees, are appropriate and in accordance with the firm's policies and procedures;
- expenses are appropriately treated when calculating net- and/or gross-of-fees performance returns; and
- the calculation and use of accrued income is reasonable, appropriate, and in accordance with the firm's policies and procedures.

4. *Portfolio trade processing*. Objective: to determine that purchases and sales of investments for portfolios in the examined composite have been properly recorded on the appropriate dates.

Sufficient procedures must be performed to determine that

- portfolio trading activity is supported by appropriate documentation, such as custody statements, trade confirmations, and reconciliations, and
- the methods used to account for portfolio trading activity are appropriate and in accordance with the firm's policies and procedures.

It is preferable that verifiers obtain appropriate documentation directly from independent external parties (e.g., custodian, broker).

5. *Portfolio Valuation*. Objective: to determine that the beginning- and end-of-performance measurement period valuations of investments, including derivatives, for portfolios in the examined composite are
- valued correctly and
 - valued on the correct dates.

Sufficient procedures must be performed to determine that

- beginning- and end-of-performance measurement period investment valuations are in accordance with the firm's valuation policies and procedures and the GIPS Valuation Principles in Chapter II of the GIPS standards;
- portfolios are valued on the date of all large cash flows in accordance with the firm's policies and procedures;
- foreign currency exchange rates are used in accordance with the firm's valuation policies; and
- the methods used for portfolio valuation are appropriate and consistently applied.

6. *Existence and ownership of client assets*. Objective: to determine that the firm's policies and procedures for ensuring the existence and ownership of client assets for the portfolios in the examined composite are appropriate and have been consistently applied.

Sufficient procedures must be performed to determine that

- beginning- and end-of-performance measurement period portfolio positions are supported by appropriate documentation, such as custody statements and custody reconciliations, and
- the methods used to ensure the existence and ownership of assets are appropriate and in accordance with the firm's policies and procedures.

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It is preferable that verifiers obtain appropriate documentation directly from independent external parties (e.g., custodian, broker).

7. *Performance calculation.* Objective: to determine that the methods used to calculate portfolio, composite, and benchmark returns and other required and recommended numerical data for the examined compliant presentation are appropriate and have been consistently applied and that the returns and other required and recommended numerical data have been correctly calculated.

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The verifier must take a sample of all required and recommended numerical data (e.g., composite and benchmark calculations, risk measures, internal dispersion) to determine its accuracy, and sufficient procedures must be performed to determine that

- portfolio and composite performance is calculated in accordance with the firm's policies and procedures;
 - calculation methodologies that meet the requirements of the GIPS standards are used;
 - portfolio and composite returns are accurately calculated;
 - if custom benchmarks or a combination of multiple benchmarks are used, the calculation methodology is correct and consistently applied and the method and data used are in accordance with the benchmark description in the composite's compliant presentation; and
 - calculations of required risk measures are accurate and consistently applied.
8. *Composite compliant presentation information and disclosures.* Objective: to determine that the compliant presentation for the examined composite includes all the information and disclosures required by the GIPS standards, such that the information and disclosures
- have been accurately and properly presented in the examined composite's compliant presentation and
 - are supported by appropriate documentation.

This objective is also applicable to additional information (i.e., recommended disclosure and presentation and reporting items) if it is included in the examined composite's compliant presentation.

Sufficient procedures must be performed to determine that

- the composite benchmark reflects the investment mandate, objective, or strategy of the composite;
- the compliant presentation includes all the information and disclosures required by the GIPS standards;
- the inclusion of such items as required by the disclosure and presentation and reporting provisions are appropriate and reasonable; and
- the information and disclosures are consistent with the firm's records and in accordance with the firm's policies and procedures.

When supplemental information is presented in the examined composite's compliant presentation, at a minimum, the verifier must determine that the supplemental information is not misleading, clearly not false, or not otherwise allowed to be presented and is correctly and clearly labeled and identified as supplemental information to a particular compliant

presentation. Please see the Guidance Statement on the Use of Supplemental Information for additional guidance. The firm and the verifier must decide if any supplemental information will be subject to the performance examination.

9. *Maintenance of records.* The verifier must maintain sufficient documentation to support all procedures performed supporting the issuance of the performance examination report, including all significant judgments and conclusions made by the verifier.

Representation Letter

At the conclusion of the performance examination engagement and prior to expressing an opinion, the verifier conducting the performance examination must obtain from the management of the firm a representation letter confirming, at a minimum, the following items:

1. the firm's policies and procedures used in establishing and maintaining compliance with the GIPS standards are as described in the firm's policies and procedures documents and have been consistently applied throughout the period(s) being examined;
2. the firm has constructed the composite and calculated the composite performance in compliance with the GIPS standards;
3. the firm has prepared and presented the composite presentation in compliance with the GIPS standards;
4. the firm complies with the GIPS standards for the period(s) being examined; and
5. any other relevant representations made to the verifier during the performance examination.

Typically, the representation letter will also include the following representations:

- the firm's management bears all responsibility for maintaining compliance with the GIPS standards, including production and distribution of the compliant presentation;
- the compliant presentation for the composite is a fair and accurate representation of the firm's investment performance;
- the firm has not knowingly presented performance or performance-related information for the composite that is false or misleading;
- to the best of the firm's knowledge and belief, there has been no
 - a. fraud or alleged fraud involving management or employees who have significant roles in the firm's processes and procedures relating to compliance with the GIPS standards or
 - b. fraud or alleged fraud involving others that could have a material effect on the firm's compliance with the GIPS standards;
- the firm has provided the verifier with all necessary documents to be able to perform the performance examination, and no relevant documents have been withheld;
- the time period the verifier is reporting on;
- the firm complies with all applicable laws and regulations regarding the calculation and presentation of performance for the composite; and
- no events that would materially influence performance results or the outcome of the performance examination have occurred up to the date of the representation letter.

Performance Examination Report

A performance examination is performed with respect to a specific composite and its associated compliant presentation and does not provide assurance on the compliant presentation for any other composite. If performance examinations are performed on multiple composites and their associated compliant presentations, the verifier may issue a single performance examination report covering the composites and their associated compliant presentations that have been examined. The performance examination report can be prepared as part of a verification report (combined report) or as a separate report attached to the verification report. The compliant presentation for any composite that has been examined must be included in or attached to the performance examination report.

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1. In order for a performance examination report to be issued, the verifier must ensure the firm has a verification report(s) that opines that
 - a. the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and
 - b. the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.
2. A performance examination report must not cover periods beyond those periods covered by the verification report(s). A performance examination report must not be issued prior to the verification report.
3. The performance examination report must opine that
 - a. the firm has constructed the composite and calculated the composite performance in compliance with the GIPS standards and
 - b. the firm has prepared and presented the composite presentation in compliance with the GIPS standards.

The following information is also required to be included in the performance examination report (please refer to additional guidance regarding the verification report in the Guidance Statement on Verification):

- the report title, which must include the words "performance examination";
- the report date;
- the report addressee;
- the defined firm for which the verification has been performed;
- the period(s) for which the verification has been performed;
- the respective responsibilities of the firm's management and the verifier, including a statement acknowledging the responsibility of the firm for the claim of compliance and for the preparation of the compliant presentation;
- the name of the composite that has been examined;
- the period(s) for which the performance examination has been performed;
- a statement indicating that the performance examination of the specified composite and its associated compliant presentation has been performed in accordance with the required performance examination procedures of the GIPS standards;
- a statement indicating that the performance examination does not ensure the accuracy of any other specific composite presentation;

- a statement indicating whether or not the performance examination covers supplemental information included in or attached to the compliant presentation;
- a statement describing any other professional guidance that has been applied (e.g., AICPA, IAASB, ICAEW, JICPA guidance); and
- the signature or official seal of the verifier.

The firm must not state that a composite presentation has been examined unless the performance examination report has been issued for the specific composite presentation.

4. After completing the performance examination procedures, the verifier may conclude that the composite presentation does not comply with the GIPS standards or the records of the firm cannot support the performance examination. In such situations, the verifier and the firm must consider the impact of the verifier's inability to provide the performance examination report on the investment management firm's claim of compliance with the GIPS standards. A performance examination report must not be issued when the verifier knows that the firm is not in compliance with the GIPS standards, the composite presentation does not comply with the GIPS standards, or the records of the firm cannot support the examination of the specific composite and its associated presentation. When a performance examination report cannot be issued, the verifier must issue a statement to the firm clarifying why a performance examination report cannot be issued.

Recommendation Letter

After the performance examination is complete, it is recommended that the verifier issue a recommendation letter to the firm describing specific findings, recommendations, and other areas needing improvement arising from the performance examination.

Effective Date

This Guidance Statement was originally effective 31 December 2006. Subsequent revisions have been made to this guidance to coincide with the 2010 edition of the GIPS standards. Verifiers must conduct their performance examination engagements in accordance with this Guidance Statement for all performance examinations contracted on or after 1 July 2012. The contract date is typically evidenced by the date of the engagement letter signed by management of both the verification firm and the investment management firm. Verifiers may also voluntarily conduct their performance examination engagements in accordance with this Guidance Statement for engagements contracted prior to 1 July 2012 and are encouraged to do so. The prior version of this Guidance Statement is available on the GIPS standards website (www.gipsstandards.org).

4-8 GUIDANCE STATEMENT ON PERFORMANCE RECORD PORTABILITY

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

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Introduction

In the current global market for merger, acquisition, and consolidation of investment management firms, past performance records are increasingly valuable assets for their owners. Historical records are the result of many factors (e.g., people, process, discipline, strategy) that may not be easily transferred to a new entity and still warrant having the same label as the old entity. The applicability and integrity of the performance record is only as good as the ongoing integrity of the strategy and all the contributing factors. In addition, because the legal issues and requirements surrounding portability can be particularly complex, firms are reminded that they must comply with all applicable laws and regulations regarding the calculation and presentation of performance, which includes laws and regulations related to portability, before applying this Guidance Statement.

Performance is the Record of the Firm, Not of the Individual

Changes in a firm's organization must not lead to alteration of historical composite performance. Therefore, composites must include all portfolios managed by a member of a firm, even if the individual responsible for the past results is no longer with the firm. Composites must not include portfolios managed by members of the firm before they joined the firm unless the conditions listed below are met. If the conditions are met on a composite-specific basis, performance of a past firm or affiliation must be linked to or used to represent the historical performance of a new or acquiring firm. Using the performance data from a prior firm or affiliation as supplemental information is permitted as long as the past record is identified clearly as such and is not linked to the results of the new affiliation. If the provisions for portability are met, then it is possible for multiple firms to claim the same performance history as their own.

The GIPS standards provide how a firm is to be defined within the context of the GIPS standards. "Firm" mergers can happen within an affiliated group and this Guidance Statement will apply to such situations. If a firm acquires another firm or affiliation, the firm has one year to bring any non-compliant assets into compliance. However, the important determinant of allowable performance record portability is not a firm's former compliance with the GIPS standards, but whether the acquiring firm continues the original strategy that defined the composite with all of its continuing factors.

Performance data from a prior firm may be used, with the proper disclosures, as supplemental information. If the conditions listed below are not met, this supplemental information must not be linked to the ongoing performance of the new firm. The key issue is the linking of prior performance results to the ongoing performance record at the new firm or affiliation.

When a manager, group of managers, or an entire firm joins a new firm or affiliation, the GIPS standards require that:

- Performance of a past firm or affiliation must be linked to or used to represent the historical performance of a new or acquiring firm if, on a composite-specific basis:
 - substantially all of the investment decision makers are employed by the new or acquiring firm (e.g., research department staff, portfolio managers, other relevant staff);
 - the decision-making process remains substantially intact and independent within the new or acquiring firm; and
 - *the new or acquiring firm has records that document and support the performance.*
- If a firm acquires another firm or affiliation, the firm has one year to bring any non-compliant assets into compliance.
- Firms must disclose if the performance from a past firm or affiliation is linked to the performance of the firm.

If all of the above requirements are not met, the past performance record of the former firm or affiliation from the former firm must not be linked to the ongoing performance record of a new or acquiring firm. However, the past performance record may be presented as supplemental information when relevant, provided the new or acquiring firm has all data and information necessary to support the performance.

In the case where two firms join and two composites are to be merged, the new firm must first determine if there is a “surviving” composite. A surviving composite is the composite that represents the continuity of investment strategy, process, and personnel. In order to be a surviving composite, the decision-making process must remain substantially intact and independent at the new firm.

If the firm identifies a surviving composite, its performance history must be presented and linked to the ongoing performance of the merged composite. It is recommended that the performance of the “non-surviving” composite be made available as supplemental information upon request. For example, as a result of a merger, two composites (“C” and “D”) are combined in a merged composite “CD.” If the firm is able to satisfy all the rules of portability and determines that composite C is the surviving composite, then the performance history from composite C must be linked to the ongoing record of composite CD. Although the assets from composite D are included in composite CD, the performance history of composite D is not linked to the ongoing record of composite CD but should be made available upon request.

If the firm determines that neither composite maintains all the elements of continuity, then there has not been a merger of composites and neither historical performance record can be linked to the ongoing composite performance record, but it is recommended that both of the “non-surviving” composites be presented as supplemental information, provided the firm has all data and information necessary to support the performance. For example, if the staff of two firms are combined into one and the investment decision-making process is shared (and thus changed), the historical performance records of both of the non-surviving composites should be presented as supplemental information and must not be linked to the ongoing results of the new composite.

If the presenting firm is a “manager of managers” and is hired by its clients because of the presenting firm’s manager selection skills and the firm maintains discretion of the underlying assets (has the control to hire or fire the sub-advisor), the firm must include those assets in the total firm assets and present the performance of the underlying assets in the presenting firm’s composites. Similarly, if the presenting firm replaces one sub-advisor with another, the presenting firm must include within the same composite the performance of the assets assigned to the new sub-advisor

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going forward and leave the results from the former sub-advisor unchanged. The GIPS standards require that beginning 1 January 2006, firms must disclose the use of a sub-advisor(s) and the periods a sub-advisor(s) was used.

If the presenting firm does not have discretion over the selection of the sub-advisor, then the performance record of the underlying assets must not be included in the presenting firm's composites.

Firms must keep in mind that this Guidance Statement falls under the over-riding principles of the GIPS standards: fair representation and full disclosure. The GIPS standards require that firms must disclose all significant events that would help a prospective client interpret the compliant presentation. As such, if events that impact the firm's operations and/or investment process rise to the level of a significant event (e.g., change in ownership, merger, acquisition, departure of key investment professional), they must be disclosed.

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Effective Date

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

4-9 GUIDANCE STATEMENT ON PRIVATE EQUITY

Introduction

For purposes of compliance with the GIPS standards, private equity encompasses investment in nonpublic companies at various stages of development and includes venture capital, buyout, mezzanine, and some distressed securities investing. Private equity also includes investments in public companies with the intent of taking them private or investments directly in public companies through structures known as PIPEs (private investment in public equity).

Private equity investments can be made in virtually any industry or geographic sector. Venture capital investments normally take a minority equity position in a company, while buyout funds will take a controlling position in or total ownership of a company. As the industry has evolved, it has become more specialized, providing prospective clients with investment opportunities outside of the investment categories popular even in the recent past.

The private equity industry has evolved from being principally composed of primary fund vehicles investing in individual companies to a complex mix of primary fund vehicles, secondary fund vehicles, funds of funds, direct investments, co-investments, and sponsored primaries, among others. The industry has evolved to the extent that some investment strategies that were novel some years ago are now common. For example, historically, investors in funds invested only in the funds themselves. It is now common for investors to invest directly in companies rather than only in funds. Private equity investments may overlap investments in sectors also invested in by other asset classes, such as real estate. As a result, there has been increasing interest in how the overlap creates issues for harmonizing the provisions among the various asset classes.

Investments by private equity vehicles may include investments in individual companies, in other funds, in debt securities, and in infrastructure projects, among others. Technically, all of those investments are ultimately investments in securities because the investor takes some ownership position; therefore, these collectively will be termed “underlying investments” for purposes of this guidance.

Investment Vehicles

Investments in private equity are made through a variety of investment vehicles. This is generally done through fund vehicles that are referred to in these provisions as “primary funds” or through a fund of funds.

Primary Funds

Primary funds are investment vehicles that make investments in individual companies, which are typically termed “portfolio companies.” The strategy of the fund may be broad or may have a specific investment stage and/or geographic focus.

Funds of Funds

Funds of funds invest in primary funds rather than directly in portfolio companies (also see the section on co-investment later in this section) with the fund of funds taking a position as an investor in the underlying primary funds.

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Secondary Funds

Secondary investment funds, which themselves may be structured either as a primary fund or a fund of funds, acquire an interest in a private equity fund from one or more of the original investors before the end of the fund's fixed life.

There are also specialized secondary funds that focus on acquiring portfolio companies from other private equity funds. These are typically seen as another type of primary fund and are not synonymous with secondary funds that acquire interests in private equity funds and thus must be considered a primary fund for compliance purposes.

There is often confusion as to the difference between a secondary fund and a fund of funds because both have interests in other primary funds. The difference is that a fund of funds is typically an original investor in an underlying fund while a secondary fund acquires the interest from another investor. There are exceptions because a fund of funds may make an opportunistic secondary investment, but its primary focus is to be an original investor.

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Co-Investment

In some instances, an investor in a primary fund may invest directly into portfolio companies alongside the primary fund. A fund of funds may also invest directly in portfolio companies alongside its underlying funds. These are termed "co-investments." To take advantage of this particular investment, there are now specialized funds that focus on co-investments.

Investment Flows

When investing in private equity through a closed-end primary fund or closed-end fund of funds, an investor makes an initial commitment of capital that is then "called" or drawn down as the investment manager of the primary fund or the investment managers of the underlying funds in a fund of funds find investment opportunities. Capital is returned to the investor via distributions on the sale or recapitalization of individual portfolio companies by the private equity funds, although in some cases, investors may also receive earnings-derived distributions.

Private equity investment vehicles typically have a limited life (i.e., they are not open ended) and are generally illiquid. The ultimate return of the private equity investment vehicle is not known until the fund or partnership is finally liquidated. Because of the unique characteristics of this asset class, additional performance reporting requirements are needed. The GIPS standards, which are based on the principles of fair representation and full disclosure, seek to provide prospective clients with the critical pieces of information needed to evaluate the firm's performance.

Compliance

Compliance with the GIPS standards can only be achieved on a firm-wide basis and requires adherence to not only the private equity provisions but also all provisions in Sections 0-5 in Chapter I of the GIPS standards, unless otherwise noted.

Valuations

Accounting standards up through the 1990s were driven in part by an overriding principle of prudence, seeking to protect investors and creditors from overstatements of asset values and profits. Traditional valuation methodologies, such as the use of historical cost, were easy to justify, thus placing a burden of proof on those seeking to deviate from conservative valuations. However,

there are a number of shortcomings in historical cost methods, which led to pressure for change. Although the precise tipping point for change from a historical cost basis differed by jurisdiction, it became apparent over various market cycles that in some cases conservatism can operate against the interests of some stakeholders.

For example, the historical cost approach has an outward appearance of being conservative and thus in the best interest of stakeholders. However, the use of historical cost can become a defense against the proper write-down of impaired investments. Conversely, the true value of a company's assets may be materially understated, leading to a potentially undervalued takeover bid. Furthermore, as valuation methodologies in public markets became more sophisticated by incorporating cash flows, brand values, the value of intellectual property, and earnings growth, traditional balance sheet conservatism became a less compelling approach.

Fair Value

It has been the position of the GIPS Executive Committee (and previously the Investment Performance Council) for some time that fair value is the most appropriate way to view private equity valuations. It was recommended that a fair value basis be used to value private equity investments in the 2005 edition of the GIPS standards. As fair value is progressively adopted as the preferred industry practice, and is mandated by various accounting standards, the GIPS standards require the use of fair value for all investments, including private equity investments, as of 1 January 2011.

Scope

The following are provisions that apply to the calculation and presentation of private equity investments made by fixed-life, fixed-commitment private equity investment vehicles, including primary funds and funds of funds. These provisions also apply to fixed-life, fixed-commitment secondary funds, which must apply either the provisions applicable to primary funds or the provisions applicable to funds of funds, depending on which form the secondary fund uses to make investments. Private equity open-end and evergreen funds must follow Sections 0–5 in Chapter I of the GIPS standards. Real estate closed-end funds must follow Section 6 in Chapter I of the GIPS standards.

Investment Structures

Closed-End Fund Vehicles (GIPS private equity provisions are applicable)

The predominant vehicle in the global private equity industry is the independent, private, fixed-life, closed-end fund. These vehicles may be organized in a variety of legal forms (e.g., limited partnership, trust, unit trust) depending on the jurisdiction. A firm may have several funds in existence at any one time, each of which is independent from the others. These funds by and large have a defined “start date” and most often have a fixed life (typically ten years) that can be extended by a pre-set number of defined periods (e.g., two one-year periods) upon agreement of the investors. This is termed a closed-end fund because the number of investors/shares is fixed for the life of the fund and closed to new investors, although ownership interest may be transferred (sold) to another investor under certain circumstances. This also means that the capital available for investment (capital commitments) is also fixed for the life of the fund.

An example of a closed-end fund vehicle is the limited partnership. A limited partnership is the most common structure used in the United States and is a fund of pooled interests managed by a general partner (generally an affiliated entity of the firm) who raises capital (i.e., committed capital)

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from outside investors (limited partners). The general partner charges an investment management fee, typically from 1% to 3% per annum, on the total committed capital. Most funds require at least a nominal 1% investment by the general partner. In addition, the general partner will take a profit split (known as the “carried interest” or simply the “carry”) of usually 20% of profits.

The general partner will “call” the capital from the limited partners in tranches as needed for investment in underlying companies. These capital calls are also termed “drawdowns” or “take-downs.” The cumulative capital calls are known as paid-in capital. Another unique feature of this type of vehicle is that any proceeds from investments must be distributed to the limited partners; reinvestment is only permitted if allowed in the contract (known as a limited partnership agreement [LPA] or partnership agreement) between the general partner and the limited partners. In recent years, there has been an increasing number of cases where (by agreement) distributions may be recalled for subsequent investment. In addition, committed capital in these vehicles cannot be withdrawn (“redeemed”), as is the case in other pooled investment vehicles, such as hedge funds. In a typical private equity limited partnership, the cash flows are easy to enumerate because return is calculated on the basis of the cash flows between the partners (general and limited) and the fund. The investment management fee is generally charged on the total assets committed to the fund by the limited partners rather than on the value of the invested capital of the fund.

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Funds of Funds (GIPS private equity provisions are applicable)

A fund of funds is a special type of fund vehicle that makes investments in primary private equity funds rather than in individual portfolio companies. The private equity fund of funds operates much like a primary fund vehicle except that the underlying investments are funds rather than companies. Recognizing that funds of funds do not necessarily control the underlying funds in which they invest, it is not necessary for each underlying fund in a fund of funds to be in compliance with the GIPS standards in order for the fund of funds firm to be compliant. A closed-end fund of funds that invests in open-ended vehicles would be required to follow the private equity provisions. Funds of funds must meet all relevant private equity requirements at the fund of funds level. Unless otherwise noted, each private equity provision applies to fund of funds vehicles.

Direct Investments and Co-Investments (GIPS private equity provisions are applicable)

Although an investment by a primary fund into a portfolio company is technically a “direct investment,” because the investment is made directly into the company, the term is generally applied to separate investments in companies by investors outside of a primary fund. For example, an investor who invests directly in a company is said to be making a direct investment, rather than investing through a fund. Co-investments are a special case of direct investments where an investor in a fund makes a direct investment in a portfolio company along with the fund. This is generally allowed in a pre-established co-investment agreement. In many cases the direct investment or co-investment will have a different fee structure than a comparable investment in a fund. It is not uncommon for these co-investments to be “no-fee, no-carry” transactions. If a composite includes any non-fee-paying portfolios, the firm must present, as of each period-end, the percentage of the composite that is represented by non-fee-paying portfolios.

Side-by-Side Vehicles (GIPS private equity provisions are applicable)

There are instances in which parallel vehicles are created that invest alongside a primary fund for reasons such as individual client accommodation, jurisdictional considerations, or tax considerations. The vehicle itself usually invests on a pro-rata basis with its affiliated primary fund. Best

practice is for firms to disclose if there is a side-by-side vehicle associated with a fund. While the terms and conditions for the side-by-side vehicle may be significantly different from those of the primary fund, if the side-by-side vehicle has a similar strategy and the same vintage year as the primary fund, the side-by-side vehicle must be included in the same composite as the primary fund. In the case that a side-by-side vehicle is materially different in strategy or other characteristic from the primary fund, then the side-by-side vehicle should be included in a separate composite.

Evergreen Funds (GIPS private equity provisions are not applicable)

In contrast to the typical closed-end, fixed-life limited partnership (described earlier) there are investment vehicles that are neither fixed life nor fixed commitment. They are often called “open-end funds” or “evergreen funds.” While they do not have the same structure as a limited partnership, they may make the same type of investments into venture capital, buyouts, distressed debt, and similar investments and are usually also classified as private equity funds. However, the GIPS standards have excluded these from application of the private equity provisions, even though they may make the same type of investments. The investment structure typically doesn’t lend itself to the same type of treatment as the closed-end, fixed-life fund.

To understand why the private equity provisions do not apply, it should be understood that the basic metric and industry practice used in measuring performance in the private equity industry is the since inception internal rate of return (SI-IRR). In the typical open-ended vehicle without a fixed amount of committed capital, an investment manager does not have control over the timing of the cash flows. While an SI-IRR can technically be calculated for such a cash flow stream, a time-weighted return is more appropriate given the cash flow stream and the decision process being measured. For this reason, evergreen vehicles are not good candidates for using the SI-IRR but, rather, are best treated using a time-weighted rate of return (TWRR) calculation.

As a result, the private equity provisions exclude funds that have an evergreen structure and require that they instead comply with the provisions in Sections 0-5 in Chapter I of the GIPS standards. The exception is the special case of evergreen funds of funds where the GIPS private equity provisions can be applied (see discussion later in this section).

Captive and Semi-Captive Funds (GIPS private equity provisions are applicable if funds are closed end)

Some private equity vehicles are organized as captive vehicles or semi-captive vehicles. Captive refers to a fund that only invests for the interest of its owner organization (e.g., corporation, university, foundation). The salient feature is that the fund only invests its parent’s capital; there are no outside investors. Corporate venture groups of technology companies are examples of this type of vehicle, although several insurance companies and investment banks also have similar vehicles. A captive or semi-captive vehicle that is closed end would qualify for private equity provisions application.

A semi-captive vehicle is a vehicle that invests both parent entity capital as well as outside capital. These funds normally charge an asset-based investment management fee and/or carried interest to the outside investors, and are usually closed end because the number of investors is fixed, although a number of evergreen semi-captive funds also exist. If a captive or semi-captive vehicle is a closed end vehicle, then the GIPS private equity provisions apply. If the vehicle is evergreen, the GIPS private equity provisions do not apply.

Open-End Funds (GIPS private equity provisions are not applicable)

Another investment structure is an open-end investment vehicle that acts much like a publicly quoted mutual fund. The fund is an investment vehicle that is traded on an exchange and priced daily. In addition, there are open-ended vehicles that, although not traded on an exchange, may be “priced” monthly. In these open-end investment vehicles, where the investment manager does not have control of the timing of cash flows from its investors, the IRR calculation is not appropriate. These types of open-end investment vehicle must adhere to the provisions in Sections 0-5 in Chapter I of the GIPS standards, rather than the private equity provisions.

Special Case of Evergreen Funds of Funds (GIPS private equity provisions can be applied)

The private equity provisions generally exclude evergreen open-ended vehicles. While not explicit in the provisions, there is one exception to the applicability of the private equity provisions. The private equity provisions of the 2010 edition of the GIPS standards provide funds of funds with the ability to define composites by vintage year of the funds of funds or by strategy. This flexibility accommodates a common type of structure used by funds of funds that have characteristics of an evergreen vehicle but the terms and structure resemble a typical private equity investment. This particular vehicle has the following characteristics:

- It is an open-end fund of funds vehicle that is neither publicly traded nor available to the general public.
- It does not have a finite life and is in essence evergreen.
- It invests in private equity funds as is typical for a fund of funds as either a limited partner or external investor. The fund of funds manager has full discretion regarding selection of the underlying funds. The underlying funds are managed by independent third-party managers/general partners. The fund of funds manager does not influence the investment decisions taken by those third-party managers. The fund of funds may also have other co-investments with the underlying funds.
- The fund of funds typically invests by strategy rather than by vintage year.
- The manager of the fund of funds charges a management fee to the investors.
- The timing and size of external cash flows into/from the fund of funds are determined by the third-party managers managing the underlying funds as they call the capital to make use of the investment opportunities or make distributions.

A vehicle of this structure may, but is not required to, comply with the private equity provisions that apply to funds of funds. If an evergreen fund of funds vehicle meets the above criteria and chooses to apply the private equity provisions, it must also comply with all of the private equity requirements in Section 7 of Chapter I of the GIPS standards. Alternatively, these vehicles can apply the provisions in Sections 0-5 of Chapter I of the GIPS standards.

Determining the Non-GIPS-Compliant SI-IRR Performance Period for Private Equity Composites

The private equity provisions require that private equity composites present the since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm’s inception or the composite inception date if the

firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The measurement period for an SI-IRR is the period from the inception date of the investment vehicle and/or composite through the end of the period that is being reported. Please note that the term “since inception” is independent of the calculation method used. For example, it is possible to calculate a “since inception time-weighted rate of return.” Although it is not required or recommended in the GIPS standards, it is also possible to calculate an IRR between any two points in time within an investment period that is not necessarily since inception.

In a “since inception” IRR calculation, the beginning date remains constant and does not change. The measurement period for an SI-IRR becomes increasingly longer as the ending date is extended, whereas the beginning date is constant. A TWRR, as typically disclosed in a compliant presentation, does not have a constant beginning date like an SI-IRR but, rather, is a mathematical linking of several interim independent sub-periods. Conversely, an SI-IRR has only one measurement period—from inception to the end of the period being measured, with no linking of interim independent sub-periods.

It is necessary to use the period-end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period-end, starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Effective Date

The effective date for this Guidance Statement is 1 October 2012. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions that were in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

Private Equity—Requirements

Input Data—Requirements

Provision 7.A.1

For periods ending on or after 1 January 2011, PRIVATE EQUITY investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II of the GIPS standards.

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Discussion

Performance reporting is of little value unless the underlying valuations are based on sound valuation principles. The GIPS Valuation Principles, including requirements and recommendations specific to private equity, establish a broad foundation for valuing investments. In order to create comparable valuations for consistent performance calculation, private equity investments must be valued in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II of the GIPS standards. For periods ending prior to 1 January 2011, private equity investments must be valued according to either the GIPS Private Equity Valuation Principles in Appendix D of the 2005 edition of the GIPS standards or the GIPS Valuation Principles in Chapter II of the 2010 edition of the GIPS standards.

These broad principles can be supplemented with more detailed valuation guidelines, such as the standardized methods used for valuing private equity investments presented in the International Private Equity and Venture Capital Valuation (IPEV) Guidelines.

Fund Reporting and Valuation Considerations In some instances, the concept of fair value is misunderstood as being the same as “market value.” However, although related, they are not the same. At any point in time, a private equity portfolio’s valuation may be different from market prices due to an inherent lag effect in the industry. In private equity reporting, there is typically a lag effect in valuation reporting because a private equity fund has to apply the firm’s valuation methodology to portfolio investments, accumulate its total portfolio valuations, and report this information to its investors. The reporting lag inherent in this process means that there can be a valuation lag of a quarter or, in some cases, even longer. Thus, a 31 March valuation may be what is termed a roll-forward valuation (i.e., a valuation based on 31 December of the prior year adjusted by interim cash flows between 1 January and 31 March). This has the added effect that valuations of private equity holdings may not be contemporaneous with marketable securities that can truly be “marked to market.”

If these roll-forward valuations are used, firms must assess to what extent the estimated values represent the current fair value (and can be used for GIPS compliance purposes), or if the final values should be used, and how they will fit within the composite-specific valuation policies and procedures. Two possible scenarios include, but are not limited to, the following:

1. 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.
2. The firm uses estimated values to determine fair value and produce the compliant presentation on a timely basis. If using estimated values provided by third parties, the firm should obtain an understanding of the process for determining estimated values and determine whether reliance can be placed on this process. After the final values have been determined, the firm must assess the differences between the estimated and final 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 the compliant presentation for that composite must be adjusted on a prospective basis and whether any additional disclosure of this adjustment may be required. Firms must also consider if the compliant presentation should be revised retroactively according to the composite-specific valuation policies and procedures. If composite valuations are revised retroactively, firms must consider the Guidance Statement on Error Correction and the firm's error correction policies.

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 should consider disclosing this fact in compliant presentations to provide enough information for a prospective client to interpret the performance record. The GIPS standards state that firms must not present performance or performance-related information that is false or misleading.

Portfolio Company Reporting Considerations Given the subjective methods used in private equity valuation, it should be noted that two funds invested in the same company may agree on a valuation on the date of initial or subsequent investment but at other times it may be possible, and is likely, that valuations may diverge because there is no market price and each firm invested in the portfolio company can use its own valuation methodologies to value those investments.

Provision 7.A.2

PRIVATE EQUITY investments MUST be valued at least annually.

Discussion

In Sections 0-5 in Chapter I of the GIPS standards, portfolios are required to be valued monthly for periods beginning on or after 1 January 2001 and portfolios must be valued at the time of all large cash flows for periods beginning on or after 1 January 2010. In a calculation where time-weighted returns are used, valuations at key cash flow events and at period-end are needed because those valuations become terminal values in the time-weighted return. In a true time-weighted return calculation, sub-period returns are calculated between each valuation and geometrically linked together to derive a return for the period.

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The GIPS standards require an SI-IRR rather than a TWRR for private equity portfolios. In an SI-IRR, valuations are only needed at the end of the period being measured. Valuations in private equity investments are generally performed on a less frequent basis because they are not liquid securities. Typically, valuations are reported on a quarterly basis rather than monthly or daily. The GIPS standards require private equity investments to be valued at least annually in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II of the GIPS standards. Quarterly valuations are recommended. In addition, firms must value portfolios as of the calendar year-end or the last business day of the year for periods ending on or after 1 January 2006.

The practical implication of this is that private equity portfolios typically have quarterly valuations but must be valued at least once in a 12-month period. Most private equity firms have annual audits for their funds, meaning that this year-end valuation will most likely be the valuation used for compliance with the GIPS standards. More frequent valuations are generally required for client reporting purposes and are considered good business practice; thus, the GIPS standards recommend quarterly valuation for private equity.

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Calculation Methodology—Requirements

Provision 7.A.3

FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).

Discussion

An investment manager should not be rewarded or penalized for investment decisions outside of his or her control. In an open-end fund, the timing of cash flows into and out of the fund is usually not at the discretion of the investment manager. As a result, the time-weighted rate of return, which adjusts for the effect of the timing of the cash flows in the portfolio, is required for open-end funds.

On the other hand, in a fixed-life private equity fund, the decisions to raise capital, draw down capital in the form of capital calls, and distribute proceeds are all at the discretion of the private equity manager. The timing of cash flows is part of the investment decision process. The private equity firm's performance must reflect the results of those timing decisions; and thus, the IRR is required.

In general, the IRR is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. The SI-IRR is a specific version of the IRR where the measurement period covers the entire investment period since inception.

The IRR is the return for which the net present value of a cash flow series is equated to zero and is calculated as follows:

$$0 = \sum_{i=0}^I CF_i (1 + r_{IRR})^{-\left(\frac{t_i}{365}\right)},$$

where

CF_i = cash flow i [negative values for inflows (paid-in capital) and positive values for outflows (distributions)]

i = number of cash flows (1, 2, ..., I) during the measurement period

r_{IRR} = annualized internal rate of return

t_i = number of calendar days between the beginning of the measurement period and the date of cash flow i

The since inception internal rate of return (SI-IRR) is a special version of the IRR where the period-end value of the investment is treated as a synthetic terminal cash outflow and is calculated as follows:

$$0 = \left[\sum_{i=0}^I CF_i (1 + r_{SI-IRR})^{-\left(\frac{t_i}{365}\right)} \right] + \left[V_E (1 + r_{SI-IRR})^{-\left(\frac{TD}{365}\right)} \right],$$

where

CF_i = cash flow i [negative values for inflows (paid-in capital) and positive values for outflows (distributions)]

i = number of cash flows (1, 2, ..., I) during the measurement period

r_{SI-IRR} = annualized since inception internal rate of return

t_i = number of calendar days between the beginning of the measurement period and the date of cash flow i

TD = total number of calendar days in the measurement period

V_E = value of the investment at the end of the measurement period. In the case of closed-end funds, this is typically the net asset value at the end of the measurement period

Note: the above annualized formula assumes a 365 day per year convention and may have slight inaccuracies when the measurement period contains a leap year(s).

Firms must calculate and present the annualized SI-IRR. If the period is less than a full year, firms must present the non-annualized SI-IRR. The non-annualized SI-IRR is calculated as follows:

$$R_{SI-IRR} = \left[(1 + r_{SI-IRR})^{\frac{TD}{365}} \right] - 1,$$

where

R_{SI-IRR} = non-annualized since inception internal rate of return

r_{SI-IRR} = annualized since inception internal rate of return

TD = total number of calendar days in the measurement period

Note: the above formula assumes a 365 day per year convention and may have slight inaccuracies when the measurement period contains a leap year(s).

Provision 7.A.4

For periods ending on or after 1 January 2011, the SI-IRR MUST be calculated using daily cash flows. Stock DISTRIBUTIONS MUST be included as cash flows and MUST be valued at the time of DISTRIBUTION.

Discussion

Using daily cash flows to calculate the SI-IRR results in a more accurate return. For private equity investments, the GIPS standards require daily cash flows for periods after 1 January 2011 and recommend daily cash flows for periods prior to 1 January 2011. For periods prior to 1 January 2011, the SI-IRR must be calculated using either daily or monthly cash flows.

The date of the incoming cash flow (paid-in capital) is intended to reflect the date the firm obtains control of the capital from the investor, which is not necessarily the date the capital is invested in underlying companies (in the case of a primary fund) or funds (in the case of a fund of funds). For practical purposes, this should be the date of the capital call because there may be a day or so lag in between the date of the capital call and the date the investor actually delivers the capital. Similarly, the date of the distribution is the date the distribution is returned to the investor, which is not necessarily the date the firm receives the proceeds from the underlying investment because there may be a lag between the date of the distribution notice to investors and the date the investor actually receives the proceeds.

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There has been confusion as to what daily cash flows mean and how to reconcile daily cash flows with historical results based on cash flows with a different frequency. Using daily cash flows means that the cash flows are dated on the date the cash flows occur—for example, the date of the capital call or the date of the distribution. Due to the administrative burden, historically, cash flows have been accounted for on a less frequent basis. For some funds in the 1980s, cash flow data were aggregated on a quarterly basis or even, in some cases, on an annual basis. (The same is still true in some emerging markets today.) Since cash flows were usually reported on a quarterly basis (or, in some cases, on an annual basis), there was little reason to calculate returns with cash flows on a more frequent basis, even if available.

There were practical reasons for this practice aside from the administrative burden. Before the advent of the modern financial calculator, it was very difficult to calculate an SI-IRR. There were approximations and formulas for calculating both the TWRR and the IRR, such as the Dietz and the Modified Dietz methods. Some methods attempted to approximate daily cash flows. However, these methods were still not as accurate as a daily cash flows stream incorporating the actual dates of the cash flows.

Even with the introduction of spreadsheets, the ability to create a spreadsheet that used daily cash flows meant creating extremely large and cumbersome spreadsheets because these tools typically needed an entry for every date from beginning to end even if the date didn't have a cash flow.

Software products addressed this issue, and certain spreadsheets and performance systems only require dates on which cash flows actually occurred. However, monthly cash flow streams are still often used. In some cases, whole businesses have been created to consolidate cash flows into monthly streams in order to accommodate legacy performance measurement systems. Daily cash flow conventions are now the norm and are not difficult to produce with systems now available.

The principal issue is dealing with legacy cash flows streams that might be dated monthly for periods prior to 1 January 2011. While it may not be as accurate as requiring reconstruction of a daily cash flow stream historically, the administrative burden and cost of reconstruction would be difficult to justify given the benefit gained. When constructing such a stream historically, the firm must assume that all cash flows occurred on a particular date in the month regardless of the actual date of the cash flow. If monthly cash flows are used with daily cash flows in the same cash flow stream, the IRR formula must use a daily compounding convention for the entire cash flow stream. Thus, a firm that dates cash flows at month-end prior to 1 January 2011 and then uses daily cash flows after 1 January 2011 would compound the entire stream daily to be in compliance with the

GIPS standards. While the resultant SI-IRR is not as precise as retroactively reconstructing the daily cash flows, the difficulty of daily cash flow reconstruction means that combining the monthly and daily cash flow streams is a reasonable accommodation.

Provision 7.A.5

All returns **MUST** be calculated after the deduction of actual **TRANSACTION EXPENSES** incurred during the period.

Discussion

Fees and expenses must be evaluated to determine their proper treatment when calculating returns. Firms are required to deduct actual transaction expenses incurred during the period when calculating both gross-of-fees and net-of-fees returns. Transaction expenses include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing portfolio investments as well as trading expenses, if any.

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Provision 7.A.6

NET-OF-FEES returns **MUST** be net of actual **INVESTMENT MANAGEMENT FEES** (including **CARRIED INTEREST**).

Discussion

For both primary funds and funds of funds, private equity investment management fees usually include two components: an asset-based management fee (based on either invested or committed capital) that is paid on an ongoing basis and/or a performance-based fee, known as carried interest, which is accrued and paid as typically agreed in the limited partnership agreement. Collectively, these fees are referred to as investment management fees. Firms are required to deduct these actual investment management fees when calculating net-of-fees returns. Carried interest can often have a greater impact than the asset-based management fee.

When calculating net-of-fees returns, the terminal value should be net of investment management fees (which include carried interest) that have been accrued but not yet paid. The intent is to provide an estimate of what the limited partner would receive if the portfolio were liquidated, unrealized gains and losses were realized, and the fund's assets were distributed at the date of the performance calculation.

When calculating both gross-of-fees and net-of-fees returns, a firm may reflect the deduction of other expenses incurred at the primary fund or fund of funds level, such as administrative expenses, but it is not required to do so. In the case of an investment management firm that manages a fund of funds, the firm must calculate all returns that reflect the deduction of all of the underlying funds' investment management fees and other expenses. The firm must also deduct the fund of funds' investment management fees when calculating the net-of-fees return. The firm may also deduct other expenses from the fund of funds' net-of-fees return to arrive at what is generally referred to as a "net-net" return. Deducting this added layer of fees reflects the true return to the ultimate investor.

In practice, investment management fees can be paid either inside or outside of the investment vehicle, which can have an effect on returns. Firms should disclose how such fees are paid.

Provision 7.A.7

For FUNDS OF FUNDS, all returns MUST be net of all underlying partnership and/or fund fees and expenses, including CARRIED INTEREST.

Discussion

For funds of funds, all returns must be calculated after the deduction of actual transaction expenses incurred during the period. In addition, all expenses related to investments in underlying funds, whether or not they are reflected in the valuations of the underlying funds, must reduce both the gross-of-fees and net-of-fees SI-IRR. Note that this requirement also applies to the carried interest and investment management fees of the underlying funds. Such expenses might include management fees billed in addition to or outside of the limited partners' capital commitment or limited partner clawback expenses (e.g., portfolio company litigation) charged directly to the fund of funds. It is typically not possible to allocate the fund of funds level fees to the underlying portfolio investments individually because those fees are a joint cost and it would be arbitrary to allocate them down to the individual portfolio investments.

In addition to investment management fees and transaction expenses, fund of funds expenses used in calculating “net-net” returns to investors may include, but are not limited to, legal, auditing, consulting, accounting, and custodian fees and expenses; out-of-pocket expenses incurred in connection with transactions not consummated; expenses of the advisory board and annual meetings; premiums for insurance obtained by the fund of funds to protect it; taxes, fees, or other governmental charges levied against the fund of funds; organizational expenses up to a specified limit; expenses incurred in connection with the distribution of marketable securities; advertising and public notice costs; and costs of dissolving and liquidating the partnership.

Composite Construction—Requirements

The GIPS standards are structured around the concept of composites. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. In addition, primary funds must be grouped by vintage year such that funds with different vintage years are in different composites.

Firms must remember that the GIPS standards have requirements and recommendations regarding composite construction, which can be found in Section 3 in Chapter I of the GIPS standards as well as the Guidance Statement on Composite Definition. Most importantly, firms are required to include *all* fee-paying discretionary portfolios, including funds and partnerships, in at least one composite that is managed according to a particular investment mandate, objective, or strategy. Creating meaningful composites is critical to the fair presentation, consistency, and comparability of performance results over time and among firms. Firms must understand that the GIPS standards require a firm-wide level of compliance and are not for just selected composites or funds.

Firms should realize that all provisions and guidance related to composites apply to funds and partnerships if the fund or partnership is a single portfolio composite. For example, when the GIPS standards state that the annualized SI-IRR (since inception internal rate of return) must be presented for the composite, because each composite will typically contain only one fund or partnership, this will be the same as the annualized SI-IRR for the fund or partnership.

The following hierarchy may be helpful as firms consider how to define private equity composites:

*Vintage Year**Strategy* (e.g., venture, buyout, generalist, mezzanine, fund of funds, other private equity)*Sub-Strategy* (e.g., size of fund, stage, geography)**Provision 7.A.8**

COMPOSITE DEFINITIONS MUST remain consistent throughout the life of the COMPOSITE.

Discussion

The GIPS standards require that vintage year and investment mandate, objective, or strategy remain consistent through the life of the composite. Thus, a composite cannot change from being classified as a generalist private equity composite to a venture-focused composite, even though it may have invested in more venture deals as the strategy evolved. The vintage year selected for the composite must be consistent through the life of the fund to avoid gaming. There are two methods of classifying funds by vintage year: the year of the investment vehicle's first drawdown or capital call from its investors or the year when the first committed capital from outside investors is closed and legally binding. In most cases, a composite will contain only one fund/partnership. If a firm has multiple funds/partnerships (including side-by-side vehicles) with the same vintage year and strategy, they must be combined into a single composite. Side-by-side investment vehicles and co-investments in underlying portfolio companies must be included in the same composite as the related primary fund if the side-by-side investment vehicle or co-investment meets the primary fund's composite definition.

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Provision 7.A.9

PRIMARY FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR and investment mandate, objective, or strategy.

Discussion

The introduction outlined the features of the three most prevalent fund structures: the primary fund, the secondary fund, and the fund of funds. To review, a primary fund invests directly in portfolio companies or other underlying private equity investments. A fund of funds invests in primary fund vehicles rather than making direct investments in portfolio companies. A secondary fund buys partnership interests from other investors and may be organized as a primary fund or as a fund of funds. The private equity provisions apply to all of the above structures as long as they are fixed-life, fixed-commitment vehicles or evergreen fund of funds structures. Composite construction may be impacted by the investment vehicles' structure so it is important to note which composite construction requirements apply. A primary fund's composite definition will be a combination of vintage year and investment mandate, objective, or strategy. A secondary fund's composite inclusion will depend on whether it has structured itself as a primary fund (Provision 7.A.9 applies) or as a fund of funds (Provision 7.A.9 does not apply).

Provision 7.A.10

FUNDS OF FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR of the FUND OF FUNDS and/or investment mandate, objective, or strategy.

Discussion

A fund of funds is a vehicle that invests in private equity funds as an external investor. These underlying fund investments are not typically in the same vintage year and do not necessarily share the same investment mandate, objective, or strategy. Thus, a fund of funds might include investments in a 1998 venture fund, a 2003 buyout fund, a 2004 buyout fund, and a 2006 distressed fund. In addition, a fund of funds firm may have separately managed accounts that follow this same investment style but with different vintage years and strategies.

Requiring a firm to create fund of funds composites based on both vintage year and investment mandate, objective, or strategy was found to be impractical and not consistent with the information that prospective clients require for their fund of funds investments. Therefore, a firm may create fund of funds composites based on either vintage year of the fund of funds or investment mandate, objective, or strategy, or may choose to create a composite that considers both. In either case, all discretionary funds of funds must be included in at least one of the composites as discussed earlier. For examples of how a fund of funds firm could present composite performance, refer to Appendix A: Sample Presentations in the GIPS standards.

Funds of funds have to be careful in their use of the term “vintage year.” In a fund of funds context, the generic term “vintage year” can refer to the vintage year of the fund of funds itself or the vintage year of the underlying fund vehicles in which it invests. In addition, a firm may have separately managed accounts that have a “subscription year,” which denotes the year an investor signed the investment agreement with the fund of funds. This is often also termed “vintage year.”

When the term “vintage year” is used to create a fund of funds composite, the term refers to the vintage year of the fund of funds vehicle itself. It does not refer to the vintage year of the underlying fund investments. However, Provision 7.A.22 does require that if a fund of funds composite is defined by strategy only, the firm must also provide performance of the underlying fund investments aggregated by the vintage year of the underlying investments. It is only in this context that the underlying fund investments’ vintage year is considered.

Disclosures—Requirements

Provision 7.A.11

FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.

Discussion

The disclosure of the vintage year increases transparency and comparability by allowing prospective clients to understand the time frame when the fund was initiated or first closed to investment.

The concept of the vintage year is to set a starting date so that funds started in the same year can be compared on an equal basis. While there may be several ways that start date could be determined, for compliance with the GIPS standards, the relevant start date is the vintage year of the fund. The GIPS standards require that the vintage year be determined by one of two methods: based on the year of the investment vehicle's first drawdown or capital call from its investors or based on the year when the first committed capital from outside investors is closed and legally binding.

Historically, the vintage year was determined by the date of the first closing of a fund. This date typically also coincided with the fund's first capital call for investments. As the industry evolved, there were more and more cases where the first close did not coincide with actual capital calls but instead were "dry closes," where the fund closed its first commitments but drew no capital because it had no investments to make. Thus, another method evolved in which vintage year was defined by the date of the first capital call, whether for investment or management fees, rather than the first close.

These two methods are both legitimate methods of defining vintage year. The GIPS standards require disclosure of the vintage year and how the vintage year is defined for the composite. The vintage year chosen must be the same for the entire life of the composite.

It is important to note that the calculation of the SI-IRR relies on the first cash flow. The definition of vintage year does not impact the SI-IRR calculation, but it will have an impact on the benchmark that is chosen. The benchmark chosen to compare performance of the composite must reflect the same vintage year used for the composite.

Sample Disclosure:

"The vintage year of the Venture Capital Composite is 2001 and was determined by the year of the first drawdown of capital."

Provision 7.A.12

FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.

Discussion

While most private equity funds generally have a 10-year life, it is common to have multiple extensions whereby some funds may have lives as long as 17 or 18 years. The residual value of the investments may be *de minimis* at that final liquidation date, but the longer the life, the lower the fund's SI-IRR will be, all other things being equal. At some point, the fund is finally liquidated either by disposing of the remaining investments or by writing off any remaining investments. The final liquidation date is the date when the last portfolio in a composite is fully distributed or written off.

Provision 7.A.13

FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period.

4 Guidance Statements

Discussion

Given the subjective nature of the judgments that are required in valuing private equity investments, it is important that the latest valuation methodologies used be disclosed. Portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles as of 1 January 2011. Any key assumptions and subjective judgments made should be disclosed.

Sample Disclosure:

“Accounting convention is U.S. GAAP. Partnership fund investments are carried at fair value as determined by the General Partner at its discretion. The Partnership's fund investments are generally carried at the valuations provided by the general partners or managers of such investments. The valuations provided by the general partners or managers of the underlying funds reflect the fair value of the Partnership's capital account balance of each fund investment, including unrealized gains and losses, and reflect the values as reported in the audited financial statements of the respective fund at the fund's fiscal year-end. The valuations used were based upon the fund managers' valuations as of [date] or at the latest available date. In reviewing these underlying valuations, the General Partner is advised by the Investment Advisor, who reviews the capital account balances and may adjust the value of each fund investment. The General Partner uses the market approach to estimate the fair value of private equity investments. The market approach utilizes prices and other relevant information generated by market transactions, including the type of security, size of the position, degree of liquidity, restrictions on the disposition, data from the latest round of financing, and current financial position and operating results, among other factors. In circumstances where fair values are not provided in respect of any of the partnership's fund investments, the Investment Advisor will seek to determine the fair value of such investments based upon information provided by the general partners or managers of such funds or from other sources. Notwithstanding the above, the variety of valuation bases adopted and quality of management data of the ultimate underlying Investee companies means that there are inherent difficulties in determining the value of these investments. Amounts realised on the sale of these investments may differ from the values used to calculate returns and other fund measures used to prepare this composite presentation and the difference could be significant.”

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Provision 7.A.14

For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies.

Discussion

Consistent with the recognition that valuations are a significant input into the performance equation and that the valuation of private equity investments involves the use of subjective estimates, for periods ending on or after 1 January 2011, firms are required to disclose material changes to valuation policies and/or methodologies that might affect performance results or make historical comparability of performance results difficult. This includes any changes to international guidelines

that have had a material impact on valuation practices or adoption of different accounting principles, valuation policies or industry guidelines. Some examples of a material change include, but are not limited to, the following:

- new valuation principles adopted by a local accounting standards board,
- adoption of new international standards in lieu of local standards,
- change of economic criteria used to value investments, and/or
- change from discounted cash flows basis to a comparables basis.

Sample Disclosure:

“Effective [date], our valuation policy was changed from a discounted cash flow methodology to a market comparable basis. The reason for this change is that market comparables are more reflective of the value of the investments given the changes in the sectors we have invested in over the last few years. The new methodology is consistent with the definition of fair value and the GIPS Valuation Principles and the International Private Equity Valuation principles, policies, and recommended methodologies.”

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Provision 7.A.15

If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied.

Discussion

Since the early 1990s, there have been several local, national, and international valuation principles adopted that have specifically addressed private equity. Almost every major national industry association has developed its own valuation guidelines. Many of the valuation standards across the globe have been subsumed into the International Private Equity and Venture Capital (IPEV) Valuation Guidelines which have broad global representation. The U.S. industry’s attempt to codify standards has been subsumed into FAS 157/ASC Topic 820. It is not uncommon for the GIPS Valuation Principles to be supplemented by other local or international standards because other standards may be more stringent in their requirements.

The disclosure of which jurisdiction’s valuation guidelines have been used in addition to the GIPS Valuation Principles will help prospective clients to determine the comparability of compliant presentations from different firms and/or jurisdictions.

Sample Disclosure:

“The Global Diversified Distressed Composite adheres to the XYZ Venture Capital Association’s valuation guidelines as well as the GIPS Valuation Principles. The XYZ valuation standards are based on fair value but provide more prescriptive advice in terms of how to value specific investments, such as secondary investments and distressed debt investments.”

Provision 7.A.16

FIRMS MUST disclose the calculation methodology used for the BENCHMARK. If FIRMS present the PUBLIC MARKET EQUIVALENT of a COMPOSITE as a BENCHMARK, FIRMS MUST disclose the index used to calculate the PUBLIC MARKET EQUIVALENT.

Discussion

The benchmark selected must be appropriate for comparing the performance of the composite. However, unlike those for publicly traded securities, industry benchmarks for private equity are not as widely available or are only available through certain commercial vendors. Firms may use public market indices as a benchmark, but the public market indices by themselves are not directly comparable to the SI-IRR because the market indices typically use a time-weighted return. The public market equivalent (PME) is a method where a public market index is used to create a comparable SI-IRR from a series of cash flows that replicate those of the composite and that can be compared with the SI-IRR of the private equity composite.

The GIPS standards require that the calculation methodology for the benchmark be disclosed. This provides transparency as to the comparability of the performance of the composite and the benchmark. The disclosure includes the calculation method itself (e.g., Is the benchmark a net IRR? On what basis is it compounded? What method is used to determine the vintage year for the benchmark? What metric or statistic is being used for comparison?) For example, the metric for a benchmark could be an average, median, upper quartile, or other percentile. It is expected that the benchmark description includes the name or source of the benchmark as well as the metric being used. If a PME is used as a benchmark, the firm must disclose which public market index is used to create the PME.

Sample Disclosure:

“The benchmark is the 2008 vintage year (determined by the date of first capital call) pooled SI-IRR for U.S. venture capital funds, published by ACME advisory.”

Provision 7.A.17

FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.

Discussion

The SI-IRR calculation is sensitive to the relative timing of cash flows. In some cases, especially early in the life of a fund, using a quarterly cash flow dating convention (only allowed for periods prior to 1 January 2006) can have a very different outcome from using a monthly or daily convention due to the compounding effect of the SI-IRR. Accordingly, firms are required to disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011. Daily cash flows must be used for periods after 1 January 2011.

Sample Disclosure:

“The SI-IRR calculation incorporates monthly cash flows for periods prior to 31 December 2009 and daily cash flows thereafter.”

Provision 7.A.18

For GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.

Discussion

In order to help prospective clients better understand the gross-of-fees return calculation, firms must disclose if any other fees are deducted in addition to actual transaction expenses. For example, a closed-end fund's gross-of-fees return might reflect the deduction of administrative expenses, such as custodian and fund accounting fees. The same is true for a fund of funds. While fund of funds gross-of-fees returns must be reduced by all fees and expenses of the underlying funds, including carried interest, such returns could also reflect the deduction of other expenses at the fund of funds level. Firms are required to disclose if other fees have been deducted to derive the gross-of-fees return.

Sample Disclosure:

“Gross returns reflect the deduction of administrative expenses at the fund of funds level but do not reflect the deduction of ABC Fund of Funds Manager's investment management fees.”

Provision 7.A.19

For NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.

Discussion

When presenting private equity performance, firms are required to present both gross-of-fees and net-of-fees returns. Net-of-fees returns must be net of actual investment management fees and transaction expenses. Net returns may reflect the deduction of other expenses, such as administrative expenses. Expenses in addition to the investment management fees and transaction expenses that are reflected in net returns must be disclosed. Investment management fees typically include a recurring asset-based management fee (most often based on committed capital), a performance-based management fee (most commonly based on the performance of the portfolio above a pre-determined hurdle rate), and certain types of transaction-based investment management fees.

Sample Disclosure:

“Net returns are net of transaction expenses, administrative expenses, management fees, and carried interest.”

Provision 7.A.20

For any performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

Discussion

Firms may link non-GIPS compliant performance to their GIPS-compliant history, provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. If the firm chooses to present non-compliant performance for periods prior to 1 January 2006, the firm must disclose which periods are not in compliance. Prospective clients and existing clients are encouraged to inquire about the reasons why the periods prior to 1 January 2006 are not compliant and consider the effects of non-compliance on the historical performance. Note that the SI-IRR and other private equity performance measures are “since inception” measures. The measurement period for an SI-IRR is the period from the inception date of a fund or composite through the end of the period that is being reported. Please also refer to the earlier section on determining the non-GIPS-compliant SI-IRR performance period for private equity composites.

It is necessary to use the period-end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity fund composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Sample Disclosure:

“Fund IV was formed in 1996. During 1996 and 1997, cash flows were dated to the end of the quarter. Cash flows beginning 1 January 1997 are all dated as of the end of the month, while cash flows beginning 1 January 2003 are all dated as of the actual cash flow date. Therefore, performance for periods ended 31 December 1996 and 31 December 1997 is not in compliance with the GIPS standards.”

Presentations and Reporting—Requirements

Provision 7.A.21

The following items MUST be presented in each COMPLIANT PRESENTATION:

- a. FIRMS MUST present both the NET-OF-FEES and GROSS-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM’s inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets

the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.

Discussion

The intent of this provision is to provide investors with a reasonably accurate estimate of the effect of investment management fees on performance. Deriving SI-IRR gross-of-fees returns from SI-IRR net-of-fees returns and vice versa is not as straight forward as it might seem. There is no uniform method nor standardized formula to derive gross-of-fees SI-IRR returns directly from net-of-fees SI-IRR returns or vice versa. However, it is possible to calculate gross-of-fees SI-IRR and net-of-fees SI-IRR independently. The calculations would be based on the specific facts and circumstances regarding the timing and the terms of the fees, and independent and distinct cash flow streams for gross-of-fees SI-IRR and net-of-fees SI-IRR would be utilized.

The gross-of-fees SI-IRR is the return on investments reduced by any transaction expenses but before deducting investment management fees.

The calculation of a net-of-fees SI-IRR as required by the GIPS standards must reflect the deduction of investment management fees including performance-based fees. Administrative costs and other expenses are not required to be deducted from gross-of-fees or net-of-fees returns. In many jurisdictions, however, it is common practice to deduct such items when computing gross-of-fees SI-IRR and net-of-fees SI-IRR. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses.

The five-year reporting requirement is most relevant for asset classes reporting performance on a periodic time-weighted basis. For example, a non-private-equity investment firm that is first coming into compliance with the GIPS standards and has a ten-year track record can report performance on the last five years of its track record. These results will be independent of any performance preceding those five years. In the case of private equity returns that are based on since inception, the current performance is dependent on all transactions historically. If a fund has been in existence less than five years, it must present the SI-IRR though each annual period-end from inception.

Most investors will want to see the entire track record of annual SI-IRRs. It is typical that returns will be negative in the early years and will then likely turn positive. The plot of the cumulative since inception net cash flows or since inception returns of a fund is typically referred to as the “J-curve.” The early negative results are the result of the fact that in some funds, like venture funds, it will take time before the fund’s value exceeds paid-in capital. In addition, in the early cash flows, the cash flows called for management fees may be larger than the cash flows made for investment purposes. As a result, it is recognized that the early years of a fund are not indicative of long-term performance. This is especially true for venture capital funds because the early capital calls for management fees and length of time for investment development and growth mean that early returns will usually be highly negative until the fund recovers from the J-curve effect. However, the J-curve effect should be minimized with respect to the gross-of-fees return because management fees are not deducted in the gross-of-fees calculation.

Provision 7.A.21

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- b. For periods beginning on or after 1 January 2011, when the initial period is less than a full year, **FIRMS MUST** present the **NET-OF-FEES** and **GROSS-OF-FEES SI-IRR** through the initial annual period end.

Discussion

Firms are required to present any partial-year performance for the initial reporting period on a non-annualized basis for composites that begin on or after 1 January 2011. For example, a fund that began on 30 November 2011 and has a one-month initial return through 31 December 2011 of 3% would be required to present that 3% as the partial year’s performance. The annualized return of 42.6% must not be presented. Many spreadsheet and software applications automatically annualize all returns, and firms are reminded that for periods of less than a year, the firm must “de-annualize” any annualized returns that are calculated.

The method chosen to de-annualize is at the discretion of the firm. For example, the firm may de-annualize the return from the bottom up by compounding daily cash flows for the investment period or by taking the implied annual return and calculating the equivalent return for the investment period. In the situation just presented, the 42.6% implied annualized return could be de-annualized by the following formulas:

$$\left\{ \left[\left(1 + 0.426 \right) \left(\frac{1}{12} \right) \right] - 1 \right\} \times 100 = 3\% \text{ or } \left\{ \left[\left(1 + 0.426 \right) \left(\frac{30.42}{365} \right) \right] - 1 \right\} \times 100 = 3\%,$$

both resulting in a de-annualized one-month return of 3%.

Please note there may be some minor differences between methods due to compounding frequency. In addition, daily compounding can be affected over long periods of time due to leap years.

Provision 7.A.21

The following items **MUST** be presented in each **COMPLIANT PRESENTATION**:

- c. For periods ending on or after 1 January 2011, **FIRMS MUST** present the **NET-OF-FEES** and **GROSS-OF-FEES SI-IRR** through the **COMPOSITE FINAL LIQUIDATION DATE**.

Discussion

Funds typically have an initial 10-year life that can be extended through either prior or current agreement for a stipulated number of years. Many times, a fund may have one or two portfolio companies that have not been liquidated and continue to be held in the fund. On a since inception basis, the returns do not vary much during those extension periods unless the remaining investments have some major events that cause significant revaluation. In the end, the investments are

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liquidated by some means and the fund eventually is also liquidated. A firm must report performance through that composite's final liquidation date in order to capture the residual value, either good or bad, in the last stages of the composite's existence.

Provision 7.A.22

For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy, FIRMS MUST also present the SI-IRR of the underlying investments aggregated by VINTAGE YEAR as well as other measures as REQUIRED in 7.A.23. These measures MUST be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES and MUST be presented as of the most recent annual period end.

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Discussion

Each fund of funds manager determines the strategies to invest in and the vintage years over which to invest. These distinguishing characteristics are routinely described in detail in the limited partnership agreement. Fund of funds firms differentiate themselves from each other by offering narrow or broad strategies, offering regional or global geographical focuses, investing in primary or secondary markets, and the usage of direct investments or co-investments. These investment mandates are generally employed over two to five consecutive vintage years, although this can vary widely.

One of the significant changes in the 2010 edition of the GIPS standards is in how fund of funds composites can be defined. In the 2005 edition of the GIPS standards, all private equity funds, including funds of funds, were required to be included in composites that were defined by vintage year and investment mandate, objective, or strategy. Given how funds of funds structure their investment portfolios, this often led to a tremendous number of composites, many of which were irrelevant to prospective clients. The 2010 edition of the GIPS standards allows fund of funds firms to create composites that are defined by vintage year and/or investment mandate, objective, or strategy. Following the 2005 edition of the GIPS standards, a fund of funds firm with five funds, each of which had the same strategy but different vintage year, would create five composites. Following the 2010 edition of the GIPS standards, the same firm could choose to define composites either by vintage year (five composites) or investment mandate, objective, or strategy (one composite).

If the firm chooses to create a fund of funds composite defined only by investment mandate, objective, or strategy, the firm is required to present the SI-IRR of the underlying investments that have been aggregated by vintage year as of the most recent annual period-end. The firm must also present, as of the most recent annual period-end, all of the metrics required by Provision 7.A.23 by vintage year as well. See Appendix A of the GIPS standards for examples.

Presenting the underlying investments by vintage years has the added benefit of increased comparability with benchmarks. Because of the numerous variations and structures of funds of funds, fund of funds composites may have underlying investments that span a number of vintage years. Since the number of vintage years of the underlying investments varies significantly, fund of funds composites are not usually comparable with vintage year benchmarks or with other funds of funds. By stratifying the fund of funds composites by the vintage year of the underlying investments, additional analysis of the composite can be performed. This allows for analysis by vintage year of all investments made by the fund of funds by comparing them directly to an appropriate vintage year benchmark.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL.
- b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS.
- c. COMPOSITE cumulative COMMITTED CAPITAL.
- d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI).
- e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI).
- f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE).
- g. RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).

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Discussion

While the since inception IRR is the basic metric used to report performance for private equity investments, it is not the only useful metric used to gauge performance. Other measures are also useful to provide additional insight. The IRR by its nature is sensitive to early cash flow events, and the IRR calculation assumes that the residual value of a composite is totally liquid, whereas in reality, the residual value is the unrealized (and often illiquid) portion of the composite. As a result, other metrics have been developed that allow a prospective client to examine aspects of performance other than simply a rate of return.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL.

Discussion

The composite since inception paid-in capital consists of all capital inflows to an investment vehicle by the investors (e.g., limited partners). These inflows are also referred to as contributions to an investment vehicle by the investors. Paid-in capital also includes distributions that are subsequently recalled and reinvested into the investment vehicle.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS.

Discussion

The composite since inception distributions include all cash and stock distributed from an investment vehicle to the investors (e.g., limited partners).

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- c. COMPOSITE cumulative COMMITTED CAPITAL.

Discussion

The composite cumulative committed capital represents the total pledges of capital to an investment vehicle by the investors (e.g., limited partners).

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Provision 7.A.23

FIRMS MUST present as of each annual period end:

- d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI).

Discussion

The investment multiple, or TVPI, provides investors with a multiple that indicates how many times more the investment is worth compared with the original investment without taking into account the time value of money. It is equal to the sum of the composite since inception distributions and its residual value divided by the composite since inception paid-in capital (or contributions). The investment multiple is calculated as

$$\text{TVPI} = \text{DPI} + \text{RVPI} \text{ or } (\text{Cumulative distributions since inception} + \text{Period-end residual value}) / \text{Cumulative paid-in capital since inception),}$$

where

DPI = realization multiple

RVPI = unrealized multiple

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI).

4 Guidance Statements

Discussion

The DPI, or realization multiple, measures how much capital has actually been returned to investors. It is the amount of capital that has been “realized” by investors and is often viewed as the amount of the TVPI that is “realized.” It is equal to the sum of the since inception distributions divided by the since inception paid-in capital (or contributions). It is calculated as

$$\text{DPI} = (\text{Cumulative distributions since inception}) / (\text{Cumulative paid-in capital since inception}).$$

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE).

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Discussion

The paid-in capital multiple (also known as the PIC multiple or PIC ratio) gives prospective investors information regarding how much committed capital has actually been drawn down. In industry terminology, it is also known as the “dry-powder ratio” because it measures how much capital is left to invest. It is equal to the since inception paid-in capital (or contributions) divided by total capital commitments. It is calculated as

$$\text{PIC} = (\text{Cumulative paid-in capital since inception}) / (\text{Cumulative committed capital}).$$

Recycling/Reinvestment and Recalable Cash Flows Private equity vehicles are usually characterized by the prohibition (unless stipulated by agreement) to reinvest proceeds or allow redemptions. This means that unless otherwise agreed to, private equity investment vehicles must distribute proceeds from investments to investors (e.g., limited partners) and cannot reinvest that capital. In some cases, distributions are “recalable”, that is, after the investment vehicle distributes proceeds to its investors, it can draw down the same capital again, which makes it possible for the investment vehicle to draw capital in excess of its total committed capital.

Distributions can be either recalable or non-recalable. This means that a recalable distribution must be treated as an actual distribution and if and when that distribution is recalled, it must be treated as additional paid-in capital. The treatment of recalable distributions with respect to committed capital should be disclosed in the compliant presentation.

Please note that recalable distributions have an impact on the performance metric calculations and the firm may wish to consider additional disclosure when there is material distortion to the PIC or realization multiples. If a recalable distribution is re-contributed and reflected as paid-in capital a second time, the result will be cumulative paid-in capital since inception being higher than total committed capital. It also means that the DPI, RVPI, and TVPI multiples will be lower, all other things being equal, for investment vehicles that have had recalable distributions because the denominator will be increased. In addition, the PIC ratio will be higher for investment vehicles that have had recalable distributions, all other things being equal.

Provision 7.A.23

FIRMS MUST present as of each annual period end:

- g. RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE OR RVPI).

Discussion

The unrealized multiple, or RVPI, is the converse of the realization multiple. It is equal to the residual value at the end of the period divided by since inception paid-in capital (or contributions). It is calculated as

$$\text{RVPI} = (\text{Residual value at period-end}) / (\text{Cumulative paid-in capital since inception}).$$

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Provision 7.A.24

FIRMS MUST present the SI-IRR for the BENCHMARK through each annual period end. The BENCHMARK MUST:

- a. Reflect the investment mandate, objective, or strategy of the COMPOSITE;
- b. Be presented for the same time periods as presented for the COMPOSITE; and
- c. Be the same VINTAGE YEAR as the COMPOSITE.

Discussion

Firms are required to present the annualized SI-IRR of a benchmark that reflects the same investment mandate, objective, or strategy of the composite that corresponds to the same time periods as presented for the composite and has the same vintage year as the composite. Firms must disclose the calculation methodology of the benchmark and, if a custom benchmark or multiple benchmarks are used, how each benchmark is constructed, including the benchmark components, weights, and rebalancing process. If the firm determines no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.

Provision 7.A.25

FOR FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy and a BENCHMARK is presented for the underlying investments, the BENCHMARK MUST be the same VINTAGE YEAR and investment mandate, objective, or strategy as the underlying investments.

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Discussion

A variety of appropriate benchmarks can be used for direct comparison or opportunity cost comparison. A fund of funds is composed of underlying funds of various vintage years. If a firm chooses to present a benchmark for the underlying investments, an appropriate benchmark is one that mirrors the exact vintage year of the underlying funds for direct comparison. If the benchmark is presented for the underlying investments that span a number of vintage years, a corresponding benchmark including multiple vintage years should be used. For example, for a fund of funds composite with underlying buyout funds with 2004, 2006, and 2008 vintage years, the benchmark should be composed of buyout funds with 2004, 2006, and 2008 vintage years because this is the direct peer comparison for those that invested in the same years.

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Provision 7.A.26

For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.

Discussion

Direct investments (or co-investments) by a fund of funds may augment the strategy used in the investment in underlying fund vehicles. Direct investments may have different terms and conditions that might change the return characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the returns of the fund of funds composite. If no assets are invested in direct investments, no disclosure is required.

Provision 7.A.27

For periods ending on or after 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.

Discussion

Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending on or after 1 January 2011, firms must disclose, for primary fund composites, the percentage of the composite that is invested in other funds as of each annual period-end, if any. If no assets are invested in other funds, no disclosure is required.

Provision 7.A.28

FIRMS MUST NOT present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, FIRMS may present non-GIPS-compliant performance.

Discussion

As previously discussed, there may be legitimate reasons for which reported performance may not be compliant prior to 1 January 2006. Given the fact that performance for private equity is always reported on a since inception basis, the past is always incorporated into the IRR in contrast to a TWRR, which does not necessarily incorporate since inception results. It could be argued that the since inception basis of private equity reporting would mean that any period of historical non-compliance could make the current period also non-compliant because the current calculation may depend on inputs that were not in compliance with the GIPS standards. However, this is not the case—a firm may present prior non-GIPS-compliant performance while claiming compliance even if the prior non-compliant period's inputs are used in current period reporting. The early use of quarterly cash flows or the inability to value portfolios in accordance with private equity valuation standards for investments prior to 1 January 2006 does not invalidate current compliance with the GIPS standards.

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Private Equity—Recommendations**Provision 7.B.1**

PRIVATE EQUITY investments SHOULD be valued at least quarterly.

Discussion

There was a time when private equity valuations were only available annually, but the industry has evolved to the point where quarterly valuation reporting is a standard industry practice. The use of quarterly valuations is recommended because it provides prospective clients with earlier notification of any significant movements and allows more effective tracking and comparative analysis of investments.

Provision 7.B.2

For periods ending prior to 1 January 2011, the SI-IRR SHOULD be calculated using daily cash flows.

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Discussion

Daily cash flows improve the accuracy of the return calculations, including the SI-IRR required by the GIPS standards for private equity investments. Firms should, therefore, use daily cash flows for periods prior to 1 January 2011 and are required to use daily cash flows for periods after 1 January 2011.

Provision 7.B.3

FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end.

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Discussion

Normally, the valuations used for financial reporting and performance reporting do not differ significantly. If they do, the material differences as of each annual period-end should be explained and disclosed.

Sample Disclosure:

“There was a material change in the value of Fund XX caused by a significant write-down of an investment in the portfolio in the fourth quarter of 2012. Due to a time lag in reporting, this valuation is not reflected in the 2012 year-end financial report but was recognized in the 2013 report. However, our compliant presentations reflect this decrease in valuation as of 31 December 2012. In the opinion of the GP, this represents a material difference between the valuations used in financial reporting versus performance reporting.”

Provision 7.B.4

For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

Discussion

A firm must disclose material changes to valuation policies and/or methodologies used to value private equity investments for periods ending on or after 1 January 2011. Firms are recommended to disclose material changes to valuation policies and/or methodologies for periods ending prior to 1 January 2011.

Provision 7.B.5

For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by VINTAGE YEAR of the FUND OF FUNDS, FIRMS SHOULD also present the SI-IRR of the underlying investments aggregated by investment mandate, objective, or strategy and other measures as listed in 7.A.23. These measures SHOULD be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES.

Discussion

As a corollary to Provision 7.A.22, where a fund of funds firm is required to provide summary statistics by vintage year if the firm chooses to create composites by investment mandate, objective, or strategy, Provision 7.B.5 recommends that if a fund of funds composite is defined by vintage year, the firm should also provide summary statistics by strategy.

Provision 7.B.6

For periods ending prior to 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.

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Discussion

Direct investments (or co-investments) by a fund of funds may augment the strategy used in the investment in underlying fund vehicles. Direct investments may have different terms and conditions that might change the performance characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the performance of the fund of funds composite.

Provision 7.B.7

For periods ending prior to 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.

Discussion

Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending prior to 1 January 2011, firms should disclose, for primary fund composites, the percentage of the composites that is invested in other funds as of each annual period-end.

4-10 GUIDANCE STATEMENT ON REAL ESTATE

Adoption Date: 16 March 2012 Effective Date: 1 October 2012 Retroactive Application: Not Required

Introduction and Scope

The real estate provisions in Section 6 of Chapter I of the Global Investment Performance Standards apply to

- wholly owned or partially owned properties;
- real estate commingled funds, separate accounts, and unit trusts;
- unlisted, private placement securities issued by private real estate investment trusts (REITs) and real estate operating companies (REOCs); and
- equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where some portion of return to the investor is related to the performance of the underlying real estate assets.

Real estate includes land, buildings under development, completed buildings, and other structures or improvements held for investment purposes.

The real estate provisions apply irrespective of whether a real estate investment is producing revenue and also apply to real estate investments with leverage (gearing).

It is important that firms managing real estate investments understand that compliance with the GIPS standards refers to firm-wide compliance, which requires adherence not just to the real estate provisions but to all the applicable general provisions of the GIPS standards. The general provisions that do not apply to real estate composites are noted parenthetically within Section 6 of Chapter I of the GIPS standards.

The following investment types are not considered real estate investments and, therefore, must follow Sections 0–5 in Chapter I of the GIPS standards:

- publicly traded real estate securities;
- mortgage-backed securities (MBS, CMBS); and
- private debt investments, including commercial and residential loans where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying real estate.

The following guidance includes a discussion of issues relating to real estate investments.

Investment Discretion

The GIPS standards require that all actual, fee-paying, discretionary portfolios be included in at least one composite. Discretion is the ability of the firm to implement its intended strategy. Each firm must document its definition of discretion and must apply the definition consistently. As stated in the Guidance Statement on Composite Definition, there are degrees of discretion and not

all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy.

The firm's definition of discretion must include criteria such that if the firm has sole responsibility or sufficient decision-making authority for major investment decisions, the real estate portfolio must be considered discretionary. Major decisions include, but are not limited to, determining the investment universe, acquisitions, dispositions, investment structuring, financing, capital improvements, leasing, and operating budgets. In some cases, client-imposed restrictions may result in some decision-making authority being retained by the client. However, if the firm has sufficient decision-making authority to implement the intended investment mandate, objective, or strategy, the portfolio should be considered discretionary.

The following is an example of a discretionary portfolio:

- The firm, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions and, therefore, can fully implement its investment strategy. This is often the case for products sponsored by the firm, such as real estate pooled or commingled investment fund vehicles.

The following are examples where the firm may be able to characterize the portfolio as discretionary, consistent with its definition of discretion:

- The firm, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions so long as the firm does not exceed specified thresholds agreed to with a non-pooled or non-commingled investment vehicle client.
- The firm retains control over property management (day-to-day operations); makes strategic acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition recommendations; and is not required to but typically does obtain client approval for these items prior to transaction execution.

The following are examples where, in most instances, the firm would characterize the portfolio as non-discretionary, consistent with its definition of discretion:

- The client has complete investment discretion regarding real estate investments.
- The client prohibits or significantly limits repositioning of the portfolio through dispositions.

Composite Construction

One of the key principles of the GIPS standards is the presentation of composite performance, where a composite is defined as an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The real estate provisions of the GIPS standards embrace the notion of composite-level reporting. Real estate investment management firms are required to present performance in composites defined by investment mandate, objective, or strategy. Real estate closed-end fund composites must be defined by vintage year and investment mandate, objective, or strategy, and the composite definition utilized must remain consistent throughout the life of the composite. The vintage year concept is an important factor for real estate

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closed-end fund composites and could potentially limit real estate closed-end fund composites to one fund per composite because firms are unlikely to raise another fund with the same strategy in the same vintage year.

Users and recipients of real estate performance frequently request only an aggregation of property-level performance, which is not consistent with the composite construction principles of the GIPS standards, which are based on investment-level performance. Although firms are not prohibited from presenting property-level performance outside of a compliant presentation or as supplemental information to a compliant presentation, firms are required to make every reasonable effort to provide a compliant presentation to all prospective clients. Please see the Guidance Statement on the Use of Supplemental Information for further information.

The term “investment level” is intended to reflect the impact of ownership and financing structures and includes all underlying property-level activity. Investment-level returns are distinct from property-level returns, which exclude all of the non-property (investment-level) balance sheet items as well as income and expenses. Property-level returns include only those income and expenses that directly relate to operating the property.

A real estate investment management firm may be asked to provide an aggregation of historical performance by property type, which is much narrower than any of the broader investment strategies managed by the firm. For example, the firm may be asked to provide investment performance consisting of only its office building investments, which requires extracting the performance of all office building investments from its broader real estate investment strategies. Such an aggregation is not a composite. This performance can be shown outside of a compliant presentation or as supplemental information to a compliant presentation. If the aggregation is representative of a distinct investment strategy, the track record of the narrower mandate may be able to be presented as a carve-out. Please see the Guidance Statement on the Treatment of Carve-Outs for further information.

For periods beginning on or after 1 January 2011 (for periods ending on or after 1 January 2011 with respect to since-inception internal rate of return), the composite construction requirements for real estate closed-end fund composites mandate that closed-end real estate funds, if any, be in separate composites. The real estate provisions of the GIPS standards contain additional requirements and recommendations specifically for closed-end fund composites. In addition to creating separate composites for closed-end real estate funds, provided all composite construction requirements are adhered to, a firm may choose to include open-end and closed-end real estate funds in another composite because firms are permitted to include a portfolio in more than one composite. If a firm includes both open-end and closed-end real estate funds in a composite, the firm must follow the general real estate provisions (those that are not specific to closed-end fund composites) with respect to this composite and should consider disclosing the types of portfolios included in the composite as part of the composite description. Please see the Guidance Statement on Composite Definition for further information on composite construction.

Inclusion of Portfolios in Composites

The GIPS standards state that composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. When computing time-weighted rates of return, a “partial period” or “stub period” can occur for the period from a portfolio’s inception up

to the beginning of the first full period when a portfolio is placed into the composite. A question that often arises is whether it is proper to reflect stub-period portfolio performance in the calculation of the time-weighted composite performance.

Historically, firms have used different approaches to address the partial-period issue. The nature of the real estate asset class is unique, and it is often composed of illiquid investments with infrequent acquisition and disposition activity. When calculating time-weighted returns for periods beginning on or after 1 January 2011, it is recommended that real estate composites include new portfolios on the portfolio's inception date, which is typically the date of the portfolio's first external cash flow.

Similarly, the GIPS standards state that 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. When computing time-weighted rates of return, a partial period or stub period can occur for the period from the last full period a portfolio is included in a composite to the portfolio liquidation date. When calculating time-weighted returns for periods beginning on or after 1 January 2011, it is recommended that real estate portfolios remain in composites as long as they are invested according to the composite strategy. If the client terminates the portfolio and divesting begins, the portfolio should be removed from the composite as soon as it no longer reflects the composite strategy due to the liquidation.

Each firm must document its policies and procedures for inclusion of real estate portfolios in composites and must apply these policies and procedures consistently. For periods beginning on or after 1 January 2011, firms must disclose in each real estate compliant presentation their policies for inclusion of real estate portfolios when calculating time-weighted returns. For periods beginning on or after 1 January 2011, firms should disclose any time period differences between the composite and the benchmark.

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Fees and Expenses

When calculating returns, the following guidance must be used to determine how real estate investment management and other fees and expenses are treated.

Gross-of-fees and net-of-fees returns must be net of all property-level expenses. Property-level expenses are those that directly relate to the operations of the property. Gross-of-fees and net-of-fees returns must also be net of debt service, including preferred equity dividends.

The difference between gross-of-fees and net-of-fees returns should reflect only investment management fees that the firm charges for providing investment management services. Investment management fees typically include a recurring base management fee (often calculated on the basis of invested or committed capital), a performance-based fee (carried interest), and certain types of transaction-based investment management fees.

Fees and expenses must be evaluated to determine their proper treatment when calculating returns. Firms are required to deduct actual transaction expenses incurred during the period when calculating both gross-of-fees and net-of-fees returns. Acquisition, disposition, and financing services performed by the firm, an affiliate of the firm, or a third party on a particular transaction are considered "transaction expenses" and must be deducted from both gross-of-fees and net-of-fees returns. These transaction expenses (also referred to as "brokerage expenses") are direct costs incurred upon implementation of a particular investment transaction and are considered true transaction expenses. If any of these transaction services are performed by the firm or an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation.

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Please note that the true acquisition and disposition transaction expenses described above are different from investment management fees specifically associated with acquisition and disposition services performed by the investment manager. It is common practice in the real estate industry that investment management agreements separate the investment management fee into one or more of the following components: base investment management, acquisition, disposition, and financing. In this scenario, the fees specifically relating to acquisition and disposition are typically considered to be part of the investment management fee because they relate to the investment management responsibilities performed by the firm in formulating its investment decisions as part of the normal investment decision-making process. Please also note that financing fees, if applicable, are typically identified separately in the investment management agreement and are classified as transaction costs because they are usually related to post-acquisition refinancing.

Investment-level administrative costs are not required to be deducted from gross-of-fees or net-of-fees returns. In many jurisdictions, however, it is common practice in the real estate industry to deduct such items when computing gross-of-fees and net-of-fees returns. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses. If the investment-level administrative fees and expenses include services performed by the investment management firm or an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation.

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Determining the Non-GIPS-Compliant SI-IRR Performance Period for Real Estate Closed-End Fund Composites

The GIPS real estate provisions require that real estate closed-end fund composites present the net-of-fees since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm's inception or the composite inception date if the firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The measurement period for an SI-IRR is the period from the inception date of the investment vehicle and/or composite through the end of the period that is being reported. Please note that the term "since inception" is independent of the calculation method used. For example, it is possible to calculate a "since inception time-weighted rate of return." Although it is not required or recommended in the GIPS standards, it is also possible to calculate an IRR between any two points in time within an investment period that is not necessarily since inception.

In a "since inception" IRR calculation, the beginning date remains constant and does not change. The measurement period for an SI-IRR becomes increasingly longer as the ending date is extended, whereas the beginning date is constant. A TWRR, as typically disclosed in a compliant presentation,

does not have a constant beginning date like an SI-IRR but, rather, it is a mathematical linking of several interim independent sub-periods. Conversely, an SI-IRR has one measurement period — from inception to the end of the period being measured, with no linking of interim independent sub-periods.

It is necessary to use the period-end date of an SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the real estate closed-end fund composite history begins 1 January 2003, an SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present an SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Effective Date

The effective date for this Guidance Statement is 1 October 2012. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions that were in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

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4-11 GUIDANCE STATEMENT ON RECORDKEEPING REQUIREMENTS

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

The GIPS standards state, “All data and information necessary to support all items included in a compliant presentation must be captured and maintained.”

The following guidance relates only to records necessary to satisfy the recordkeeping requirements of the GIPS standards. In all instances, either paper (hard-copy) records or electronically stored records will suffice. If records are stored electronically, the records must be easily accessible and printable if needed. Although most firms are looking for a very precise list of the minimum supporting documents that must be maintained to support all parts of the compliant presentation, including the ability to recreate the firm’s performance history, there is not a single list of records that will suffice in all situations.

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Guiding Principles

1. Above all else, a firm must comply with all applicable laws and regulations regarding the calculation and presentation of performance, including any recordkeeping requirements.
2. For each performance period presented in the compliant presentation, a firm must maintain sufficient records that allow for the recalculation of portfolio-level returns. Depending on the system and methods used for calculating portfolio-level returns and to prove the existence and ownership of client assets, one firm may need different records than another firm needs. Records to support portfolio-level returns might include a combination of the following (this list is not meant to be an exhaustive list):
 - associated bank/custodial statements and reconciliations,
 - portfolio statements of investments and valuations, including information supporting the determination of fair value as required by the GIPS Valuation Principles,
 - information to prove the existence and ownership of client assets,
 - portfolio transactions reports,
 - outstanding trades reports,
 - corporate action reports,
 - income received/earned reports,
 - accrued income reports,
 - foreign or other withholding tax reclaim reports,
 - cash flow/weighted cash flow reports,

- information on calculation methodology used,
 - information provided by a third party (e.g., the sponsor in a wrap fee/SMA relationship) where it may be necessary for a firm to take additional steps to ensure the information provided by the third party can be relied on to meet the requirements of the GIPS standards, and
 - investment management fee information.
3. For each performance period presented in the compliant presentation, a firm must maintain sufficient records that allow for the recalculation of composite-level returns and other composite-level data. Depending on the system and methods used for calculating composite-level returns and data, one firm may need different records than another firm needs. Records to support composite-level returns and other composite-level data might include a combination of the following (this list is not meant to be an exhaustive list):
 - portfolios included in/excluded from the composite,
 - when each portfolio entered (and exited, if applicable) the composite,
 - each portfolio's return,
 - value used to weight each portfolio (beginning value or beginning value plus weighted external cash flows),
 - number of portfolios in the composite and the composite assets presented as of each annual period-end,
 - internal dispersion calculation data,
 - investment management fee information, and
 - ex-post standard deviation and additional measures of risk calculation data.
 4. A firm must maintain records to support why a portfolio was assigned to a specific composite or was excluded from all composites. Supporting records might include a combination of the following (this list is not meant to be an exhaustive list):
 - composite definition, particularly related to the composite inclusion criteria, including the definition of discretion,
 - portfolios excluded from composites and the reasons for exclusion,
 - investment management agreements and amendments thereto,
 - reports provided to clients, including attribution information, if utilized to help determine composite assignment, and
 - e-mail/other correspondence with clients regarding documented changes to a portfolio's investment mandate, objective, or strategy.
 5. A firm must maintain records to support its claim of compliance on a firm-wide basis. Information must be maintained to support the following items (this list is not meant to be an exhaustive list):
 - definition of the firm, historically and current,
 - total firm assets reported as of each annual period-end,
 - composite definitions and composite creation dates,
 - list of composite descriptions, and
 - compliant presentations and supporting information for all composites, including any supplemental information.

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6. The GIPS standards require 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.” Therefore, firms must maintain all policies and procedures (both current and previous versions) that support the claim of compliance.
7. When firms utilize third-party service providers, firms are encouraged to ensure that they have adequate service-level agreements to provide the historical records necessary, both currently and at a date in the future. If a firm utilizes a third party to provide any service (e.g., sub-advisor, custodian, performance measurement), the firm is responsible for its claim of compliance and must ensure that the records and information provided meet the requirements of the GIPS standards.
8. A firm must maintain any additional records necessary to support a claim of compliance, which might include a combination of the following (this list is not meant to be an exhaustive list):
 - marketing output/request for proposal (RFP) responses,
 - externally reviewed system and control reports (e.g., accounting reports, other internal controls/compliance reports for the client and/or custodians),
 - third-party (e.g., sub-advisory, custodial, performance data provider) agreements,
 - minutes of relevant decision-making committees (e.g., a board, an investment committee, a composite/GIPS compliance committee),
 - client fee schedules/agreements,
 - fee data, including custody and administrative fees,
 - systems manuals, especially for the systems that generate the portfolio and composite reports (including returns and additional disclosures/statistics),
 - documentation of efforts made to provide all prospective clients with compliant presentations,
 - documentation of efforts made to provide, in the case of a material error, a corrected compliant presentation, including disclosure of the error, to all appropriate parties in accordance with the firm’s error correction policy,
 - underlying benchmark data (if not publicly available), and
 - documentation of providing the following to any prospective client who requested:
 - a list of composite descriptions,
 - a compliant presentation(s),
 - composite definition(s),
 - policies for valuing portfolios,
 - policies for calculating performance,
 - policies for preparing compliant presentations,
 - verification report(s), and
 - performance examination report(s).
9. All records deemed necessary by the firm must be maintained for each year that is presented in a compliant presentation. At some point in time, a firm may be able to reduce the amount of records stored, as long as the firm can maintain the ability to recalculate the required

returns. For example, an annual summary portfolio transaction report may be maintained instead of individual monthly detail reports. The summary report could be used to recreate period-specific information if needed. Electronically-stored records/reports are acceptable.

10. If a firm that claims compliance with the GIPS standards experiences a catastrophic event where all of its records and electronic or other back-up systems have been destroyed, the firm should try to reconstruct the information necessary by obtaining the information from clients, custodians, consultants, verifiers or any other party outside the firm that might have duplicate copies of those records. However, if the underlying data to support the compliant presentation was destroyed because of extreme circumstances beyond the control of the manager and unavailable from other sources, the firm may continue to claim compliance and show performance if the lack of records for the unavailable period(s) is disclosed. The disclosure must include the reason why the records are unavailable and state that the firm is unable to duplicate the records.

For example, if the records for Firm A from its inception 1 January 2007 through 31 December 2007 were destroyed under extreme circumstances beyond the control of the manager, the firm can claim compliance with the GIPS standards by disclosing that the firm's records for the period from 1 January 2007 through 31 December 2007 were destroyed under extreme circumstances beyond the control of the manager and the data are unavailable from other sources. The firm must also consider any applicable regulatory requirements and must remember that the GIPS standards are ethical standards based on the principles of fair representation and full disclosure. Any performance information that is presented must adhere to these principles.

Effective Date

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

4-12 GUIDANCE STATEMENT ON THE TREATMENT OF CARVE-OUTS

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

A carve-out is defined as a portion of a portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multiple-strategy portfolio managed to a broader mandate. For example, the Asian securities from a Euro-Pacific portfolio or the equity portion of a balanced portfolio could be considered a carve-out. Carve-outs are generally based on asset class, geographic region, or industry sector.

Inherent Problems

Carve-outs have several problems associated with them. Because they represent only a portion of a broader, more diversified strategy carve-out returns are only a valid track record if they are representative of what would have been achieved in a portfolio dedicated to the carved-out strategy. The use of carve-outs gives the impression that the firm has experience managing portfolios dedicated to a particular strategy, when this may not be the case. For example, a carve-out of the U.K. equities in a global equity portfolio that holds only two U.K. equities is not representative of a diversified U.K.-only portfolio.

A second problem occurs if cash is not accounted for separately. If the carve-out is not accounted for separately with its own cash balance, then the return is potentially not representative of a stand-alone portfolio. The GIPS standards require that returns from cash and cash equivalents held in portfolios must be included in all return calculations. Unless the carved-out portion is accounted for as a separate portfolio, there will be no cash associated with the returns. For periods prior to 1 January 2010, if carve-outs were included in a composite, cash must have been allocated to the carve-out in a timely and consistent manner or have been accounted for separately with its own cash balance.

For periods beginning on or after 1 January 2010, a carve-out must not be included in a composite unless the carve-out is managed separately with its own cash balance. Cash allocation is no longer allowed. If the firm intends to carve out an asset class, sector, industry, size range (e.g., large cap), or style type (e.g., value), each carved-out segment must have either its own cash balance or be accounted for separately with its own associated cash position.

The rationale behind the inclusion of cash at all times in total returns is based on the principle of fair representation. A composite that includes portfolios without any cash would not be representative to the typical prospective client who hires the firm on a fully discretionary basis, where cash allocation and management would be implicit. It would be misleading to present returns without cash, since this does not fairly represent how a separate portfolio would be managed.

Guiding Principles

Firms must remember the fundamental principles of the GIPS standards, fair representation and full disclosure, and must not present performance or performance-related information that is false or misleading. Any carve-out included in a composite must be representative of an actual segregated portfolio managed to that strategy. The carved-out segment must be discretionary and structured materially the same as a portfolio dedicated to that strategy and have a risk profile that is substantially similar. For example, the equity segment of a balanced portfolio may be structured differently from a separately managed equity portfolio because additional risks taken in the equity segment may be offset by lower risk taken in the fixed income segment. The firm must determine if the carved-out segment is representative of a separately managed portfolio dedicated to the same strategy.

Firms must establish a policy for the creation, use, and calculation of carve-outs and apply the policy consistently. For periods ending prior to 1 January 2010, the calculation methodology used to calculate and allocate the return achieved on cash must be determined by the firm, documented, and applied consistently.

The GIPS standards state, “For periods beginning on or after 1 January 2010, a carve-out must not be included in a composite unless the carve-out is managed separately with its own cash balance.” Accordingly, it is necessary to clarify what is permissible for periods ending prior to 1 January 2010 and for periods beginning on or after 1 January 2010.

The following guiding principles must be met when using carve-outs.

For Periods Ending Prior to 1 January 2010

- The carve-out should be managed separately (i.e., the segment should be managed as if it were a separate portfolio rather than a segment of a larger portfolio).
- The carve-out must be representative of a stand-alone portfolio managed to the same strategy.
- If a firm creates a carve-out of a particular strategy, then all similar portfolio segments managed to that strategy must also be carved out and included in the composite (e.g., if the equity segment of a balanced portfolio is carved out and included in an equity composite, then all similar equity segments of the firm’s portfolios must be carved out and included in the equity composite, provided the conditions outlined in this Guidance Statement are met).
- If a firm chooses to carve out a portion of a portfolio, the firm is not compelled to carve out other parts of the portfolio.
- When presenting net-of-fees performance of composites containing carve-outs, investment management fees must be deducted from the gross-of-fees carved-out returns. The investment management fees must be representative of the fees charged for a separately managed portfolio for the asset class carved-out considering the fee schedule for the composite containing the carve-outs.
- The carve-out should have its cash accounted for separately. If the segment does not have its own cash, cash must be allocated to the segment on a consistent basis. Acceptable allocation methods include:

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- *Beginning-of-Period Allocation.* Identify the cash allocation percentage for each portfolio segment at the beginning of the period. For example, at the beginning of January, identify the percentage of residual cash that will be allocated to the carve-outs at month-end.
- *Strategic Asset Allocation.* Base the allocation directly upon the target strategic asset allocation. For example, if the portfolio is targeted to have 40% in equities and 60% in bonds, then the allocation will relate to the actual amounts invested. If the portfolio had a target allocation of 40%, but at the beginning of the period only held 35% in equities, then the cash return would constitute the difference (5%). Firms must determine which method to use, document it, and it apply consistently.

For Periods Beginning on or after 1 January 2010

- The carve-out must be managed separately (i.e., the segment must be managed as if it were a separate portfolio rather than a segment of a larger portfolio).
- The carve-out must be representative of a stand-alone portfolio managed to the same strategy.
- The carve-out must have its own cash. Cash allocation is not permitted. Possible methods for properly accounting for the cash positions include:
 - Separate portfolios: Cash and securities are actually segregated into a separate portfolio at the custodian.
 - Multiple cash accounts: Each segment's cash is accounted for separately (e.g., equity cash account, fixed income cash account).
 - Sub-portfolios: Each segment of a portfolio is accounted for as if it were a separate portfolio.
- Firms must determine which of the segments of multiple-strategy portfolios are managed separately with their own cash balances to determine the universe of possible carve-outs. If a firm creates a carve-out of a particular strategy and wishes to include the carve-out in a composite, then all similar portfolio segments managed to that strategy and managed separately with their own cash balances must also be included in the composite, provided the conditions above are met.
- Segments not managed separately with their own cash balances are not eligible for inclusion in composites because they do not meet the definition of a carve-out as of 1 January 2010.
- If a firm chooses to carve out a portion of a portfolio, the firm is not compelled to carve out other parts of the portfolio.
- When presenting net-of-fees performance of composites containing carve-outs, investment management fees must be deducted from the carved-out gross-of-fees returns. The investment management fees must be representative of the fees charged for a separately managed portfolio for the asset class carved out considering the fee schedule for the composite containing the carve-outs.

Performance Record for Discontinued Carve-Outs

When a firm that has created carve-outs using cash allocation methods for periods prior to 1 January 2010, does not choose to apply any method for accounting for the cash position to the carve-outs and thus discontinues the carve-outs for periods after 1 January 2010, then the firm must meet all of the following conditions:

- the past performance record of the carve-outs using cash allocation methods must be left unchanged within the same composites in which the carve-outs were included;
- for periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite includes carve-outs, the firm must present the percentage of composite assets represented by carve-outs as of each annual period end; and
- if the firm has a composite consisting of only carve-outs using cash allocation methods and does not apply any method for accounting for the cash position to any of the carve-outs in the composite for periods beginning on or after 1 January 2010, the composite is terminated but must continue to be listed on the firm's list of composite descriptions for five years after termination.

Acceptable Uses

Effective 1 January 2010, carve-outs must be managed separately with their own cash balances (i.e., allocation of cash is no longer allowed for periods beginning on or after 1 January 2010). This change is not retroactive, so the history of existing carve-outs must not change. Carve-out track records that are representative of the composite strategy may be used like any other portfolio provided that the carve-out is managed separately with its own cash.

Firms are not permitted to combine different carve-outs or composites to create a new, simulated strategy composite for purposes of compliance with the GIPS standards. For example, a firm may not combine an equity carve-out and a fixed income carve-out to create a simulated balanced composite. Although composed of actual returns, this type of composite is hypothetical because it does not reflect real asset allocation decisions and, therefore, is viewed as model or simulated results under the GIPS standards. This information can be presented as supplemental information, provided the firm has the supporting records, but must not be linked to actual returns.

Disclosures

The GIPS standards require that for periods prior to 1 January 2010, if carve-outs are included in a composite, firms must disclose the policy used to allocate cash to carve-outs. It is recommended that firms disclose any change in the cash allocation methods.

In addition, it is required that for periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite includes carve-outs, the firm must present the percentage of composite assets represented by carve-outs as of each annual period-end.

Effective Date

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

4-13 GUIDANCE STATEMENT ON TREATMENT OF SIGNIFICANT CASH FLOWS

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

Dealing with large external cash flows in a portfolio is a common struggle for most firms. These flows of cash or investments can make a significant impact on the implementation of an investment mandate, objective, or strategy and, thus, on a portfolio's and composite's performance. Accordingly, this Guidance Statement clarifies the issues related to the treatment of significant cash flows under the Global Investment Performance Standards.

Background

The GIPS standards require that composites include new portfolios on a timely and consistent basis after each portfolio comes under management. The GIPS standards also state that terminated portfolios must be included in the historical performance of the appropriate composites through the last full measurement period that each portfolio was under management.

The GIPS standards were developed with the understanding that new portfolios may require a period of time (a "grace period") for a firm to fully implement the intended investment mandate, objective, or strategy. During the grace period, the portfolio is not required to be included in a composite. The necessary length of this grace period may vary from composite to composite, depending on a number of factors that impact the implementation of an investment mandate, objective, or strategy. It is also reasonable that when external cash flows to a portfolio are significantly large, the same process applies that governs the introduction of a new portfolio into a composite.

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External Cash Flow Definition

For the purposes of the GIPS standards, an external cash flow is defined as capital (cash or investments) that enters or exits a portfolio. A significant cash flow is defined as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. Transfers of assets between asset classes within a portfolio or manager-initiated flows must not be used to move portfolios out of composites on a temporary basis.

The cash flow may be defined by the firm as a single flow or an aggregate of a number of flows within a stated period of time. In cases of multiple cash flows over an extended period of time, firms should refer to the discussion of discretion in the Guidance Statement on Composite Definition and consider whether the portfolio should be classified as non-discretionary.

For a discussion of the distinction between external cash flows, large cash flows, and significant cash flows, please see the Guidance Statement on Calculation Methodology.

Significant Cash Flows

Firms that wish to remove portfolios from composites in cases of significant cash flows must define “significant” on an ex-ante composite-specific basis and must consistently follow the composite-specific policy. The definition may be influenced by the characteristics of the asset class(es) within the strategy, such as market liquidity, and/or by the trading capabilities of the investment manager. (For instance, a significant cash flow may be considered 10% of a portfolio’s value for an emerging market fixed income composite but may be in excess of 50% of a portfolio’s value for a more liquid composite, such as European equities.) In theory, the determination of significance should primarily be based on the liquidity of the asset class and the investment strategy employed. Because of the dynamic nature of global markets and the inherent subjectivity involved, it is impractical to establish absolute levels of significance for each asset class. Theoretically, external cash flows that are relatively small on a composite level but relatively large on a portfolio level, can potentially distort the portfolio’s performance and skew the measure of internal dispersion. The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of portfolio assets (based on the most recent valuation).

Grace Periods for the Treatment of Significant Cash Flows

Each composite must have a portfolio inclusion policy for new portfolios and an exclusion policy for terminated portfolios. It is the responsibility of the firm to set reasonable guidelines for each composite regarding the inclusion and exclusion of portfolios in the composite. Composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. Firms are encouraged to establish a policy that includes new portfolios in composites as soon as possible, preferably at the start of the first full performance measurement period. Firms must establish a policy that includes terminated portfolios in the historical performance of the composite through the last full measurement period that each portfolio was under management. Similarly, these policies should be replicated for the purpose of addressing significant cash flows in composites.

Grace period policies, as well as definitions and policies concerning significant cash flows, must be established and documented for each composite by the firm *before* they are implemented (i.e., before a significant cash flow occurs and preferably at the time each composite is created), and firms must not retroactively apply these policies to restate performance. Once implemented, the firm must consistently apply these policies (i.e., if a cash flow in a portfolio occurs that meets the definition of significant for that composite, the portfolio must be removed according to the guidelines). Firms must not reconsider whether a portfolio should be removed from a composite on an ex-post basis (after the fact) when it can be determined whether the cash flow has helped or hurt performance. It should be noted that the removal of a portfolio from a composite due to a significant cash flow will not affect the specific portfolio’s performance history. The definitions and policies for significant cash flows and grace periods for new portfolios or portfolios with significant cash flows can be amended, but the changes must not be applied retroactively. It is expected that the removal of portfolios due to significant cash flows will be an infrequent occurrence, particularly in composites that are invested in the larger, most liquid asset classes.

Firms are recommended to periodically review their policies regarding significant cash flows, especially if firms find that they are frequently removing portfolios due to significant cash flows. Firms are encouraged to establish significant cash flow policies and definitions for all of their composites but are not required to do so.

Temporary Removal of Entire Portfolios with Significant Cash Flows

If a firm has adopted a significant cash flow policy for a specific composite, the firm must disclose how it defines a “significant cash flow” for that composite and for which periods.

Firms are required to disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. With respect to significant cash flows, this information is expected to include:

- the grace period for the composite,
- if the definitions, policies, or grace periods for handling significant cash flows have been redefined, the date and description of the change,
- the number of portfolios removed during a given period,
- the number of times portfolios were removed during a given period, and
- the amount of composite assets represented by the portfolios affected by the application of these policies.

It is important to note that if all of a composite’s portfolios were removed during one or more periods due to significant cash flows, there would be a break in the composite performance record. If a composite loses all of its member portfolios (whether that is due to significant cash flows, portfolio termination, or some other reason), the performance record stops. If portfolios are later added to that composite, the periods must not be mathematically linked. The periods both before and after the break in track record must be presented, with the break in performance clearly shown.

It is also important to note that removing a portfolio due to a significant cash flow removes the portfolio when transaction costs are expected to be higher. The intent of this Guidance Statement is not to allow firms to “hide” transaction costs but, rather, to remove the potentially more disruptive effects that occur as a result of a significant cash flow.

Documentation

Firms that have adopted a significant cash flow policy must document each time a portfolio moves into or out of a composite due to a significant cash flow. Documentation must be part of the firm’s recordkeeping process and, at a minimum, must include:

- the date of the significant cash flow, the date the firm removes the portfolio from the composite, and the date the firm returns the portfolio to the composite,

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- depending upon the firm's definition of significant cash flow, the amount of the significant cash flow or the amount of the significant cash flow as a percentage of the most recent portfolio value, and
- if the significant cash flow is moving into or out of the portfolio.

Documentation will allow third parties to easily determine whether firms have followed their grace period policy and definition of significant cash flow.

Firms must document their definitions and policies regarding significant cash flows, including the definition of the grace period and measure of significance. Firms must also document any changes that are made to the definitions or policies.

Temporary New Accounts

The use of temporary new accounts is the most direct method for dealing with significant cash flows. A temporary new account is defined as an account for temporarily holding client-directed external cash flows until they are invested according to the composite strategy or disbursed. Firms can use a temporary new account to remove the effect of a significant cash flow on a portfolio. When a significant cash flow occurs in a portfolio, the firm may direct the external cash flow to a temporary new account according to the composite's significant cash flow policy. For example, if a significant cash flow is withdrawn from a portfolio at the end of the month, the firm would move the necessary cash and/or investments into a temporary new account for liquidation and/or distribution to the client.

Temporary new accounts must not be included in any composite. The portfolio that experiences a significant cash flow (the "main portfolio") would reflect the withdrawal of cash and/or investments as an external cash flow out of the main portfolio. Performance of the main portfolio would be calculated to include this cash outflow at the date of transfer to the temporary new account. The temporary new account would receive the cash and/or investments as an external cash flow from the main portfolio on that date. The investments would remain in the temporary new account until the funds are distributed. The same principles would hold true with a significant cash flow into the main portfolio. In this case, the cash and/or investments received would remain in the temporary new account until all cash and/or investments are invested in line with the main portfolio's investment mandate, objective, or strategy and then would be transferred into the main portfolio on that date and treated as an external cash flow.

Firms that are currently able to use a temporary new account methodology are encouraged to continue to do so. The GIPS standards recommend the use of temporary new accounts to remove the effects of significant cash flows. The removal of portfolios due to significant cash flows may no longer be permitted at some point in the future. The firm's policy for the use of temporary new accounts must be defined and consistently applied in the same manner as the policy for the temporary exclusion of a portfolio from a composite.

Effective Date

The effective date for this Guidance Statement is 1 January 2011. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

4-14 GUIDANCE STATEMENT ON THE USE OF SUPPLEMENTAL INFORMATION

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

In preparing performance reports, firms must keep in mind the spirit and objectives of the Global Investment Performance Standards: fair representation and full disclosure. Meeting the intent of the GIPS standards may necessitate including information in compliant presentations beyond the required and recommended provisions of the GIPS standards to adequately cover the firm's specific situations. Firms that claim compliance with the GIPS standards are encouraged to present all relevant information, beyond that required and recommended in the GIPS standards, to fully explain their performance.

What Is Supplemental Information?

Supplemental information is defined as any performance-related information included as part of a compliant presentation that supplements or enhances the required and/or recommended provisions of the GIPS standards. Supplemental information should provide users of the compliant presentation with the proper context in which to better understand the performance results. Because supplemental information has the potential to be misleading in relation to the firm's claim of compliance, this Guidance Statement defines and addresses the proper use of supplemental information.

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What Is *Not* Supplemental Information?

- Additional information that is required or recommended under the GIPS standards is not considered "supplemental information." Additional information is not required to be labeled/identified as supplemental or separate from the required compliant information.
- Non-performance-related information is also omitted from this Guidance Statement and is not required to be labeled/identified as supplemental or separate from the required compliant information. Non-performance-related information includes, but is not limited to, general information regarding the firm, ownership structures, staff biographies, or details about the investment process.

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- False or misleading information: Firms that claim compliance with the GIPS standards must not present performance or performance-related information that is false or misleading. For example, the following two items are misleading and unrepresentative; therefore, compliant firms are prohibited from presenting this information (unless specifically requested from the firm by a prospective client or existing client in a one-on-one presentation):
 1. Model, hypothetical, back-tested, or simulated results *linked* to actual performance results.
 2. Non-portable performance from a prior firm *linked* to current ongoing performance results.

This is not an exhaustive list and is only provided to show examples of potentially misleading information.

Guiding Principles

If a firm chooses to show supplemental information, it is important to consider the following guiding principles:

- Supplemental information must satisfy the spirit and principles of the GIPS standards: fair representation and full disclosure.
- Supplemental information must comply with all applicable laws and regulations regarding the calculation and presentation of performance.
- Supplemental information must not include performance or performance-related information that is false or misleading.
- Supplemental information must *not* contradict or conflict with the information provided in the compliant presentation.
- Supplemental information must be clearly labeled and identified as supplemental information to a particular compliant presentation.

This Guidance Statement does *not* prohibit firms from preparing and presenting information according to specific requests from prospective clients. However, firms are required to provide a compliant presentation prior to or accompanying any supplemental information.

Examples of Supplemental Information

Supplemental information must relate directly to the compliant presentation. Examples of supplemental information include, but are not limited to:

- carve-out returns that exclude cash,
- non-portable returns (not linked),
- model, hypothetical, backtested, or simulated returns (not linked),
- representative portfolio information, such as:
 1. portfolio-level country weightings,

2. portfolio-level sector weightings,
 3. portfolio-level risk measures,
- attribution
 - composite or portfolio-level specific holdings,
 - peer group comparisons,
 - *Ex ante* risk and *ex ante* risk-adjusted return measures.

Location of Supplemental Information

Supplemental information must be clearly labeled and identified as supplemental to a particular compliant presentation. The presentation and location of supplemental information in relation to the required or recommended information depends on the type of supplemental information and its potential to mislead prospective clients.

There are certain situations that allow for the presentation of both compliant and supplemental information on the same page; however, firms should consider that there are also many situations that call for the separation of compliant and supplemental information. When in doubt, firms are encouraged to place the compliant and supplemental information on separate pages.

Firms must provide a compliant presentation prior to or accompanying any supplemental information. Firms must clearly label and identify all supplemental information as supplemental to a specific compliant presentation. For example:

- place supplemental information on the same or back of the page as the compliant data, if appropriate, or
- include a statement indicating that the supplemental information supplements the XYZ Composite presentation (as provided on pg. 11 *or* provided on 15 March 20XX).

This Guidance Statement does *not* restrict firms from providing any specific information requested by prospective clients or their agents.

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Supplemental Information—Verification

Supplemental information is not subject to verification under the GIPS standards. It is the ultimate responsibility of the firm claiming compliance to ensure that it abides by the ethical principles and spirit of the GIPS standards each time it presents performance results.

Effective Date

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

4-15 GUIDANCE STATEMENT ON VERIFICATION

Adoption Date: 29 December 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required Public Comment Period: 27 August 2010–25 November 2010

Introduction

This Guidance Statement supplements the verification procedures outlined in Chapter IV of the Global Investment Performance Standards and provides additional guidance to verifiers and investment management firms. Verification is a process by which a verifier assesses whether the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The GIPS standards recommend that firms be verified.

Verifier Qualification Requirements

The verification must be performed by a “verifier” with appropriate professional abilities and experience and a practical level of expertise regarding investment management practices, including performance calculation procedures and business processes. Verifiers must be knowledgeable about the GIPS standards and must understand all the requirements and recommendations of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*. Verifiers must also be knowledgeable about applicable laws and regulations regarding the calculation and presentation of performance.

The verification must be performed by a verifier who is independent of the investment management firm. Verifiers must maintain fairness and independence at all times when performing procedures to evaluate a firm’s claim of compliance as well as in expressing their opinion in the verification report. Please see the Guidance Statement on Verifier Independence for additional guidance.

Verifiers generally comprise auditing, consulting, and other firms that have a high degree of knowledge regarding the investment management industry. Verifiers must follow currently accepted standards of practice within their industry (if applicable) when performing a verification pursuant to the GIPS standards.

The GIPS standards do not include additional qualification requirements to conduct a verification.

Knowledge of Firm Policies

Verifiers must understand the firm's policies and procedures for establishing and maintaining compliance with all applicable requirements and adopted recommendations of the GIPS standards. The verifier must obtain a copy of the firm's policies and procedures used in establishing and maintaining compliance with the GIPS standards and ensure that all applicable policies and procedures are properly included and adequately documented. The verifier must also ensure that the policies and procedures are clear, unambiguous, and consistent with the GIPS standards and meet any applicable requirements of the GIPS standards. For example, verifiers must understand the firm's policies and procedures with regard to, but not limited to, the following items:

- investment discretion. The verifier must obtain a copy of the firm's definition of investment discretion and the firm's guidelines for determining whether portfolios are discretionary;
- definition of composite according to investment strategy. The verifier must obtain the firm's list of composite definitions with criteria for assignment of portfolios in each composite;
- timing of inclusion of new portfolios in the composites;
- timing of exclusion of closed portfolios in the composites;
- accrual of interest and dividend income;
- treatment of fees;
- valuation of portfolio investments, including policies for determination of fair value;
- computing the rates of return for each portfolio;
- handling of cash flows (assumptions on the timing of capital inflows/outflows and handling of large and, where applicable, significant cash flows);
- computing composite returns;
- error correction;
- presentation of composite returns;
- use of leverage, derivatives and short positions;
- maintenance of books and records supporting the calculation of portfolio and composite returns, including the existence and ownership of client assets;
- selection, construction, and calculation of composite benchmarks; and
- any other policies and procedures relevant to performance presentation.

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Sampling

Verifiers may use a sampling methodology when performing verification procedures. The size of the sample will vary based on the verifier's judgment. Not only must the verifier determine the appropriate sample size, but the verifier must also determine if the sample selected is reasonable considering the firm's specific circumstances. Please see Chapter IV of the GIPS standards for further requirements on sample selection.

Using the Work of Other Verifiers and Independent Third Parties

The GIPS standards state that a principal verifier may accept the work of another verifier as part of the basis for the principal verifier's opinion. For example, when a firm engaged in global asset management services undertakes verification on a worldwide basis, including local offices/branches, the principal verifier may use the results of work performed for a local office/branch by another verifier. Similarly, when another verifier has already performed a verification, the current verifier may choose to accept the work of the previous verifier. A principal verifier may also choose to rely on the audit and/or internal control work of a qualified and reputable independent third party with appropriate professional abilities and experience and a practical level of expertise regarding investment management practices, including performance calculation procedures and business processes. This third party must be knowledgeable about the GIPS standards and must understand all the applicable requirements and recommendations of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website (www.gipsstandards.org) as well as in the *GIPS Handbook*. This third party must also be knowledgeable about applicable laws and regulations regarding the calculation and presentation of performance. In addition, a principal verifier may choose to rely on the other audit and/or internal control work performed by the verifier.

Representation Letter

Prior to expressing an opinion, the verifier must obtain from the management of the firm a representation letter including confirmation that policies and procedures used in establishing and maintaining compliance with the GIPS standards are as described in the firm's policies and procedures documents and have been consistently applied throughout the period(s) being verified. The representation letter must also include confirmation that the firm complies with the GIPS standards for the period(s) being verified and any other relevant representations made to the verifier during verification. Typically, the representation letter will include the following representations:

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- the firm's policies and procedures for establishing and maintaining compliance with the GIPS standards are properly described in the firm's GIPS policies and procedures documents;
- the firm's policies and procedures for establishing and maintaining compliance with the GIPS standards have been consistently applied throughout the period being verified;
- the firm is in compliance with the GIPS standards on a firm-wide basis;
- the firm's management bears all responsibility for maintaining compliance with the GIPS standards, including production and distribution of all compliant presentations;
- the compliant presentations are a fair and honest representation of the firm's investment performance;
- the firm has not knowingly presented performance or performance-related information that is false or misleading;
- the firm has provided the verifier with all necessary documents to be able to perform the verification and no relevant documents have been withheld;

- the time period the verifiers are reporting on;
- the firm complies with all applicable laws and regulations regarding the calculation and presentation of performance; and
- no events that would materially influence performance results or the outcome of the verification have occurred up to the date of the representation letter.

GIPS Verification Report

The verification report must opine that:

1. the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and
2. the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The following information is also required to be included in the verification report:

- the report title;
- the report date;
- the report addressee;
- the defined firm for which the verification has been performed;
- the period(s) for which the verification has been performed;
- the respective responsibilities of the firm's management and of the verifier, including a statement acknowledging the responsibility of the firm for the claim of compliance;
- a statement to the effect that verification has been performed in accordance with the required verification procedures of the GIPS standards;
- a statement indicating that verification does not ensure the accuracy of any specific composite presentation;
- a statement describing any other professional guidance that has been applied (e.g., AICPA, IAASB, ICAEW, JICPA guidance); and
- the signature or official seal of the verifier.

In addition to the required content, the verifier's opinion may also include additional information, as appropriate, to make the context of the particular verification work clear.

Without such a report from the verifier, the firm must not state that it has been verified.

If the verifier concludes that the firm is not in compliance with the GIPS standards or that the records of the firm cannot support a verification, the verifier must issue a statement to the firm clarifying why a verification report could not be issued.

Recommendation Letter

After the verification is complete, it is recommended that verifiers issue a recommendation letter to the firm describing specific findings, recommendations, or other areas of improvement arising from the verification.

Performance Examinations of Compliant Presentations

A verification does not have the objective of examining specific performance results presented. To accomplish that objective, a firm may also choose to have a specifically focused performance examination of a particular composite's compliant presentation. A performance examination is not required for a firm to be verified.

Please see the Guidance Statement on Performance Examinations for specific guidance.

Effective Date

This Guidance Statement was originally effective 13 March 2002 and was initially revised to reflect the changes to the GIPS standards effective as of 1 January 2006. Subsequent revisions made to this guidance were made to coincide with the effective date of the 2010 edition of the GIPS standards, which is 1 January 2011. Verifiers must conduct their verification engagements in accordance with this Guidance Statement for all verifications contracted on or after 1 January 2011 or prior to 1 January 2011 if the investment management firm has adopted the 2010 edition of the GIPS standards. The contract date is typically evidenced by the date of the engagement letter signed by management of both the verifier and the investment management firm. Verifiers may also voluntarily conduct their verification engagements in accordance with this Guidance Statement prior to 1 January 2011 and are encouraged to do so. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

4-16 GUIDANCE STATEMENT ON VERIFIER INDEPENDENCE

Adoption Date: 31 October 2005
Effective Date: 1 January 2006
Retroactive Application: Not Required
Public Comment Period: October 2004–February 2005

Introduction

The GIPS standards define verification as the review of an investment management firm's performance measurement processes and procedures by an independent third-party "verifier," where the phrase "independent third-party" generally means that neither the verification firm (or verifier) nor the investment management firm (also known as a verification client) has a direct conflict of interest. A direct conflict of interest exists when an independence issue between the investment management firm and the verification firm cannot be managed effectively; i.e., the conflict is not "cured." The purpose of this Guidance Statement is to guide investment management firms and their (potential) verification firms in the process of determining if independence issues exist between them.

A verification firm is selected and appointed by the investment management firm; the investment management firm must retain the ultimate responsibility for the decisions made. The GIPS standards do not contain specific qualification requirements for a verifier, other than the verifier must be an independent third party. The self-regulatory nature of the GIPS standards necessitates a strong commitment to ethical integrity on the part of the investment management firm as well as the verification firm. Verification provides substantial benefit not only to the investment management firm whose policies and processes are verified but also to the prospective investor relying on the performance information presented by the investment management firm.

This Guidance Statement serves as minimum guidance. It is not intended to replace or supersede any applicable independence guidance for a verification firm that is subject to its existing professional independence guidance. If any conflicts exist between this guidance and the verification firm's professional independence guidance, verification firms must follow their professional independence guidance and disclose the conflict to the investment management firm (verification client).

Defining Independent

Defining the term "independent" is not a simple process. Crucial to the verification process is the assumption by all interested parties that the verifier [for purposes of this document, used interchangeably with verification firm or verification unit (of a larger/parent firm)], performs its service in an unbiased manner and is not verifying its own work.

When considering a verification engagement, the investment management firm and the verification firm must determine any known independence issues existing between the two organizations. Both the investment management firm and the verification firm should create their own policies and procedures that address independence. As part of its evaluation process, each firm should consider policies and procedures used by the other organization to address independence. For

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example, if an investment management firm is contemplating hiring a verification firm which offers additional products and services that the investment management firm could or does utilize, the investment management firm must understand how the verification unit achieves independence within the parent organization as well as with the investment management firm. A verifier must disclose to the investment management firm the services known to the verifier that other units of the verification firm may be providing to the investment management firm. During the process of determining if any independence issues exist, both the investment management firm and the verification firm should be cognizant of actual (existing in fact) as well as perceived (potentially viewed as) independence issues. Each organization's self-examination of independence should always keep in mind the following question: If a prospective client of the investment management firm places reliance on the verification firm's report, could the prospective client's perception of the value of the verification report potentially be changed if the prospective client knew about other existing relationships between the investment management firm and the verification firm?

For verifiers that provide services in addition to verification services, it may prove difficult for the verification unit to identify other services (especially highly sensitive or confidential services) provided to the investment management firm by other units of the verification firm without input/notification from the investment management firm. However, the investment management firm itself may be aware of services being provided by other units of the verification firm to the investment management firm. The investment management firm must then be responsible for deciding whether a service provided by the verification firm—but unknown to its verification unit—results in an independence issue.

Potential independence issues must be disclosed by the verification firm and the investment management firm to each other. Additionally, because disclosure alone does not “cure” the independence issue, the firms must then determine if the identified independence issues can be managed such that independence is achieved. It may be helpful for both the verification firm and the investment management firm to consider independence as a continuum. At one extreme of the continuum is a verification firm with no relationships with the investment management firm. At the other extreme is a verification firm with existing relationships with the investment management firm such that if the investment management firm's verification were performed by the verification firm, the independence issue could not be appropriately managed and independence not achieved. The investment management firm and the verification firm must determine where their relationship is on this continuum and if it is appropriate to proceed with the verification engagement.

The firms should document their conclusions. If the appointment of the verification firm by the investment management firm continues beyond the initial verification, the firms should reassess independence prior to each verification engagement.

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Guiding Principles

- The verification firm and its employees must be independent from its verification clients.
- The verification firm must consider any independence guidance for their profession, if applicable.
- To the best of their ability, the verification firm and the verification client (investment management firm) must consider their entire relationship when analyzing potential independence issues.

- The verification firm has an obligation to discuss with the verification client their analysis of potential independence issues and how they will be managed.
- The verification firm and the verification client must reach a conclusion regarding the verification firm's independence.
- Determining independence is the responsibility of both the verification client and the verification firm; however, the verification client (investment management firm) must retain the ultimate responsibility for the decisions made.
- Verifiers must not
 - step into a management role,
 - undertake any management function or a decision-making role relative to the implementation of and compliance with the GIPS standards, or
 - be in a position to verify their own work.

Assessment of Verifier Independence

In addition to verification services, verification firms may provide additional services and products to their verification clients. The verification firm must be cognizant of its role as advisor on issues relating to compliance with the GIPS standards, which may include being a performance measurer to the verification client prior to the verification. Potential independence issues should be mitigated; existing independence issues must be “cured.” Because each situation is unique, the following are suggested considerations. While not definitive, these considerations are provided to assist verification firms to more precisely define the types of services and products that may result in a potential independence issue.

1. What services/products that a verification firm might provide to a verification client should be considered when determining their status with regard to independence?

A verification firm can provide consulting to a verification client, including both GIPS- and non-GIPS-related services. However, when the verification unit of the verification firm provides GIPS-related services, members of the verification unit must *not* step into a management role or undertake any management function. Furthermore, the verification unit must not perform (or have performed in the past) any services which would result in their reporting on their own work product and decisions or calling their own work into question during the verification. While certain tasks may be outsourced to external service providers, responsibility for the fair representation and full disclosure of a performance presentation that adheres to the GIPS standards remains with the investment management firm.

Examples of services that if performed by the verifier may not create an independence issue include:

- participating as an advisor to the compliance project management team;
- participating in the identification of issues that hinder an investment management firm's compliance;
- educating investment management firm personnel about the GIPS standards and the compliance process;

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- providing advice on compliance issues as they arise as long as the advice does not include making decisions on these issues for the investment management firm;
- providing generic samples of client presentations;
- providing compliance checklists;
- providing formulas and calculation examples;
- providing training on performance-related topics; and
- reviewing results of performance-system conversion testing.

Examples of services that if performed by the verifier create or may create an independence issue include:

- functioning as a member of the investment management firm's compliance project management team, with responsibility for performing management tasks (e.g., compositing portfolios, defining policies, etc.);
 - acting as the project manager for the investment management firm's compliance project management team, with management decision authority;
 - making decisions about compliance issues for the investment management firm; (The verifier should only offer suggestions and present options which the investment management firm may consider when making their decisions;
 - creating source data for the calculation of performance returns;
 - providing templates for performance calculation if the verification client does not assume full responsibility for the calculation methodology;
 - assigning accounts to composites;
 - collating or creating the underlying data required to calculate account-level returns;
 - calculating account-level returns;
 - calculating composite-level returns;
 - preparing compliant presentations;
 - establishing policies and procedures; and
 - functioning as a data warehouse for the performance data on behalf of the investment management firm. The verifier can maintain data duplicated for its own purposes, but these data must not serve as the investment management firm's primary data source.
2. **Are there other issues a verifier should consider when determining their status with regard to independence?**

Other issues that are not directly related to verification services or GIPS compliance may impact a verifier's independence. For example, activities where the verification firm serves as an advocate for the verification client may impair independence. A verifier should consider their personal and financial relationships with their clients and consider whether they are, in fact, independent or could be influenced by such relationships. Mere disclosure of a personal or financial relationship does not "cure" the independence issue.

Effective Date

Verification and investment management firms must follow the principles discussed herein for all verification engagements commencing after 1 January 2006.

Q&A

1. *How much time and effort must the verification firm expend in order to identify all other services provided to a verification client?*

Both the verifier and the verification client need to expend such time as is reasonable for them to, independently and jointly, satisfy themselves that none of the known relationships between the two organizations will impair the independence of the verifier. This is a continuing joint obligation and does not just apply on the first appointment of the verifier.

From a practical point of view, the inclusion of the word "known" is an essential qualifier, as both the verifier and verification client may have a business relationship which is confidential to all but a selected few. For example, a verification firm may serve in an advisory role in a corporate acquisition/sale, which would not be disclosed under any circumstances to the employees involved with the verification appointment of either the investment firm or the verification firm.

2. *As defined in the Guidance Statement on Verifier Independence, what are "management functions"?*

In the context of this Guidance Statement, "management functions" are tasks and responsibilities that are directly related to the GIPS-compliance process. Management functions include, but are not limited to:

- identifying all portfolios of the firm;
- assigning accounts to composites;
- determining firm definition;
- determining discretion definition and/or status;
- creating composite criteria;
- establishing policies and procedures;
- calculating account- and composite-level returns; and
- preparing compliant composite presentations.

3. *Is there a formal process for reporting conflicts of interest?*

No, there is no formal process for reporting conflicts of interest. If a verifier determines that a conflict of interest prevents them from accepting a verification engagement or continuing to provide verification services to a client, the verification firm should inform the client immediately of such conflict. The verifier and the client should also discuss if a newly discovered conflict extends to historical periods, which may require that any previously issued verification reports be recalled (i.e., the investment firm must cease making any claims of verification for the period the conflict existed). If, in the future, the investment management firm is verified for that period by an independent third party, the investment management firm may again claim that it was verified for that period.

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4. *If the verification firm provides a spreadsheet template to a verification client to help in the calculation of asset-weighted standard deviations for inclusion in a composite presentation, does that create an independence issue?*

Merely providing a spreadsheet template to a verification client that includes calculation examples does not automatically create an independence issue, as long as the client assumes full responsibility for the calculation methodology.

5. *May a verification firm participate in the process of selecting a new performance measurement system for a verification client?*

Yes, as long as the verification firm's assistance is limited to making recommendations and suggestions, with the final decision being made solely by the verification client. The verification firm must not receive any monetary or non-monetary compensation from the systems providers for its review or recommendation.

6. *May a verification firm participate in the process of implementing a new performance measurement system for a verification client?*

Yes, a verification firm may participate in the process of implementing a new performance measurement system for a verification client, but the verification firm must be careful to not undertake management functions. The verifier must *not* have final responsibility for data conversion and reconciliation functions.

7. *In addition to performing a firm-wide verification, our verifier also performs a Performance Examination on one composite. The Performance Examination report will include a compliant presentation for the one examined composite. Can the verifier produce the compliant presentation for this composite?*

The verifier may not assume the responsibility for creating or producing a composite presentation for the investment management firm. The investment management firm must first provide a compliant presentation to the verifier. Once the Performance Examination is completed (based on the composite presentation provided by the investment management firm), the verifier may reformat/redesign the data from the compliant presentation in a separate document to be provided to the investment firm as part of its Performance Examination Report. Simply performing word processing and duplication functions does not impact the verifier's independence.

8. *Our investment management firm has used the same verification firm for the last five years. We recently discovered that an employee of the verification firm is related to a portfolio manager our firm hired this year. Will our firm be able to continue to use the verification firm for our annual verification next year?*

Both firms must take measures to ensure that the verification firm's employee maintains independence if that employee is used for the investment management firm's verification. If the employee is not a member of the verification unit, there may not be an issue. However, if the employee is in charge of the verification project for the investment management firm and, for example, is the spouse of the recently hired investment manager, the independence issues must be evaluated.

4-17 GUIDANCE STATEMENT ON WRAP FEE/ SEPARATELY MANAGED ACCOUNT (SMA) PORTFOLIOS

Adoption Date: 28 September 2010 Effective Date: 1 January 2011 Retroactive Application: Not Required

Introduction

The purpose of the GIPS® standards is to create performance presentations that allow for greater comparability of returns and increase the transparency of information provided to prospective clients. While it is impossible to develop standards that cover 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.

In order to provide prospective clients with a variety of investment options, firms offer different types of investment products/services as well as fee structures. One of these structures offers clients the ability to “bundle” multiple fees incurred during the management of a portfolio (i.e., bundled fees). Bundled fees can include any combination of management, trading, custody, and other administrative fees. Two specific examples of bundled fees are wrap fees¹ and all-in fees.² Wrap fee/SMA portfolios are unique and significantly different from traditional brokerage or investment management relationships, and as a result, additional guidance on how to apply the GIPS standards is necessary for firms managing wrap fee/SMA portfolios.

Scope

This Guidance Statement clarifies and interprets the broader GIPS provisions, specifically addressed from the perspective of the wrap fee/SMA investment management firm, and is applicable to those GIPS-compliant firms that have discretionary portfolio management responsibility for wrap fee/SMA portfolios. The wrap fee/SMA provisions and related guidance apply to the calculation and presentation of performance when presenting a compliant presentation to a wrap fee/SMA prospective client (which includes prospective wrap fee/SMA sponsors or prospective wrap fee/SMA clients and existing wrap fee/SMA sponsors). Unless otherwise noted, the wrap fee/SMA provisions and related guidance supplement all the provisions and guidance of the GIPS standards.

Although there are different types of wrap fee/SMA structures, these provisions apply to all wrap fee/SMA portfolios where there are bundled fees and the wrap fee/SMA sponsor serves as an intermediary between the firm and the end user of the investment services. The wrap fee/SMA

1 A wrap fee is defined as a type of bundled fee and is specific to a particular type of investment product. The wrap fee is charged by a wrap fee sponsor for investment management services and typically includes associated trading expenses that cannot be separately identified. Wrap fees can be all-inclusive, asset-based fees and may include a combination of investment management fees, trading expenses, custody fees, and/or administrative fees. A wrap fee portfolio is sometimes referred to as a “separately managed account” or “managed account.”

2 An all-in fee is defined as a type of bundled fee that can include any combination of investment management fees, trading expenses, custody fees, and administrative fees. All-in-fees are client specific and are typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.

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provisions and this Guidance Statement are not applicable to portfolios defined as other types of bundled fee portfolios. These provisions are also not applicable to model portfolios that are provided by a firm to a wrap fee/SMA sponsor if the firm does not have discretionary portfolio management responsibility for the individual wrap fee/SMA portfolios. Similarly, a firm or overlay manager in a multiple strategy portfolio (MSP) or similar program is also excluded from applying the wrap fee/SMA provisions and this guidance to such portfolios if it does not have discretion.

All wrap fee/SMA compliant presentations that include performance results for periods beginning on or after 1 January 2006 must meet all the requirements and the following guidance.

This guidance does not impose any specific additional requirements for a firm to monitor the use of its performance information once it has been provided to a third party; however, as in all situations where the performance information of the firm is distributed by a third party, the firm should take appropriate measures to ensure that its performance is not misrepresented or used in a misleading fashion.

Application of the GIPS Standards to Wrap Fee/SMA Portfolios

A number of complex issues relating to achieving fair representation and full disclosure exist for a wrap fee/SMA investment manager to calculate, maintain, and present performance results in compliance with the GIPS standards. These issues result in several challenges, which include the following:

- A single fee is charged by a “sponsor” for several combined services (e.g., advisory, trading, custody, and other services):
 - The firm typically has no involvement in or knowledge of the total fee that is charged by the wrap fee/SMA sponsor to individual wrap fee/SMA clients. The firm typically has knowledge of only the fees it receives for its investment management services.
 - The GIPS standards require firms to deduct trading expenses from all performance. Because the total fee charged to wrap fee/SMA portfolios is determined by the sponsor, a wrap fee is difficult, if not impossible, for the firm to separate into parts in order to identify which portion is attributable to a specific service (e.g., 20% of the wrap fee is attributable to custody fees, 70% is attributable to investment management fees, 5% is attributable to trading expenses, and 5% is attributable to client reporting).
- The firm typically does not have a direct relationship with the end-user of its wrap fee/SMA investment management services, even though these portfolios are often considered discretionary assets of the firm. Instead, multiple parties (typically an investment management firm, a broker or sponsor, and an end-user) are involved in this business model, with the wrap fee/SMA sponsor serving as the intermediary between the firm and the end-user of the investment services.
 - Firms must have records to support performance presented to satisfy laws and regulations as well as the requirements of the GIPS standards; however, wrap fee/SMA sponsors typically maintain underlying portfolio records, and firms may not have access to those records.

- The firm provides compliant presentations and other information to wrap fee/SMA sponsors that may or may not be used by the wrap fee/SMA sponsors for presenting to wrap fee/SMA prospective clients.
- The firm provides compliant presentations and other information to prospective wrap fee/SMA sponsors that are used by the sponsor to evaluate the firm. The wrap fee/SMA sponsor typically requires specific information from the firm that may or may not comply with the GIPS standards.

Guiding Principles

It is important for firms managing wrap fee/SMA portfolios to consider the following guiding principles when determining the manner in which to apply the GIPS standards to wrap fee/SMA portfolios:

- As specified in the GIPS standards, firms are required to comply with all applicable laws and regulations regarding the calculation and presentation of performance. This requirement includes the laws and regulations relating to recordkeeping (e.g., having records to substantiate the performance record), which can be difficult to satisfy for some wrap fee/SMA firms.
- The GIPS standards require that all returns be calculated after the deduction of the actual trading expenses incurred during the period. The wrap fee itself may be difficult to segregate into its component parts; however, the GIPS standards require the presentation of performance after the deduction of the actual trading expenses.
- Firms may wish to calculate performance history for presentation to wrap fee/SMA prospective clients using the gross-of-fees performance results for non-wrap-fee/SMA portfolios managed to the same investment mandate, objective, or strategy reduced by the highest wrap fee applicable to that product. This performance history can be presented in compliance with the GIPS standards because the performance of the investment strategy presented is based on actual assets managed by the firm and satisfies the underlying principles of fair representation and full disclosure.
- The firm must not exclude the performance of actual wrap fee/SMA portfolios when presenting performance to wrap fee/SMA prospective clients.

Definition of Firm

For purposes of claiming compliance, the GIPS standards define a firm as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity. This entity is a unit, division, department, or office that (1) is organizationally and functionally segregated from other units, divisions, departments, or offices, (2) retains discretion over the assets it manages, and (3) should have autonomy over the investment decision-making process. Possible criteria that can be used to determine this include the following:

- being a legal entity,

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- having a distinct market or client type (e.g., institutional, retail, private client), and
- using a separate and distinct investment process.

Organizations that have both a non-wrap-fee/SMA division (e.g., institutional, private client, mutual fund) and a wrap fee/SMA division should examine the alternatives for defining the firm according to this definition. These alternatives apply both to organizations that are just entering into the investment management industry as well as to those that are simply expanding their operations to now incorporate wrap fee/SMA products.

There are benefits and drawbacks that must be considered for each alternative definition. Possible scenarios include the following:

1. Define the entire organization as the firm, and the firm claims compliance with the GIPS standards.
2. Define the divisions separately, and either
 - a. the non-wrap-fee/SMA division and the wrap fee/SMA division are defined as separate firms and both claim compliance with the GIPS standards or
 - b. the non-wrap-fee/SMA division and the wrap fee/SMA division are defined as separate firms and only one division claims compliance with the GIPS standards.

1 Define the entire organization as the firm, and the firm claims compliance with the GIPS standards.

The GIPS standards recommend that firms adopt the broadest, most meaningful definition of the firm. If both the wrap fee/SMA and non-wrap-fee/SMA divisions are held out to the public as one entity, in order to meet the objectives of fair representation and full disclosure, it is required that the entire organization, including both the non-wrap-fee/SMA and wrap fee/SMA divisions, be defined as the firm for purposes of compliance with the GIPS standards. The organization will likely benefit from this broad definition because of the following:

- Both the non-wrap fee/SMA and wrap fee/SMA portfolios are included in and increase total firm assets.
- The firm has the option to combine wrap fee/SMA and non-wrap-fee/SMA portfolios managed according to a similar investment mandate, objective, or strategy in the same composite provided that additional required calculations and disclosures are made.
- Prior to the firm acquiring actual wrap fee/SMA portfolios, the firm can use the historical, non-wrap-fee/SMA gross-of-fees performance history, adjusted to deduct the highest total wrap fee charged to the end-user by the wrap fee/SMA sponsor, in order to calculate a wrap fee/SMA performance history.

However, the firm should also consider the following potential disadvantage of defining the entire organization as the firm: If the firm includes wrap fee/SMA portfolios in a composite that is presented to prospective clients other than wrap fee/SMA prospective clients or wrap fee/SMA clients, the firm must deduct the entire wrap fee from the performance of the wrap fee/SMA portfolios unless the firm is able to identify and deduct either actual trading expenses charged to wrap fee/SMA portfolios or the portion of the wrap fee that includes actual trading expenses charged to wrap fee/SMA portfolios.

2 Define the divisions separately.

Organizations that choose to hold the divisions out to the public as separate and distinct entities must define the divisions as separate firms for purposes of compliance. The claim of compliance with the GIPS standards may be made solely by either division, or both divisions may make the claim of compliance independent of each other. Firms claiming compliance with the GIPS standards may not show assets or performance of another firm except as supplemental information to an appropriate compliant presentation of the firm.

It is possible that the divisions of an organization may not be organizationally and functionally separate or independent of each other, but because

- their operations and functions are distinct within the organization and
- the divisions are held out to the public as distinct business entities,

the organization would be permitted to define one or both of the divisions as separate firms for purposes of compliance.

Underlying Records

Firms have options for satisfying the GIPS requirement that all data and information necessary to support all items included in a compliant presentation must be captured and maintained.

Some firms do not maintain or have access to the data necessary to substantiate portfolio level performance. In order to satisfy this requirement of the GIPS standards, firms may choose to

- place reliance on the performance calculated and reported by the wrap fee/SMA sponsor, which can be done on either the aggregate level, effectively viewing the wrap fee/SMA sponsor as a single portfolio, or on the underlying wrap fee/SMA portfolio level; when relying on information provided by a third party (in this instance, the wrap fee/SMA sponsor), the firm claiming compliance with the GIPS standards must take the necessary steps to be satisfied that the information provided by the wrap fee/SMA sponsor can be relied on to meet the requirements of the GIPS standards;
- utilize “shadow accounting”³ to track the wrap fee/SMA portfolios on their in-house performance measurement systems; or
- exclude the wrap fee/SMA division from the definition of the firm (see above).

A firm claiming compliance with the GIPS standards is responsible for its claim of compliance and is also responsible for reporting information in compliance with the GIPS standards to prospective clients. The firm must be sure that the performance provided by the wrap fee/SMA sponsor can be used by the firm to satisfy the requirements of the GIPS standards, or the firm must maintain separate/duplicate records that meet the requirements of the GIPS standards. Furthermore, if the firm undertakes the verification process, the wrap fee/SMA portfolios are subject to the same level of testing as all other portfolios within the firm.

For periods beginning on or after 1 January 2006, the firm must maintain or have access to supporting records for all portfolios included in a composite. A lack of records is not a reason to classify portfolios as non-discretionary.

³ “Shadow accounting” is the process of maintaining investment performance records for each portfolio that enables an investment management firm to determine beginning- and end-of-reporting-period values and cash flows.

Constructing and Maintaining Composites for Wrap Fee/SMA Portfolios

While the same investment strategy can be employed by the firm for wrap fee/SMA and non-wrap-fee/SMA portfolios, the delivery of information about the strategy to the end-user is what distinguishes wrap fee/SMA portfolios and necessitates additional guidance for creating and maintaining composites that include wrap fee/SMA portfolios.

In order for a firm claiming compliance with the GIPS standards to present performance for a specific strategy to wrap fee/SMA prospective clients that the firm historically managed for *only* non-wrap-fee/SMA portfolios, the firm must satisfy the following:

- a. The firm definition must include both the wrap fee/SMA and non-wrap-fee/SMA assets.
- b. There were no wrap fee/SMA portfolios under management for the particular strategy during the time periods for which the firm compiles the wrap fee/SMA performance using *only* non-wrap-fee/SMA portfolios.
- c. For all wrap fee/SMA composite presentations that include periods prior to the composite containing an *actual* wrap fee/SMA portfolio, the firm must disclose, for each period presented, that the composite does not contain actual wrap fee/SMA portfolios (i.e., that 0%, or none, of the composite portfolios/assets are wrap fee/SMA portfolios). This disclosure will be used by the firm prior to the implementation of the GIPS provision requiring firms with composites that include portfolios with bundled fees to present the percentage of composite assets represented by portfolios with bundled fees as of each annual period-end.

The firm may calculate a wrap fee/SMA performance history for a specific strategy by using that strategy's gross-of-fees non-wrap-fee/SMA composite history reduced by the highest total wrap fee charged to the client (end-user) by the wrap fee/SMA sponsor for the strategy (product), resulting in net-of-fees wrap fee/SMA performance.

It is up to the firm to determine the appropriate highest wrap fee to deduct. This highest wrap fee should be obtained from the prospective wrap fee/SMA sponsor and should be comparable for the investment mandate, objective, or strategy of the wrap fee/SMA composite. "Pure" gross-of-fees performance (i.e., gross of all expenses, including trading expenses) is only permitted as supplemental information to a compliant presentation. It is recognized that when starting with the gross-of-fees non-wrap-fee/SMA composite history, the gross-of-fees performance already reflects the deduction of actual trading expenses incurred. By then reducing the composite performance by the highest total wrap fee, which includes a portion attributable to trading expenses, performance will reflect the deduction of trading expenses two times (actual and portion of highest wrap fee). If the firm can identify the portion of the highest total wrap fee attributable to trading expenses, the firm may first calculate performance reflecting the deduction of both actual trading expenses and the highest wrap fee; the firm may then increase this result by the identifiable portion of the wrap fee attributable to trading expenses in order to compute a net-of-fees return.

In order to assist prospective clients and their understanding of the fees charged in these situations, when presenting gross-of-fees returns, firms must disclose if other fees are deducted in addition to the trading expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fee and trading expenses.

Beyond building an initial track record for presentation to wrap fee/SMA prospective clients, the firm must consider whether it will revise its wrap fee/SMA composite history as it accumulates an actual wrap fee/SMA performance record. Once a firm acquires one or more wrap fee/SMA portfolios for management, the firm must include the performance of the actual wrap fee/SMA

portfolio(s) in an appropriate composite in accordance with the firm's established portfolio inclusion policies. The firm must determine if it will combine wrap fee/SMA portfolios in a composite with non-wrap-fee/SMA portfolios with the same strategy or if it will have separate composites for non-wrap-fee/SMA portfolios.

The firm has three options to consider:

1. keep the calculated history, redefine the composite to include only actual wrap fee/SMA portfolios going forward, and include relevant disclosures related to the redefinition;
2. continue to include the ongoing performance of the non-wrap-fee/SMA portfolios and combine it with performance of actual wrap fee/SMA portfolios; or
3. create a new composite to represent only actual wrap fee/SMA portfolios. The new composite will reflect a recent composite creation date.

The firm must not exclude the performance of *actual* wrap fee/SMA portfolios from the appropriate composite(s). When presenting wrap fee/SMA performance to wrap fee/SMA prospective clients, the firm must choose one of the three options listed.

Firms must not redefine a composite on a retroactive basis. Once the firm includes non-wrap-fee/SMA portfolios in the wrap fee/SMA composite history, the firm must *not* retroactively strip those portfolios out of the composite in order to create a "wrap fee/SMA only" composite history.

Compliant Presentation

Depending on the recipient of the presentation, there are different requirements for presenting wrap fee/SMA performance results. Specifically, most wrap fee/SMA sponsors need different statistics and disclosures than retail investors. These differences result in separate requirements depending on if the composite results are presented to a prospective client or are solely for the internal use of an existing wrap fee/SMA sponsor. The firm may provide its performance to wrap fee/SMA prospective clients to generate new business or may provide its performance to existing wrap fee/SMA sponsors for the sponsor's internal use.

Wrap fee/SMA results for wrap fee/SMA prospective clients (the first time the firm presents performance to a wrap fee/SMA prospective client to obtain new business)

When presenting performance to a wrap fee/SMA prospective client, performance must be shown net-of-fees (i.e., the entire wrap fee). Firms may also present gross-of-fees returns as additional information and/or "pure" gross-of-fees returns as supplemental information. See the Guidance Statement on the Use of Supplemental Information.

The GIPS standards require firms to define composites according to investment mandates, objectives, or strategies. In order to facilitate the comparability of performance results and prevent firms from cherry-picking their best-performing portfolios for presentation, firms must group all appropriate wrap fee/SMA portfolios in a composite according to the same investment objective, mandate, or strategy (creating a style-defined composite) regardless of the wrap fee/SMA sponsor. If the firm has no actual wrap fee/SMA portfolios under management for the specified strategy,

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this style-defined composite will be composed of *only* non-wrap-fee/SMA portfolios managed to the specified strategy using the gross-of-fees performance results reduced by the highest wrap fee applicable to that strategy.

Once the firm has actual wrap fee/SMA portfolios under management, the firm has two options for composite construction:

1. If the firm chooses to define its composites to include only actual wrap fee/SMA portfolios going forward, the style-defined composite will consist of portfolios from all wrap fee/SMA sponsors that are managed to the specified strategy.
2. If the firm chooses to continue to combine the ongoing performance of the non-wrap-fee/SMA portfolios and actual wrap fee/SMA portfolios in the same composite, the style-defined composite will consist of the continuing non-wrap-fee/SMA portfolios as well as all wrap fee/SMA portfolios managed to the specified strategy, regardless of the wrap fee/SMA sponsor.

Regardless of the firm's composite construction choice, this style-defined composite must be presented to wrap fee/SMA prospective clients in order to demonstrate a full and fair picture of the firm's ability to manage wrap fee/SMA portfolios in the defined style. A firm may choose to present additional information and/or supplemental information demonstrating the firm's ability to manage portfolios for a specific wrap fee/SMA sponsor or group of wrap fee/SMA sponsors.

When a firm that claims compliance with the GIPS standards prepares a compliant presentation to be provided to wrap fee/SMA prospective clients (either directly by the firm or through the wrap fee/SMA sponsor), performance must be prepared net-of-fees, reflecting the actual wrap fee or the highest wrap fee charged to clients by the wrap fee/SMA sponsor. The firm may prepare other information as requested by the wrap fee/SMA sponsor consistent with the ethical principles of the GIPS standards.

Wrap fee/SMA results for existing wrap fee/SMA sponsors only for the sponsor's internal use

When reporting performance to an *existing* wrap fee/SMA sponsor for the sponsor's internal use, the firm may choose whether to show returns on a gross-of-fees or net-of-fees basis. (Firms may also present "pure" gross-of-fees returns as supplemental information.) However, as described above, all presentations that are prepared by the firm and will be provided to wrap fee/SMA prospective clients must be presented net-of-fees, reflecting the actual wrap fee or the highest wrap fee charged to clients by the wrap fee/SMA sponsor.

When a firm is reporting the performance of a wrap fee/SMA program to an existing wrap fee/SMA sponsor for the sponsor's internal use, there is a need to report how the firm has performed managing a particular program or "product" for that individual wrap fee/SMA sponsor. The firm may report the performance of the composite that includes only the portfolios managed for that wrap fee/SMA sponsor. Similar to the concept of existing client reporting, a firm may choose to create a smaller composite consisting only of the portfolios managed for the wrap fee/SMA sponsor in order to present to that sponsor the performance of its own wrap fee/SMA product. Provided all the requirements of the GIPS standards are met on a firm-wide basis, the sponsor-specific composite presentation may include the claim of compliance. The firm must reflect the name of the existing wrap fee/SMA sponsor in the sponsor-specific compliant presentation. Furthermore, if the presentation does not include net-of-fees returns, the firm must include a prominent disclosure stating that the sponsor-specific compliant presentation is only for the internal use of the named wrap fee/SMA sponsor.

The use of aggregate information

The use of aggregate information for performance and performance-related reporting purposes is permitted. A firm may choose to rely on and report aggregate information obtained from the wrap fee/SMA sponsor, effectively viewing the sponsor as a single portfolio. For example, at year-end, if a firm is managing 1,000 underlying wrap fee/SMA portfolios for one sponsor and the firm effectively views the sponsor as a single portfolio, the firm may choose to report “1” or “≤5” for the number of portfolios in the composite. The GIPS standards provide that the firm is not required to disclose the number of portfolios if there are five or fewer portfolios in the (wrap fee/SMA) composite.

Alternatively, the firm may choose to rely on the underlying portfolios of each sponsor, and the performance and performance-related information presented will reflect the individual wrap fee/SMA portfolios (end-users). Using the example above, the firm will report “1,000” for the number of portfolios in the composite.

Calculating Gross-of-Fees and Net-of-Fees Returns for Wrap Fee/SMA Composites

The GIPS standards require that returns be calculated net of actual trading expenses. For wrap fee/SMA portfolios, this concept is not easily applied because the wrap fee itself may be difficult, if not impossible, to segregate into its component parts. In some cases, the actual fees charged to each wrap fee/SMA portfolio are not available. See examples of calculations in Exhibit C.

Calculating performance for composites that include wrap fee/SMA portfolios to be presented to a wrap fee/SMA prospective client (the first time performance is shown to obtain new business)

When calculating performance to be presented to a wrap fee/SMA prospective client, a gross-of-fees return or “pure” gross-of-fees return must be reduced by the entire wrap fee in order to compute net-of-fees returns. This reduction is applicable to all wrap fee/SMA portfolios in the composite as well as any non-wrap-fee/SMA portfolios in the composite. The net-of-fees requirement for *wrap fee/SMA prospective clients* is applicable regardless of whether the firm can determine the portion of the wrap fee that includes trading expenses.

Calculating performance for an existing wrap fee/SMA sponsor's composite only for the sponsor's internal use

When calculating performance to be presented to an existing wrap fee/SMA sponsor for the sponsor's internal use, performance can be calculated and presented either gross-of- fees or net-of-fees. These calculations can be difficult to compute for wrap fee/SMA portfolios because the wrap fee cannot be broken into its components.

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Therefore, in cases where the trading expenses cannot be identified and segregated from a total wrap fee, either the entire wrap fee or the portion of the wrap fee containing the trading expenses must reduce the gross-of-fees returns. In these cases, custody and other administrative fees might be included in (reduce) the gross-of-fees returns. Firms may find that the gross-of-fees return is equal to the net-of-fees return.

If firms can identify these other fees and expenses, firms are permitted to add back any fees and expenses except for the trading expenses for gross-of-fees returns and may add back any fees and expenses except for the trading expenses and investment management fees for net-of-fees returns.

Calculating Internal Dispersion for a Wrap Fee/SMA Composite

The GIPS standards require that all compliant presentations include a measure of dispersion of portfolio returns, based only on those portfolios that have been included in the composite for the full year. Firms are encouraged to maintain the individual (end-user) portfolio-level returns, which will facilitate the computation of the required measure of dispersion (and number of portfolios within the composite).

A firm may choose to view the aggregate performance information reported by a wrap fee/SMA sponsor as a single portfolio. This measure of internal dispersion considers the sponsor-level returns, not the portfolio-level returns that are consolidated in the sponsor-level returns. If the composite contains five or fewer portfolios for the full year, a measure of internal dispersion is not required.

Supplemental/Additional Information

The GIPS standards recommend that firms present information that supplements the required compliant presentation that will assist clients to interpret the record. With regard to presenting wrap fee/SMA performance to wrap fee/SMA prospective clients, firms are required to show net-of-fees performance results; however, they are permitted to show “additional information” in the form of gross-of-fees results (i.e., reduced by trading expenses) as well as “supplemental information” in the form of “pure” gross-of-fees results (i.e., gross of all expenses, including trading expenses). See the Guidance Statement on the Use of Supplemental Information.

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Effective Date

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

4-17 Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios

Exhibit A Investments Large-Cap SMA Composite 1 January 2001 through 31 December 2010

Year	Net Return (%)	"Pure" Gross Return* (%)	XYZ Index Return (%)	Internal Dispersion (%)	As of 31 December			SMA Portfolios (%)
					Number of Portfolios	Composite Assets (\$ millions)	Firm Assets (\$ millions)	
2010	8.4	11.1	10.2	0.7	1,834	2,125	18,222	100
2009	21.1	24.0	21.1	1.1	1,730	2,130	17,635	100
2008	-39.7	-38.0	-39.8	1.0	1,631	2,141	19,246	100
2007	1.4	4.0	6.2	1.2	1,532	2,127	14,819	100
2006	11.4	14.1	10.5	0.9	1,428	2,116	12,362	100
2005	1.0	3.5	4.3	0.8	68	1,115	12,051	0
2004	6.8	9.5	4.9	1.0	52	1,110	13,419	0
2003	23.9	26.9	27.0	1.1	46	990	10,612	0
2002	-24.4	-22.3	-19.1	0.9	38	975	9,422	0
2001	-17.7	-15.5	-12.8	0.8	41	870	8,632	0

*Beginning 1 January 2006, "pure" gross-of-fees returns do not reflect the deduction of any expenses, including trading costs. "Pure" gross-of-fees returns are supplemental to net returns.

- Exhibit A Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Exhibit A Investments has been independently verified for the period from 1 April 1996 through 31 December 2009.
Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Large-Cap SMA Composite has been examined for the period from 1 January 2006 through 31 December 2009. The verification and performance examination reports are available upon request.
- Exhibit A Investments is an independent investment adviser registered under the Investment Advisers Act of 1940, was founded in March 1996, and manages global large-cap equity, fixed-income, and balanced strategies.
- Beginning 1 January 2006, the composite includes all separately managed (wrap) portfolios benchmarked to the XYZ Index. Performance results prior to 2006 are based on the Large-Cap Institutional Composite returns.
- The Large-Cap SMA Composite is composed of portfolios invested in U.S. equities that have a market capitalization greater than \$5 billion.
- The composite was created in February 2006. A list of composite descriptions is available upon request.
- All returns are expressed in U.S. dollars. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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7. The XYZ Index represents the companies in the U.S. equity market with the largest market capitalizations. The XYZ Index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested and includes the reinvestment of income. The returns for the index do not include any trading costs, management fees, or other costs. Index returns have been taken from published sources.
8. “Pure” gross returns, presented as supplemental information, from 2006 through 2010 do not reflect the deduction of any trading costs, fees, or expenses and are presented for comparison purposes only. “Pure” gross returns prior to 2006 reflect the deduction of trading costs. The SMA fee includes all charges for trading costs, portfolio management fees, custody fees, and other administrative fees. Net returns are calculated by subtracting the highest applicable SMA fee (2.50% on an annual basis, or 0.21% monthly) on a monthly basis from the “pure” gross composite monthly return. The standard fee schedule in effect is as follows: 2.50% on total assets.
9. The dispersion is measured by the equal-weighted standard deviation of annual returns of those portfolios that are included in the composite for the full year.
10. At 31 December 2010, the three-year annualized standard deviation of the composite and the benchmark are 12.3% and 13.2%, respectively.
11. Past performance is not an indicator of future results.

Supplemental Information			
Year	“Pure” Gross Return* (%)	Net Return (%)	
		Assuming 3% SMA Fees	Assuming 2% SMA Fees
2010	11.1	7.9	9
2009	24	20.5	21.7
2008	-38	-40.1	-39.4
2007	4	0.9	2
2006	14.1	10.8	11.9
2005	3.5	0.5	1.5
2004	9.5	6.3	7.4
2003	26.9	23.3	24.5
2002	-22.3	-24.8	-23.9
2001	-15.5	-18.1	-17.2

4-17 Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios

Exhibit B Asset Management Company Small-Cap SMA Composite 1 January 1999 through 31 December 2010

Year	Net Return (%)	XYZ Index Return (%)	Internal Dispersion (%)	As of 31 December			
				Number of Portfolios	Composite Assets (\$ millions)	Firm Assets (%)	SMA Portfolios (%)
2010	10.0	8.9	0.8	583	1,432	17	100
2009	-8.9	-15.4	0.7	573	1,324	14	100
2008	6.7	7.6	1.1	563	1,243	15	100
2007	-4.5	3.5	1.0	553	976	14	100
2006	11.0	2.6	1.2	503	890	14	100
2005	14.6	14.9	0.9	433	789	11	50
2004	-3.7	-7.3	0.8	333	654	12	40
2003	14.6	10.9	1.0	233	633	13	30
2002	19.1	14.3	1.1	133	300	12	25
2001	2.3	3.7	0.9	23	162	15	20
2000	-1.6	0.7	0.8	13	120	14	0
1999	12.7	13.4	0.7	3	25	16	0

Exhibit B Asset Management Company claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Exhibit B Asset Management Company has not been independently verified.

Exhibit B Asset Management Company is an independent investment adviser registered under the Investment Advisers Act of 1940 and manages fixed-income and equity strategies.

The Small-Cap SMA Composite (“Composite”) includes portfolios invested in U.S. small-cap equities with market capitalization less than \$2 billion. Beginning 1 January 2006, Composite includes all separately managed (wrap) portfolios benchmarked to the XYZ Small-Cap Index and sponsored by Sparky Sponsor, Inc. Performance results from 2001 through 2005 are those of Exhibit B Asset Management Company’s Small-Cap Institutional Composite and small-cap wrap portfolios managed for Sparky Sponsor. Performance results from 1999 and 2000 are those of the Small-Cap Institutional Composite. The Composite was created in August 2006. A complete list of composite descriptions is available upon request.

Portfolio returns are calculated monthly using the Modified Dietz method. Portfolios are revalued for any cash flow that exceeds 10% of the portfolio’s value. The SMA fee includes all charges for trading costs, portfolio management fees, custody fees, and other administrative fees. Net returns are calculated by subtracting the highest applicable SMA fee (2.50% on an annual basis, or 0.625% quarterly) on a quarterly basis from the “pure” gross quarterly return.

Monthly Composite returns are calculated by weighting each account’s monthly return by its relative beginning market value. All returns are expressed in U.S. dollars. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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The XYZ Small-Cap Index returns represent the returns of those U.S. companies with market capitalization less than \$2 billion. The XYZ Small-Cap Index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested and includes the reinvestment of income. The returns for the index do not include any trading costs, management fees, or other costs.

The internal dispersion is measured by the equal-weighted standard deviation of annual returns of those portfolios that are included in the Composite for the full year.

As of 31 December 2010, the three-year annualized ex-post standard deviation of the composite and the benchmark are 14.6% and 13.9%, respectively.

Past performance is not an indicator of future results. The standard fee schedule in effect is as follows: 2.50% on total assets.

Exhibit C Examples of Gross-of-Fees and Net-of-Fees Calculations

Non-wrap	Presenting to current wrap fee/SMA sponsors and clients (can choose to unbundle wrap fee)	Presenting to prospective wrap fee/SMA sponsors and clients
Return on investments	Return on investments (“pure gross”)**	Return on investments (“pure gross”)**
— Trading expenses	— Portion of wrap fee that includes trading expenses that can be segregated	
Gross-of-fees return	Gross-of-fees return	
— Investment management fee	— Portion of wrap fee that includes investment management fee that can be segregated	— Highest wrap fee <i>Or</i>
Net-of-fees return	Net-of-fees return	— Actual wrap fee
— Administrative fee	— Remaining portion of wrap fee (if any)	
Client return*	Client return*	Gross-of-fees return Net-of-fees return Client return*

*The client return is not required by the GIPS standards and is presented here as additional information that may be helpful for existing clients.

**While the “pure gross” return is not required or recommended by the GIPS standards, it can be shown as supplemental information.

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