USC/CFALA CFA® Review Program

Reading 35:
Overview of the Global Investment Performance Standards

Spring 2022

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THE GIPS® STANDARDS - OBJECTIVES

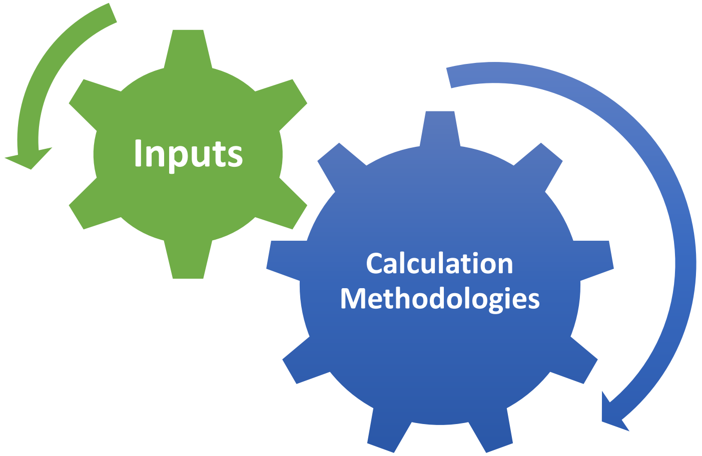
Five objectives of the Global Investment Performance Standards:

- Promote investor interests and instill investor confidence
  - Based on ***fair representation*** and ***full disclosure***
- Ensure accurate and consistent performance data
- Obtain worldwide acceptance of a single standard for calculating and presenting performance
- Promote fair, global competition among investment firms, and
- Promote industry self regulation on a global basis

a. discuss the **objectives** and scope of the GIPS standards and their benefits to prospective clients and investors, as well as investment managers

SCOPE

1



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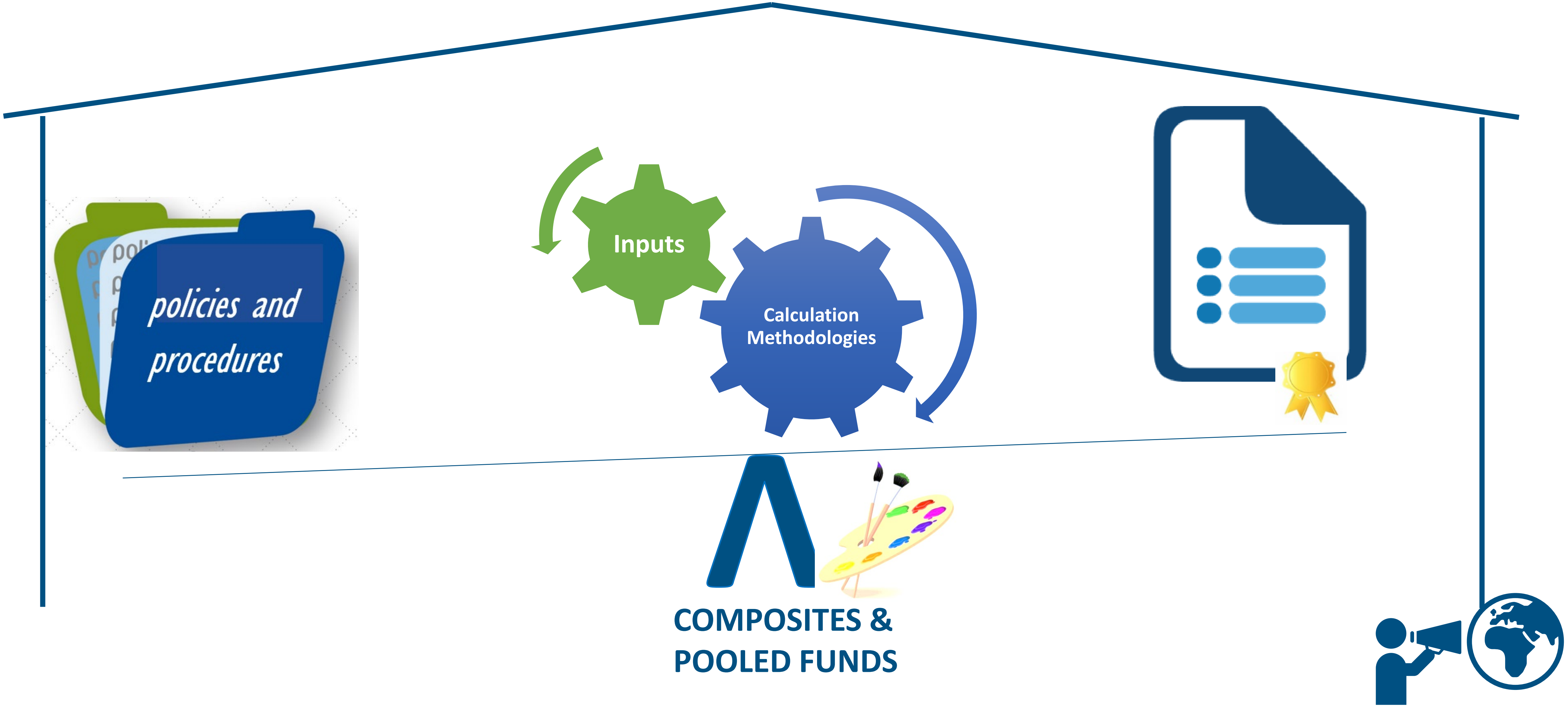
OBJECTIVES+ SCOPE



SCOPE

- Voluntary, ***ethical**** rules governing firms, asset owners and verifiers, and include both ***requirements*** and ***recommendations***
- For Firms:
  - Fundamentals of compliance
  - Input data and calculation methodology
  - Composite and Pooled Fund Maintenance
  - GIPS Reports:
    - TWR Composite
    - MWR Composite
    - TWR Pooled Fund
    - MWR Pooled Fund
  - GIPS Advertising Guidelines

a. discuss the objectives **and scope** of the GIPS standards and their benefits to prospective clients and investors, as well as investment managers

SCOPE

- To claim compliance:
  - All applicable **requirements** - minimum that **must** be followed firmwide
  - **Recommendations** – best practices that **should** be followed
  - Guidance Statements, interpretations, Q&A and clarifications

a. discuss the objectives and scope of the GIPS standards and their benefits to **prospective clients and investors**, as well as investment managers

BENEFITS

To prospective clients/investors

- Facilitate a dialogue between managers and prospective clients and investors
- Increased confidence in the accuracy of presentations
- Comparability among managers and overtime

For investment managers:

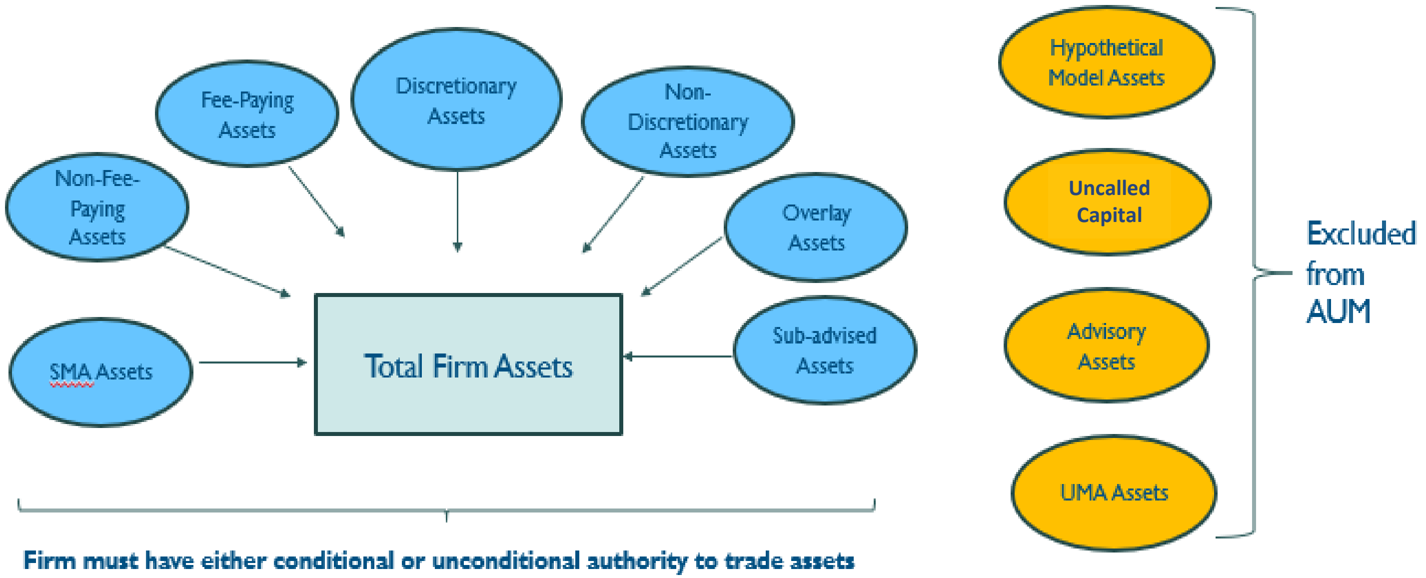
- Voluntary compliance adds credibility to the firm
- Often required by institutional consultants/clients
- Broad adoption improves the industry’s credibility
- Strengthen managerial controls

a. discuss the objectives and scope of the GIPS standards and their **benefits** to prospective clients and investors, as well as investment managers

FUNDAMENTALS: FIRM DEFINITION

- Can be a registered firm, or a subsidiary, or division ***held out*** to clients or potential clients as a ***distinct business entity***
  - Institutional vs wealth management divisions vs U.S. vs Europe
  - Should adopt broadest definition

- Defined firm = Firm assets



b: explain the fundamentals of compliance with the GIPS standards, including **the definition of the firm** and the firm's definition of discretion

FUNDAMENTALS: DEFINITION OF DISCRETION

- GIPS discretion ≠ regulatory discretion
- Discretion:
  - Is the manager able to implement the intended investment strategy?
  - Do client restrictions prevent the manager from implementing the intended strategy?
- Non-discretionary examples:
  - No tobacco, alcohol or fire arms
  - Limits on security/sector weights
  - Regular and ongoing cash withdrawals

b: explain the fundamentals of compliance with the GIPS standards, including the definition of the firm and the firm's **definition of discretion**

OTHER FUNDAMENTALS OF COMPLIANCE

- Firms must comply initially for at least 5 years or since inception of the firm
- Firms must comply with all of the requirements of the GIPS standards, including applicable laws and regulations regarding the calculation and presentation of performance
  - No "except for"
  - No calculated "consistent with" or "in accordance" with
  - No false or misleading performance information
  - If a conflict exists between the GIPS standards and law, obey the law and disclose the conflict
- GIPS Reports must be provided to ***all*** prospective clients and LDPF prospective investors
  - At least every 12 months
- *If requested*, firms must provide a:
  - Complete List of Composite and LDPF Descriptions, and a list of BDPFs
    - The list must include terminated composites for up to 5 years, but not terminated funds
    - GIPS Reports for any composite or LDPF on the list
- Use of Total Return Benchmarks reflective of the presented composite or pooled fund

b: explain **the fundamentals of compliance** with the GIPS standards, including the definition of the firm and the firm's definition of discretion

FUNDAMENTALS: POLICIES & PROCEDURES

Firms must document the policies and procedures used in establishing and maintaining compliance with the GIPS standards and apply them consistently.

P&P must address how the firm meets each requirement and any adopted recommendation, such as:

- The firm's definition of discretion
- Criteria for including portfolios in specific composites
- Timing of the inclusion and exclusion of new and terminated portfolios
- Treatment of cash flows
- Maintenance of books and records to support GIPS Reports
- Error correction policies

b: explain **the fundamentals of compliance** with the GIPS standards, including the definition of the firm and the firm's definition of discretion

FUNDAMENTALS: RECOMMENDATIONS

- Firms ***should*** comply with the recommendations of the GIPS standards
- Firms ***should*** update GIPS Reports quarterly
- Firms ***should*** be verified
  - Strongly encouraged
  - Only GIPS Report disclosure that requires affirmative or negative disclosure
- Firms ***should*** adopt the broadest, most meaningful definition of the firm
- Firms ***should*** provide each *existing client* a compliant presentation annually

b: explain **the fundamentals of compliance** with the GIPS standards, including the definition of the firm and the firm's definition of discretion

QUESTION 1:

For promotional purposes, the Jaspre Investment Management firm (JIM) wants to take advantage of the prestige associated with presenting performance results that are in compliance with the GIPS. To save time and expense, JIM decides to create five composites for marketing purposes. These portfolios represent 60% of the firm's fee-paying discretionary portfolios. Recognizing that the firm cannot claim compliance for all of its portfolios, JIM plans to include the following compliance statement with its performance presentation: "The investment results presented in this report have been prepared and presented in compliance with the Global Investment Performance Standards (GIPS®) for the majority of the assets under management by Jaspre Investment Management, Incorporated."

Discuss whether JIM's claim of compliance is acceptable under the GIPS.

- From Schweser Notes

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Discuss whether JIM's claim of compliance is acceptable under the GIPS.

- From Schweser Notes

QUESTION 2:

ABC’s CCO is discussing the firm’s claim of GIPS compliance with it’s Director of Performance in their annual meeting.

“CCO: I notice that there is a disclosure of total firm assets for each period. I know this has always been a GIPS requirement, but must we disclose assets we direct to sub-advisers under client mandate?”

Director of Performance: “Yes, unfortunately, the GIPS require that the firm include as total assets under management those assets managed by client-appointed sub-advisers if the firm retains discretion of more than 50% of the portfolio from which the assets were drawn.”

True or False – and Why?

- From Schweser Notes

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Director of Performance: "Yes, unfortunately, the GIPS require that the firm include as total assets under management those assets managed by client-appointed sub-advisers if the firm retains discretion of more than 50% of the portfolio from which the assets were drawn."

True or False – and Why?

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RETURN CALCULATION METHODOLOGY

Total returns must be used. Firms must present time-weighted returns (TWRs), unless strategy meets certain requirements to present MWRs.

- A total return captures both the return from realized and unrealized capital gains and investment income
  - REMEMBER: include accrued interest income
- Beginning 1/1/2005, firms must adjust for **daily weighted external cash flows**
- Beginning 1/1/2010, firms must revalue **<u>on the date of all large cash flows, and</u>** as of each **<u>calendar month end</u>** or the last business day of each month
- Monthly and sub-period returns must be geometrically linked

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

TIME WEIGHTED RETURN CALCULATION METHODOLOGY

- Total return $r_t = \frac{V_1 - V_0}{V_0}$
- Adjusted for day weighted cash flows $r_{ModDietz} = \frac{V_1 - V_0 - CF}{V_0 + \sum_{i=1}^{n}(CF_i \times w_i)}$
- Revalued for large cash flows – sub-periods in between monthly valuations
- Geometrically linked $r_{twr} = (1 + r_{t,1}) \times (1 + r_{t,2}) \times \ldots \times (1 + r_{t,n}) - 1$

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

RETURN CALCULATION METHODOLOGY

(EFMV – BFMV – Cash Flow) / (BFMV + Cash Flow)

Feb 1 BFMV: 100
Feb 28 EFMV: 130
Feb 21 CF: -20

Feb 21 FMV: 140

- Dietz = (130 – 100 –(-20)) / (100 + (-20/2) = 50 / 90 = 55.56%
- Modified Dietz = (130 – 100 –(-20) / (100 + (-5)*) = 50 / 95 = 52.63%
- Revalued = (140-100)/100 = 40%

(130-140-(-20) / 140+(-20) = 10/120 = 8.33%

Linked: 1.4 * 1.0833 - 1 = 51.67%

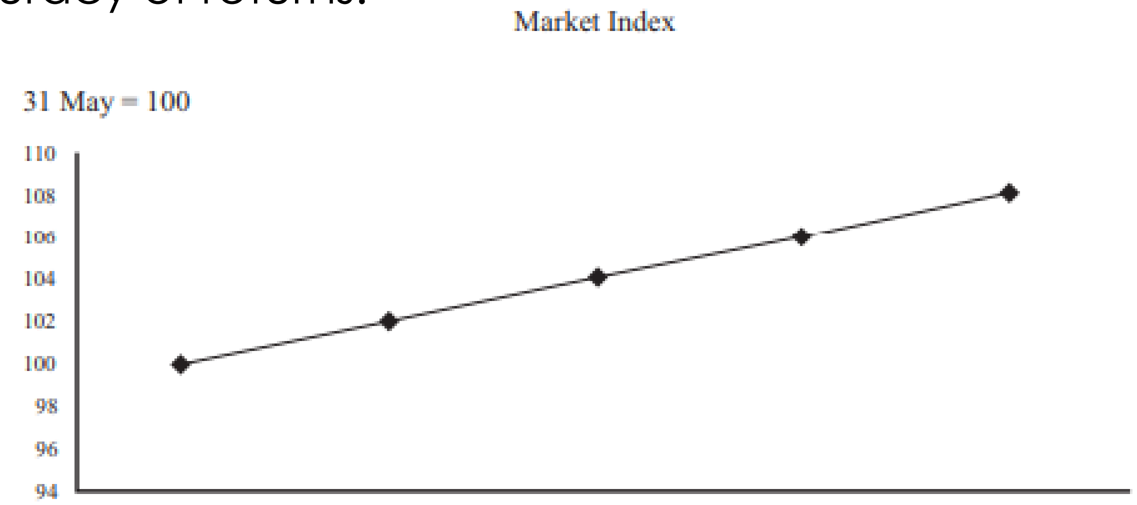
*(-20)(***28-21/28***))

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

EFFECTS OF EXTERNAL CASH FLOWS

In relatively flat, steadily rising or steadily falling markets, the timing of cash flows has a relatively small impact on the accuracy of returns.

From Reading 35:
Exhibit 3



Returns			Returns		
	31-May Fair Value	$ 100,000		31-May Fair Value	$ 100,000
2.00%	5-Jun Fair Value	$ 102,000	4.00%	15-Jun Fair Value	$ 104,000
	Contribution	$ 10,000		Contribution	$ 10,000
	Total Fair Value	$ 112,000		Total Fair Value	$ 114,000
5.88%	30-Jun Fair Value	$ 118,588	3.85%	30-Jun Fair Value	$ 118,385
8.00%	Modified Dietz	7.93%	8.00%	Modified Dietz	7.99%

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

EFFECTS OF EXTERNAL CASH FLOWS

When the market turns volatile, the impacts of external cash flows have a material impact on the accuracy of returns.

From Reading 35:
Exhibit 4

Returns			Returns		
	31-May Fair Value	$ 100,000		31-May Fair Value	$ 100,000
–5.00%	5-Jun Fair Value	$ 95,000	–10.00%	15-Jun Fair Value	$ 90,000
	Contribution	$ 10,000		Contribution	$ 10,000
	Total Fair Value	$ 105,000		Total Fair Value	$ 100,000
13.68%	30-Jun Fair Value	$ 119,364	20.00%	30-Jun Fair Value	$ 120,000
8.00%	Modified Dietz	8.64%	8.00%	Modified Dietz	9.52%

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

MONEY-WEIGHTED RETURNS

- Criteria to be able to choose to present MWRs:
  - Control over the timing of the external flows, **and**
    - Portfolios are closed-end, fixed life or fixed commitment **or**
    - Illiquid investments are a significant part of the investment strategy.
  - TWRs = MWRs if there are no cash flows

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

TREATMENT OF CASH, EXPENSES AND FEES

- Returns from cash must be included
  - Impact of holding cash:
    - Reduce returns in up markets
    - Improve returns in down markets
- Returns must be calculated <u>after the deduction</u> of ***trading expenses***
  - Typically deducted at point of trade: commissions, bid/ask spreads
  - BOTH GROSS AND NET Performance must be ***net of trading expenses***
  - BUNDLED FEES: If trading expenses and custody fees are part of a bundled all-in fee, firms must reduce gross returns by the entire bundled fee or the portion that includes transaction costs. Alternatively, firms can estimate transaction costs.
- Management fees:
  - Can be actual or model; accruing fees and expenses is recommended
  - Management fees, including performance-based fees, are the only difference between NET and GROSS PERFORMANCE
  - Lots of disclosure requirements
- Custodial fees and other administrative expenses:
  - Do not affect performance: Beyond a manager's control for composite returns – impact <u>**not**</u> reflected in performance
  - Do affect net performance for pooled funds: within a manager's control
  - For calculation purposes for composites – treat like an external cash withdrawal made by a client: EMV – BMV – custodial fee/ BMV

c: discuss **the requirements** of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees

2.B.6 VALUATION HIERARCHY

First Choice: Investments must be valued using **objective, observable, unadjusted** quoted market prices for identical investments in active markets **on the measurement date**, if available.

- 2nd Priority: For **similar** investments in active markets
- 3rd Priority: For identical or similar investments in **inactive** markets
- 4th Priority: Observable, **market-based** inputs, other than quoted prices
- 5th Priority: **Subjective, unobservable** inputs where markets are inactive at measurement date.

j: explain the recommended **valuation hierarchy** of the GIPS standards

COMPOSITE TWR RETURN CALCULATIONS

Must use an ***asset-weighted*** average of the portfolio returns

- The portfolios or an aggregate of the composite must be weighted using:
  - ***Beginning*** of period values, or
  - ***Beginning*** of period values, adjusted for cash flows

- What would happen if portfolios are weighted using ending values?
  - Best performers would get more weight
  - Worst performers would get less weight

Composite returns must be calculated at least monthly.

Periods of less than one year must **NOT** be annualized.

d: explain the requirements and recommendations of the GIPS standards with respect to **composite return calculations**, including methods for asset-weighting portfolio returns

COMPOSITE CONSTRUCTION

- All **actual, fee-paying, discretionary** portfolios must be included in **at least one** composite.
  - Non-feepaying accounts <u>may</u> be included, along with a presentation requirement to disclose the % of nonfeepaying assets
  - Non-discretionary accounts <u>must not</u> be included
  - Portfolios that are not actual accounts must not be included
  - Pooled funds that meet composite definition must be included
- GIPS discretion ≠ regulatory discretion
- Discretion:
  - Is the manager able to implement the intended investment strategy?
  - The answer will differ from firm to firm, and strategy to strategy

e: explain the meaning of “discretionary” in the context of composite construction and, given a description of the relevant facts, determine whether a portfolio is likely to be considered discretionary

FOR DISCUSSION:

Discretionary or Nondiscretionary?

- Limits on derivatives in a portfolio that doesn't use derivatives
- Regular and ongoing cash flows in a:
  - U.S. Large cap equity portfolio – large institutional account
  - U.S. Large cap equity portfolio – small retail account
  - International small cap portfolio

e: explain the meaning of "discretionary" in the context of composite construction and, given a description of the relevant facts, determine whether a portfolio is likely to be considered discretionary

QUESTION 3

A fixed-income portfolio is *most likely* to be considered non-discretionary if the client's investment policy states that:

- **A** securities held at a gain must not be sold.
- **B** the average credit quality must be investment grade.
- **C** securities held in the portfolio must be issued in developed markets.

ANSWER 3

A fixed-income portfolio is *most likely* to be considered non-discretionary if the client's investment policy states that:

- **A** securities held at a gain must not be sold.
- **B** the average credit quality must be investment grade.
- **C** securities held in the portfolio must be issued in developed markets.

TEMPORARY LOSS OF DISCRETION EXAMPLE – TAX LOSS HARVESTING

Dec				
EMV	Gross TWR	Net TWR	Delta	BMV
11,561.51	0.102%	0.102%	0.00%	11,549.74
100,888.65	0.104%	0.104%	-0.59%	101,384.12
45,705.89	0.104%	0.104%	0.00%	45,658.47
36,349.30	0.104%	0.104%	0.00%	36,311.58
35,347.24	0.104%	0.104%	0.00%	35,310.57
26,886.36	0.104%	0.104%	0.00%	26,858.46
617,660.09	0.028%	0.028%	0.00%	617,484.23
20,063.71	0.104%	0.104%	0.00%	20,042.87
5,660.76	0.017%	0.017%	26.58%	4,471.34
246,418.74	-2.639%	-2.639%	-0.47%	254,336.59
1,787,218.75	-0.32%	-0.32%		1,796,616.58
	-0.06%			

Dec				
EMV	Gross TWR	Net TWR	Delta	BMV
11,561.51	0.102%	0.102%	0.00%	11,549.74
100,888.65	0.104%	0.104%	-0.59%	101,384.12
45,705.89	0.104%	0.104%	0.00%	45,658.47
36,349.30	0.104%	0.104%	0.00%	36,311.58
35,347.24	0.104%	0.104%	0.00%	35,310.57
26,886.36	0.104%	0.104%	0.00%	26,858.46
617,660.09	0.028%	0.028%	0.00%	617,484.23
20,063.71	0.104%	0.104%	0.00%	20,042.87
5,660.76	0.017%	0.017%	26.58%	4,471.34
1,540,800.01	0.07%	0.07%		1,542,279.99
	0.09%			

Fictional example; not all portfolios in the composite are shown.

e: explain the meaning of "discretionary" in the context of composite construction and, given a description of the relevant facts, determine whether a portfolio is likely to be considered discretionary

COMPOSITE CONSTRUCTION

Composites must be defined according to **investment mandate, objective, or strategy**:

- Composites **must** include all portfolios that meet the composite definition
- Well-defined composites are essential to the firm's marketing strategy

The GIPS guidance statement on composite definition suggests a hierarchy for composite definition that is ***suggested*** but ***not required***

- Suggested Hierarchy:
  - Investment mandate – *Ex: Large cap global equities*
  - Asset Class – *Ex: Equity, fixed income, balanced, real estate*
  - Style or Strategy – *Ex: Growth, value, indexed, asset class sector*
  - Benchmarks – *Ex: S&P 500 index, Barclays Capital Aggregate Index*
  - Risk/Return Characteristics –

    Ex: An equity composite with a targeted excess return of 3% and targeted maximum volatility of 6%

f: explain the role of investment mandates, objectives, or strategies in the construction of composites

COMPOSITE CONSTRUCTION

- How many composites should a firm have?
  - The firm decides how broadly defined a composite will be. There is no right or wrong answer, it is firm-specific.

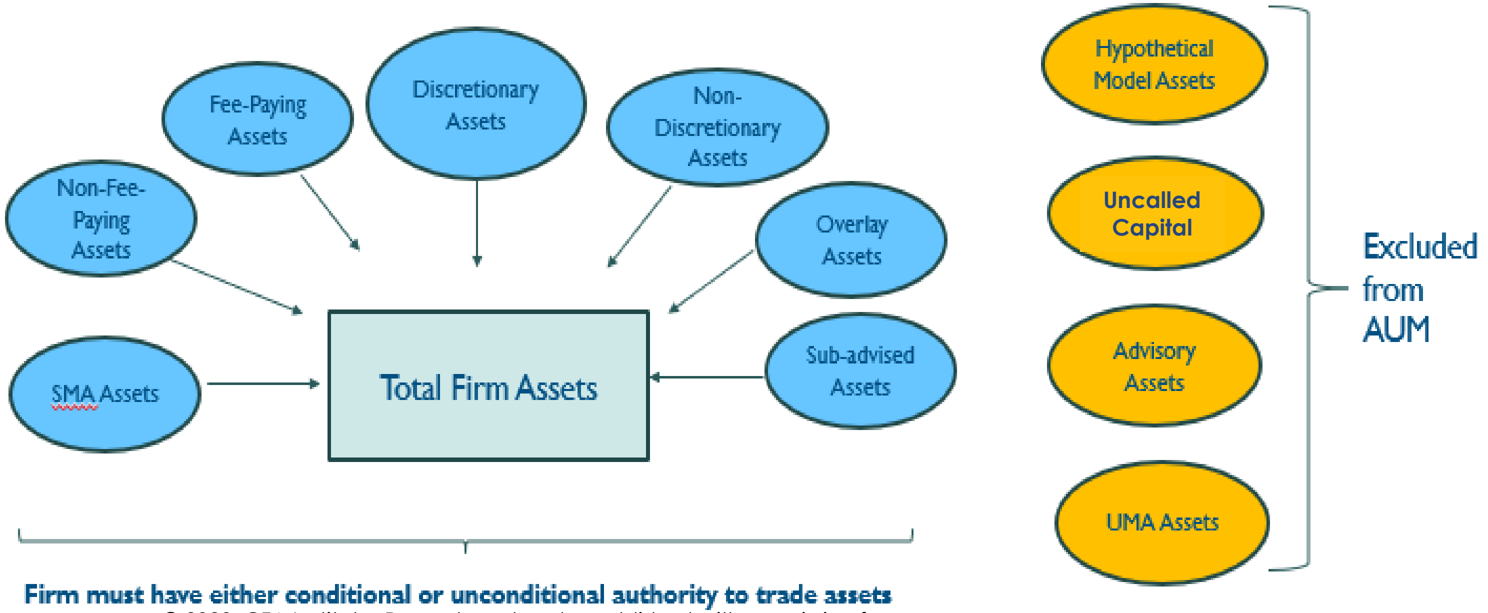
- The more composites ≈ the more specific the strategy = the < smaller the assets and the smaller the dispersion

- The fewer the composites ≈ the broader the strategy = the > larger the assets and the larger the dispersion

f: explain the role of investment mandates, objectives, or strategies in the construction of composites

COMPOSITE CONSTRUCTION

- Composites must include only assets under management within the defined firm.
- Firms are not permitted to link simulated or model portfolios with actual performance.



f: explain the role of investment mandates, objectives, or strategies in the construction of composites

COMPOSITE CONSTRUCTION: NEW / CLOSED ACCOUNT TIMING

Timing of Inclusion/Exclusion

New Accounts	Institutional Composites (C1, C6) New portfolios are included in the composite at the beginning of the first full month under management provided that the account is fully invested. Fully invested is defined as a cash level no further away than 5% of the investment model. For example, an account funding on 01/15/18 would be included in the composite on 02/01/18.
	HNW Composite (C2, C3, C4) New portfolios are included in the composite at the beginning of the first full month after the first full quarter under management provided that the account is fully invested. For example, an account funding on 1/15/18 would be included in the composite on 07/01/18.
Terminated Accounts	Terminated accounts are removed from a composite at the end of the account's last full month under management. For example, an account closing on 2/15/18 would be removed from the composite as of 01/31/18.
Changes in Mandate	Changes in mandates are removed from old composite at the end of an account's last full month under the prior strategy and put into the new composite at the beginning of the first full month under management in the new strategy. For example, an account changing mandates on 2/15/18 would be included in the old composite through 1/31/18 and added to the new composite 3/1/18.

Composites must include new portfolios on a **timely and consistent basis.**
Terminated portfolios must be included up to **the last full measurement period**.

g: explain the requirements and recommendations of the GIPS standards with respect to composite construction, including switching portfolios among composites**, the timing of the inclusion of new portfolios in composites, and the timing of the exclusion of terminated portfolios from composites**

COMPOSITE CONSTRUCTION:
CHANGES IN MANDATE, TEMPORARY ACCOUNTS FOR SCF, COMPOSITE MINIMUMS

Portfolios can only be moved from one composite to another under two scenarios

- First – if client imposed changes to the investment mandate, objective, or strategy of the portfolio cause it to no longer meet the definition of the original composite
- Second – if a redefinition of the composite makes it appropriate

Temporary Loss of Discretion – Significant External Cash Flow

- RECOMMENDATION: firms use a temporary new account rather than removing the entire portfolio from the composite

Composite minimums:

- Minimum asset levels for a composite are optional, not recommended. This policy must be applied **consistently** and **not retroactively**
  - Requires documented policies regarding consistent and timely removal if accounts fall below the minimum.
- RECOMMENDATION: avoid presenting a compliant presentation to a prospective client who is known not to meet the composite minimum

g: explain the requirements and recommendations of the GIPS standards with respect to composite construction, **including switching portfolios among composites**, the timing of the inclusion of new portfolios in composites, and the timing of the exclusion of terminated portfolios from composites

PRESENTATION AND REPORTING

GIPS compliant firms must make every reasonable effort to provide a GIPS Report to all prospective clients/investors **when they become a prospect**

- a prospective *client* is any person or entity that has **expressed interest** in one of the firm's strategies **and** qualifies to invest in that strategy via a segregated account
- a prospective *investor* is any person or entity that has **expressed interest** in one of the firm's pooled funds **and** qualifies to invest in that fund
- Includes existing clients offered new investment strategies

Prospective clients/investors must receive an updated GIPS Report with the most recent annual performance at least once every 12 months if the prospect remains a prospect

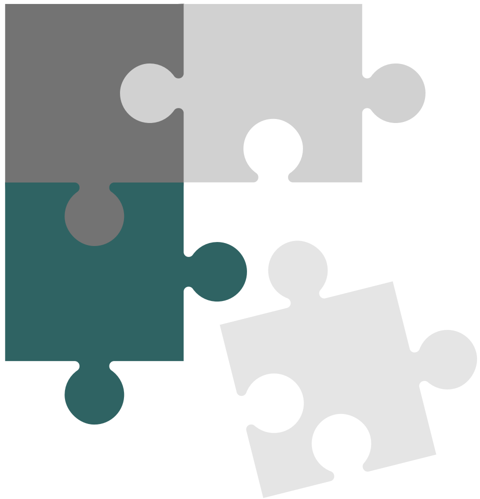
Firms must be able to **demonstrate** how this requirement was satisfied

h: explain requirements of the GIPS standards with respect to presentation and reporting

PRESENTATION AND REPORTING

Two Types of reports: GIPS Composite Reports and GIPS Pooled Funds Reports

Minimum 5 years performance (or since inception) extended each year thereafter leading up to 10 years



Key elements of Composite TWR Report (presented for **each period end**) :

- Composite and benchmark annual returns
- Number of portfolios (if six or more) in the composite
- Amount of assets in the composite
- Total firm assets under management
- Internal dispersion (if six or more portfolios)
- Three-year annualized ex post standard deviation of the composite and benchmark (if monthly returns are available)

h: explain requirements of the GIPS standards with respect to presentation and reporting

GIPS COMPLIANT PRESENTATION EXAMPLE

SAMPLE 1 COMPOSITE WITH TIME-WEIGHTED RETURNS

Spinning Top Investments
Large Cap Growth Composite
1 February 2011 to 31 December 2020

Year	Composite Gross Return TWR (%)	Composite Net Return TWR (%)	Benchmark Return (%)	3-Year Std Deviation: Composite Gross (%)	3-Year Std Deviation: Benchmark (%)	Number of Portfolios	Internal Dispersion (%)	Composite Assets ($ M)	Firm Assets[b] ($ M)
2011[a]	2.18	1.25	1.17			31	n/a	165	n/a
2012	18.66	17.49	15.48			34	2.0	235	n/a
2013	41.16	39.80	33.36			38	5.7	344	n/a
2014	14.50	13.37	13.03	11.30	9.59	45	2.8	445	1,032
2015	6.52	5.47	5.67	12.51	10.68	48	3.1	520	1,056
2016	8.22	7.15	7.09	12.95	11.15	49	2.8	505	1,185
2017	33.78	32.48	30.18	12.29	10.53	44	2.9	475	1,269
2018	−0.84	−1.83	−0.65	13.26	11.91	47	3.1	493	1,091
2019	33.08	31.78	29.76	12.81	11.71	51	3.5	549	1,252
2020	7.51	6.44	6.30	13.74	12.37	54	2.5	575	1,414

[a] Returns are for the period 1 February 2011 to 31 December 2011.

MEASURES OF INTERNAL DISPERSION

Internal dispersion: how consistently did the firm implement its intended strategy across the individual portfolios in the composite.

A high dispersion infers a higher variability of account level returns, it may suggest that the composite is defined too broadly.

The GIPS standards indicate acceptable measures include (but are not limited to):

- High/low
- Range
- Equal-weighted standard deviation
- Asset-weighted standard deviation

h: explain requirements of the GIPS standards with respect to presentation and reporting

INTERNAL DISPERSION – EQUAL WEIGHTED STANDARD DEVIATION

Slightly more difficult to calculate and interpret: the standard deviation of returns for portfolios may convey better information

- Most spreadsheet programs facilitate the calculation of equal weighted standard deviation
- Many prospective clients will have a basic understanding of standard deviation
- By giving all of the portfolios the same weight, it assumes that each portfolio is just as reflective of the investment strategy

The equal weighted standard deviation is calculated as:

$$S_c = \sqrt{\frac{\sum_{i=1}^{n}(r_i - \bar{r}_c)^2}{n-1}}$$

h: explain requirements of the GIPS standards with respect to presentation and reporting

INTERNAL DISPERSION – ASSET WEIGHTED STANDARD DEVIATION

Many firms chose to present the asset weighted standard deviation rather than the equal weighted.

- Asset weighted can be quite different than the equal weighted
- It indicates that larger portfolios are more reflective of the investment strategy
- The biggest drawback is that prospective clients will not know how evenly distributed the composite assets are among all of the portfolios

The asset weighted standard deviation is calculated as:

$$S_{C_{aw}} = \sqrt{\sum_{i=1}^{n}\left[\left(r_i - \overline{r}_{proxy}\right)^2 \times w_i\right]}$$

Where $$\overline{r}_{proxy} = \sum_{i=1}^{n}(w_i \times r_i)$$

h: explain requirements of the GIPS standards with respect to presentation and reporting

PORTABILITY REQUIREMENTS

Requirements are applied on a composite-specific basis

1. Substantially all investment decision makers are employed by the new or acquiring firm
2. The decision-making process remains substantially intact and independent within the new or acquiring firm
3. The new or acquiring firm has records that document and support the reported performance
4. There must be no break in the track record between the past firm or affiliation and the new or acquiring firm

One exception…

Firms can still port performance over to new or acquiring firm if there is a break in track record, but the two performance records may not be linked.

Firms must **disclose** when past performance is from a prior firm.

When a GIPS-compliant firm acquires another firm/affiliation, they are given one year to bring any non-compliant assets into compliance

- Only current performance must be brought into compliance within one year of the firm acquisition—historical performance can still be ported over after the first year

i: explain the conditions under which the performance of the past firm or affiliation may be linked to or used to represent the historical performance of a new or acquiring firm

PURPOSE OF VERIFICATION

- To provide the firm and the users of its GIPS Reports **greater confidence** in its claim of compliance with the GIPS standards.
- **Increased knowledge** in the performance measurement team
- Consistently **higher quality** of performance presentations
- Improved internal **processes and procedures**
- Market **advantages**

k: discuss the **purpose,** scope, and process of verification

SCOPE OF VERIFICATION

- Verification provides assurance on whether:

  (a) the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance have been designed in compliance with the GIPS standards, and

  (b) Have been implemented on a firm- wide basis

- A verification report must opine that the firm meets these two criteria
- The firm must not state that it has been verified unless a verification report has been issued
- Verification is *firm-wide* and cannot be carried out on a composite
- Verification does *not* provide assurance about the performance of any specific composite
- A firm may choose to have a detailed **performance examination** conducted on one or more specific composites or pooled funds.

k: discuss the purpose, scope, and process of verification

PROCESS OF VERIFICATION

The minimum *initial* period for which verification can be performed is one year

- Or from the firm's inception date through period-end, if less than one year
- RECOMMEND: verification cover all periods the firm claims compliance

Because verification is firm-wide, verifiers must subject the entire firm to testing, typically using a sampling methodology that must consider:

- Number of composites
- Number of portfolios in each composite
- The total assets under management
- The internal control structure of the firm
- The number of years under examination
- The methods of calculating performance

k: discuss the purpose, scope, and process of verification

PROCESS OF VERIFICATION

Verifiers must:

- Understand all of the requirements and recommendations of the standards
  - Including guidance statements, updates, interpretations, Q&A and clarifications published by the CFA institute and GIPS executive committee
- Be knowledgeable about laws and regulations regarding the calculating and presentation of performance
- Understand the firm's policies and procedures and ensure they are properly included and documented
- Understand the methodology used by the firm to value portfolios and compute performance

k: discuss the purpose, scope, and process of verification

PROCESS OF VERIFICATION

Verifiers must determine, for example:

- Portfolios are included in the correct composite
- The composite benchmark reflects the investment mandate/strategy
- The treatment of input data is consistent with the firm’s policies
  - Taxes, dividends, interest, fees, disbursements
- Validate the discretionary status of portfolios included in composites and that all actual, fee-paying, discretionary portfolios are included in at least one composite

k: discuss the purpose, scope, and process of verification

PROCESS OF VERIFICATION

Verifiers must maintain sufficient documentation supporting all procedures performed in support of the verification.

- Including receiving a representation letter from the firm confirming that the policies and procedures used in establishing and maintaining compliance are consistently applied at a firm-wide level

Remember- verification does not provide assurance that specific composite returns are correct

k: discuss the purpose, scope, and process of verification

QUESTION 4

- A charitable foundation transfers securities in kind to Taurus Asset Management Ltd. to fund a new private equity portfolio. Taurus estimates that, after liquidating the transferred securities, it will take five months to invest the foundation's assets in privately held companies. Which statement *best* describes a requirement of the GIPS standards? Taurus must include the foundation's portfolio in the appropriate private equity composite:
- **A** on a timely and consistent basis.
- **B** when the assets are substantially invested.
- **C** as of the beginning of the next full measurement period.

ANSWER 4

- A charitable foundation transfers securities in kind to Taurus Asset Management Ltd. to fund a new private equity portfolio. Taurus estimates that, after liquidating the transferred securities, it will take five months to invest the foundation's assets in privately held companies. Which statement *best* describes a requirement of the GIPS standards? Taurus must include the foundation's portfolio in the appropriate private equity composite:
- **A** on a timely and consistent basis.
- **B** when the assets are substantially invested.
- **C** as of the beginning of the next full measurement period.

QUESTION 5

After an extended period of rising interest rates, the market value of Hartford Special Machinery Company's core-plus fixed-income portfolio falls below the composite minimum of $10 million. The Hartford portfolio remains below the composite-specific minimum asset level for nine months until the client makes an additional contribution that brings it back above $10 million in assets. Belltower must:

- **A** temporarily switch the Hartford portfolio to the firm's miscellaneous composite.
- **B** include the Hartford portfolio in the core-plus fixed income composite in all measurement periods.
- **C** exclude the Hartford portfolio from the core-plus fixed income composite for the period it was below the minimum asset level.

ANSWER 5

After an extended period of rising interest rates, the market value of Hartford Special Machinery Company's core-plus fixed-income portfolio falls below the composite minimum of $10 million. The Hartford portfolio remains below the composite-specific minimum asset level for nine months until the client makes an additional contribution that brings it back above $10 million in assets. Belltower must:

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- **C** exclude the Hartford portfolio from the core-plus fixed income composite for the period it was below the minimum asset level.

QUESTION 6:

Firm XYZ claims compliance with the GIPS standards. A Verifier asks Firm XYZ to provide the account agreements for certain open and closed accounts. Reviewing the selected account agreements is *least likely* to be useful in determining whether:

- **A** XYZ's treatment of taxes, tax reclaims, and tax accruals are correct.
- **B** XYZ has appropriately classified accounts as discretionary or non-discretionary.
- **C** the accounts' objectives are consistent with the definitions of the composites in which they are included.

QUESTION 6:

Firm XYZ claims compliance with the GIPS standards. A Verifier asks Firm XYZ to provide the account agreements for certain open and closed accounts. Reviewing the selected account agreements is ***least likely*** to be useful in determining whether:

- **A** XYZ's treatment of taxes, tax reclaims, and tax accruals are correct.
- **B** XYZ has appropriately classified accounts as discretionary or non-discretionary.
- **C** the accounts' objectives are consistent with the definitions of the composites in which they are included.

QUESTION 7

- Under the GIPS standards, the *most* accurate statement is that actual direct trading expenses do **not** include:
- **A** spreads from internal brokers.
- **B** brokerage commissions.
- **C** custody fees charged per transaction.

ANSWER 7

- Under the GIPS standards, the *most* accurate statement is that actual direct trading expenses do **not** include:
- **A** spreads from internal brokers.
- **B** brokerage commissions.
- **C** custody fees charged per transaction.

SUMMARY / EXAM STRATEGY

Understand themes:

- Fair and full disclosure, requires **ethical** application, not technical compliance
- Consistent application - Only make changes on a go forward basis: no historical changes, except in the case of an error needing correction
- When standards change, they often recommend but never require, historical adoption
- Gross of fees returns are only reduced by transaction costs; the only difference between gross and net returns is the investment management fee, including performance based fees: anything else must be disclosed

SUMMARY / EXAM STRATEGY

Common sources of confusion that make for good test questions about claiming GIPS compliance:

- × The claim of compliance or verification pertains to a composite
- × Being compliant Is the same thing as getting verified
  - Being Compliant with GIPS ≠ Getting Verified
- × Firms can be compliant by using accounting systems that can calculate GIPS compliant performance
- × Software vendors, consultants or other advisory only financial organizations can follow GIPS best practices

SUMMARY / EXAM STRATEGY

3 POINT FOLLOW-UP STRATEGY (Suggestion)

- Focus on the Fundamentals
- Review the Glossary and sample GIPS Reports
- Practice Questions