Global Investment Performance Standards

CFA Institute

FOR THE DUE DILIGENCE CONSULTANT: WHAT GIPS® COMPLIANCE MEANS

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Introduction

This white paper is intended for due diligence consultants as a guide for understanding what it means for an investment adviser to claim compliance with the Global Investment Performance Standards (GIPS) from CFA Institute.

The GIPS standards are a set of global, industrywide, ethical principles that provide investment managers with leading guidance on calculating and reporting investment performance for prospective clients. The GIPS standards allow investors around the world to compare investment managers' performances on a level playing field while permitting investment managers to compete for new business in all markets.

The financial crisis and investment scandals of 2008–2009 had a significant impact on the investment management industry. Investment managers now find themselves operating in a world where investor trust in performance returns has been damaged and regulators are imposing significant changes on the industry. Investors and regulators alike are demanding greater transparency, better risk controls, and improved reporting from investment managers. The GIPS standards were designed to address these and other issues, and their adoption by a firm indicates that firm's commitment to the underlying ethical behaviors.

Control Environment

Firms claiming compliance with GIPS standards are required to document the policies and procedures they use in establishing and maintaining compliance. Implementing the provisions of the GIPS standards helps develop and foster a sound control environment where these principles add a layer to the control structure or control activities that promotes consistency in performance reporting. To claim compliance, a firm must document all the policies and procedures it follows in meeting the requirements of the GIPS standards, as well as any recommendations the firm has adopted; once those policies have been established, they must be applied consistently. The following are examples of controls typically implemented by GIPS-compliant firms:

- Maintain all records of portfolios that have historically been included in composite performance track records and why they are included.
- Perform outlier analysis to identify any portfolios that perform differently than the rest of the portfolios in their composites and ensure that they are appropriate for inclusion in the track record.
- Ensure that the calculation of total firm assets is accurate and does not double count assets.
- Use predefined thresholds to determine when to notify prospective clients of errors in investment track records previously presented to them.
- Verify the accruals and valuations used through timely reconciliations if the firm maintains internal records separately from the custodial records.
- Clearly identify and track model versus actual performance separately.

Although this list is not exhaustive, it provides some examples of the main challenges that firms are facing. For more details on the policies and procedures of a GIPS-compliant firm as well as controls that can be implemented, see the CFA Institute United States Investment Performance Committee paper

"Best Practices for Creating and Maintaining Policies and Procedures for Complying with the Global Investment Performance Standards."[1]

Valuation and Accounting

Many due diligence questionnaires ask whether portfolio market values comply with US generally accepted accounting standards, international financial reporting standards, or other local accounting standards (generally accepted accounting standards). Typically, pooled vehicles, such as hedge funds and mutual funds, have audited financial statements that comply with accounting standards, but that practice is not common in the world of separately managed accounts. Firms that comply with the GIPS standards, however, do have a principle-based standard to follow when calculating market values as well as when accounting for contributions and withdrawals.

It is critical that due diligence consultants obtain accurate investment values and client-directed cash flows in order to produce accurate performance figures. For example, if a portfolio starts with $100 and grows to $102, the return is 2%, assuming that no client-directed cash flows occurred during the period. If the beginning and ending values are inaccurate, however, the return will also be inaccurate. The GIPS standards include valuation principles, requirements, and recommendations indicating the accounting conventions that must or should be followed consistently. These conventions include the following:

- Firms must use trade date accounting.
- Accrual accounting must be used for fixed-income securities and all other investments that earn interest income and is recommended for dividends on equity securities.
- Firms must value portfolios on the date of all large cash flows and must predefine the size of a large cash flow. At a minimum, private equity and real estate assets require quarterly valuations. For real estate assets, external appraisals are required annually unless the client agreement stipulates otherwise.
- Firms may predefine 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 intended strategy, rendering the account temporarily non-discretionary.
- It is recommended that asset values be net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes should be accrued.
- 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.
- All portfolios must be valued in accordance with fair value as defined in the GIPS standards and with the GIPS valuation principles, which are consistent with most generally accepted accounting standards.

Standardizing Performance Calculation and Presentation

Different areas of the investment management industry have either a high degree of regulation or professional standards that firms are expected to follow. Firms must produce their financial statements in accordance with generally accepted accounting standards in order to be audited and so users can rely on their accounting reports. In the United States, for example, the Sarbanes–Oxley Act and the Dodd–Frank Act legislated numerous regulations on accounting and investment firms to protect consumers and other users of financial information. The mutual fund industry has very strict guidelines about how performance can be presented as well as the accompanying disclosures. But when it comes to showing performance

[1] https://www.gipsstandards.org/compliance/Documents/gips_policies_and_procedures_white_paper_final.pdf

returns on an investment strategy outside registered mutual funds, the requirements are few and far between. For investors wishing to see performance returns on an investment strategy for separately managed accounts, relatively few high-level disclosures are required by such regulatory authorities as the US Securities and Exchange Commission (SEC). The presentation of performance returns still varies across firms in the industry. Some firms present only hypothetical returns, whereas others present only the results of representative accounts or segment returns of larger portfolios. These practices make it difficult to compare firms.

The GIPS standards fill this void, providing consistent and comparable calculation methods as well as an ethical framework for presenting performance results. The GIPS standards require the use of actual composite performance, which prevents firms from cherry-picking their top-performing account or showing hypothetical returns when there is actual performance. Composites also serve as a framework for firms to show results in a comparable fashion. Composites require that all accounts managed to the same strategy, objective, or mandate be included for all periods in which they were managed on a discretionary basis. This requirement eliminates survivorship bias in a track record and provides a full picture of the firm's capabilities. Although composite definitions and descriptions can vary across firms, the principle of aggregating all similarly managed accounts for all periods is consistently applied. The GIPS standards delineate when a firm is required to use a time-weighted return (TWR) calculation versus internal rate of return (IRR). Composite-level returns, which must be asset weighted, are to be calculated using monthly periodicity at a minimum. For purposes of performance presentation, the centerpiece is the GIPS-compliant presentation. To prevent cherry-picking of time periods and metrics, the GIPS standards require a presentation of annual returns for the composite and the benchmark, showing firm and composite assets under management for each year and other statistics meaningful to the interpretation of the performance. The GIPS standards also require certain disclosures that provide context for the strategy, the firm's organization, and other key elements that are useful for the prospective client.

Leveraging Technology

A well-thought-out technology plan can be a key differentiator. Many firms use specialized software systems—whether developed internally or by a commercial software vendor—to address key provisions of the GIPS standards.

Through the use of technology, firms can continually monitor all portfolios under management and identify the composite or composites to which each portfolio belongs. Software systems can calculate portfolio-level and composite-level performance measures as well as summarize the specific measures required for a compliant presentation.

Technology within the firm can help make compliance with the GIPS standards an accurate and efficient process. Beyond the generation of composites and compliant presentations, technology should provide analysis tools that help identify outliers and other sources of possible error. It should also allow calculations to be easily verified through reports that can identify all inputs. Systems should be as automated as possible to reduce the risk of error stemming from manual intervention.

A due diligence consultant can gain insight into a firm's technology plan by asking such questions as the following:

- Which systems are used to calculate performance?
- Which systems are used to monitor composite membership?
- How are outliers in composite membership identified and treated?
- How are compliant presentations produced?

Promoting Integrity

Maintaining compliance with the GIPS standards is a team effort. It requires many stakeholders across the firm working together, typically including personnel in marketing, legal, compliance, accounting, portfolio management, and performance measurement (the specific structure varies across firms). Each team member provides different perspectives and inputs necessary for the firm to maintain compliance with the GIPS standards. Many firms have created GIPS compliance committees to facilitate the working together of this broad group of professionals. The policies and procedures a firm designs to comply with the GIPS standards foster an environment that helps ensure adequate segregation of duties and oversight, resulting in the presentation of investment results with higher integrity. A leading practice is to have these policies and procedures reviewed and approved by the firm's chief compliance officer or by those charged with governance, which substantiates the level of oversight and scrutiny applied to the firm's policies.

Third-Party Verification and Performance Examination

A firm claiming compliance with the GIPS standards may choose to undergo a recommended, independent third-party verification that tests the construction of the firm's composites as well as its policies and procedures related to compliance with the GIPS standards. Verification provides a substantial benefit to both the investment management firm undergoing the verification process and the prospective investor relying on the performance information presented by the firm, because it adds a level of trust and confidence that the firm is abiding by the GIPS standards.

Given the testing and validation performed as part of verification, it can give due diligence consultants increased confidence in a firm's claim of compliance.

Verification includes, but is not limited to, the testing of

- the appropriateness of portfolios being included in/excluded from strategy performance;
- performance calculations, including cash flows, income and expenses, trade processing, and valuations;
- the existence and ownership of client assets; and
- the presentation of appropriate disclosures.

Verification is performed on a firmwide basis and does not test the accuracy of any particular composite presentation. For additional assurance regarding a specific composite, firms may choose to have an independent third-party verifier conduct focused composite testing (performance examination). This testing includes testing similar to that performed as part of a firmwide verification but is more detailed, focusing on a specific composite presentation.

Conclusion

The goal of this paper is to reveal what a firm does to support its claim of GIPS compliance and to show how GIPS-compliant firms are committed to more than mere disclosure. A GIPS-compliant firm should be committed to the use of strong internal control processes that give investors a greater level of confidence in the integrity of the firm's track record. Although the GIPS-compliant "check box" implies that strong controls are in place, it does not preclude the need for a due diligence process of evaluating performance data and analyzing other important qualitative information. Due diligence consultants should also consider the size and sophistication of a firm, because the level of controls and technology will vary. Smaller firms with 1 or 2 strategies will not require the same control framework as larger firms with 500 strategies. The aim is to have firms claim compliance with the GIPS standards so that investment industry practitioners can help build an environment of credibility and trust based on strong ethics. The disclosures and other metrics in a GIPS-compliant presentation can help identify anomalies that lead to the asking of pertinent questions and more in-depth due diligence. In instances where firms do not comply with the GIPS standards, industry participants, such as due diligence consultants, can help contribute to this goal by asking such firms why they have chosen not to comply with the GIPS standards and either encouraging or requiring GIPS compliance by asset managers throughout the industry.