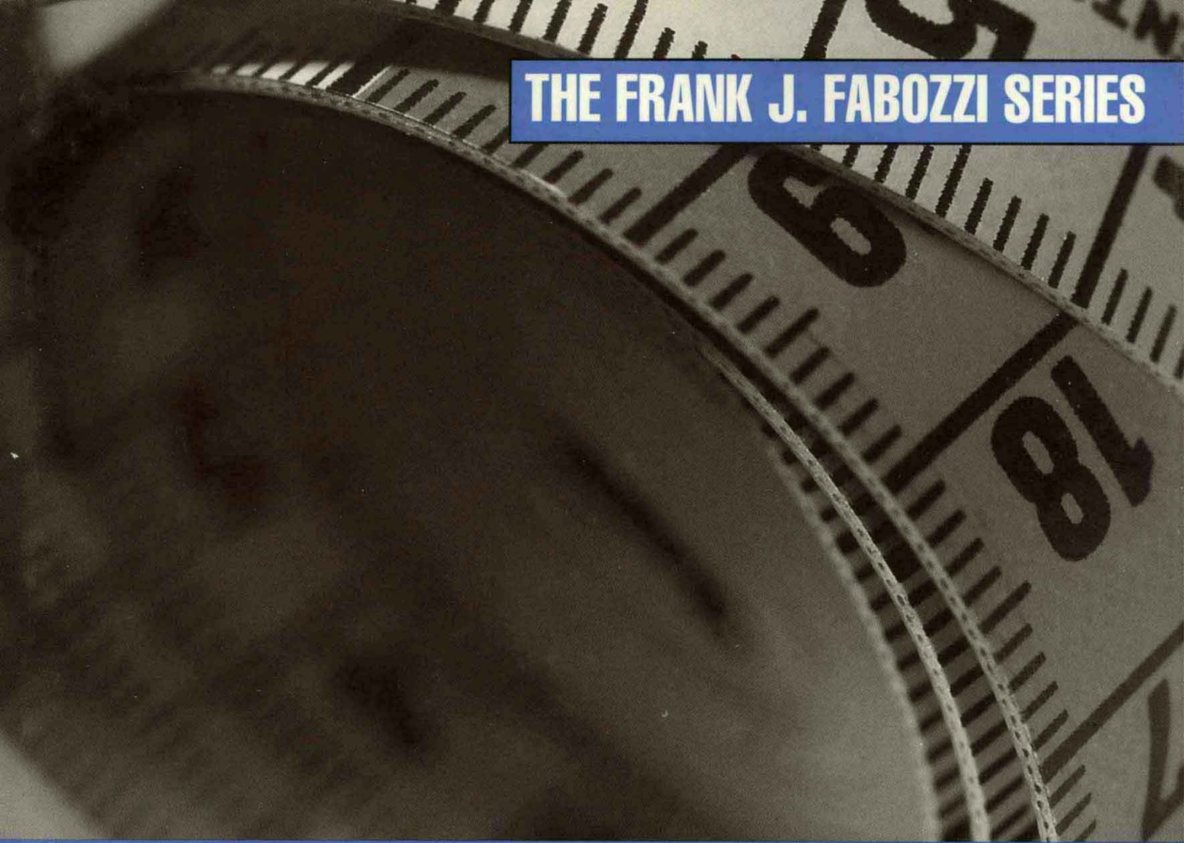

THE FRANK J. FABOZZI SERIES

COMPLYING *with the* GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS®)

BRUCE J. FEIBEL • KARYN D. VINCENT

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Karyn D. Vincent, CFA, CIPM is the founder of Vincent Performance Services LLC, which provides GIPS consulting and verification services. Previously, she served as the global practice leader for investment performance services at PricewaterhouseCoopers. Ms. Vincent is an active volunteer with CFA Institute and serves on the GIPS Executive Committee, which is responsible for overseeing the GIPS standards globally. She chairs the GIPS Interpretations Subcommittee and previously was a member of the CIPM Advisory Council. From 2002–2006 she chaired the AIMR-PPS® Implementation Committee and the GIPS Verification Subcommittee. She earned a B.S in Accounting from the University of Massachusetts Dartmouth.

Preface

Performance measurement is an important concept for anyone managing or investing institutional assets. *Complying with the Global Investment Performance Standards (GIPS®)* provides individuals and firms with two things: (1) guidance for the investment firm in achieving compliance with the Global Investment Performance Standards—the GIPS standards—and (2) detailed explanations of the rationale and methodology behind the numbers.

Expanding upon the information on the GIPS standards published by CFA Institute, this book is intended to be a comprehensive overview, but also detailed enough to provide the practical hands-on guidance required by investment professionals. Our intent is to explain not just what the GIPS standards are, but also how to comply with them. Our opinions on achieving and maintaining compliance with the GIPS standards are represented in the following chapters and when writing this book, we referred to the 2010 edition of the GIPS standards, which is officially titled, *Global Investment Performance Standards (GIPS®): As Adopted by the GIPS Executive Committee on 29 January 2010* (Charlottesville, VA: CFA Institute 2010). We also refer to other applicable interpretive guidance issued by CFA Institute and available on the GIPS standards web site as of March 19, 2011. As this book is not official guidance, individuals and firms should check the resources provided by CFA Institute if questions arise and consult with their GIPS advisors. Official CFA Institute resources for the GIPS standards, including any updates to the GIPS standards and any interpretive guidance, are located at www.gipsstandards.org.

This book covers the requirements and recommendations of the 2010 edition of the GIPS standards, which went into effect on January 1, 2011.

Acknowledgments

This book has benefited from countless conversations with clients and colleagues, and we thank all of them. Although we received advice and input from many people, any errors or omissions are our own. Our sincere hope is that this book helps firms achieve compliance with the GIPS standards, and simplifies the process of maintaining compliance. We welcome your feedback at feibels@yahoo.com and kvincent@vincentperformance.com.

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Introduction

The investment management industry has global standards for the calculation and presentation of investment performance to prospective investors. These are the Global Investment Performance Standards (GIPS®), which were created and are administered by CFA Institute. The topic of this book is how to calculate returns and present investment performance results in accordance with the GIPS standards. The GIPS standards are applicable to all investment firms globally that have discretion to manage assets.

CFA Institute is a nonprofit association of portfolio managers, analysts, and other participants in the investment management process. CFA Institute runs the Chartered Financial Analyst, or CFA program. An important goal of CFA Institute is to maintain and enhance the reputation of the investment management profession and its practitioners. In this role, CFA Institute has developed a Code of Ethics and Standards of Professional Conduct (together, the Code and Standards) outlining member responsibilities to the profession, employers, clients, prospects, and the general public. All CFA charterholders agree to uphold the Code and Standards, which include a requirement to make reasonable efforts to provide performance information that is fair, accurate, and complete. Complying with the GIPS standards helps CFA charterholders, and thus their firms, meet this requirement. The GIPS standards are widely used by firms who wish to adopt this same ethical approach to the fair presentation of performance results.

While past performance cannot guarantee future results, the reality of asset management is that the investment firm's historical performance record is a primary consideration for the investor looking to hire a new manager. Performance records are not just used to identify top-performing managers, but also to determine if the manager's track record reflects the firm's stated style and strategy. The main goals of the GIPS standards are that the performance presented to prospective investors is comparable across managers, has been prepared in such a way that it represents a complete and accurate record of performance for the strategy of interest to the prospect, and is accompanied with the disclosures necessary to ensure an accurate interpretation of the manager's record.

The competition between money managers today to attract assets from investors is intense. Thousands of organizations offer products with a myriad of strategies intended to align the opportunities presented by the capital markets with investor goals and objectives. The GIPS standards, and their predecessor standards, have been extremely successful in ensuring that investors are able to understand past performance in the process of choosing among different managers.

The GIPS standards are important to society as a whole. We all have a stake in the success of the institutions we depend on being able to make informed choices among asset management firms. After all, these managers are selected to implement investment programs that provide the funds to achieve vital goals such as the funding of retiree pensions, educating future generations of students, and performing charitable activities.

PERFORMANCE COMPOSITES

Assuming that an investment advisory firm manages more than one portfolio and periodically offers new strategies, what performance data is available to prospective clients? There are several types of returns that *could* be presented as part of the marketing process:

- For a manager who is currently managing money for multiple clients, a *representative* client account could be selected that demonstrates the performance experienced by the average client or client similar to the prospect.
- The manager may maintain a *model* portfolio that tracks the manager's intended strategy. Individual client funds are traded and rebalanced according to the model account strategy.
- Backtesting the manager's strategy or models could generate *hypothetical* performance numbers. A new manager or a manager with a new strategy will test how the strategy would have theoretically performed in the past.
- The performance of each of the firm's strategies can be presented using the aggregated or *composite* performance of all of the accounts following the same strategy.

For each of these alternatives, the manager could also choose to present the account or composite performance over particular time periods.

Given these options, prospective investors need to know exactly what the performance record represents. What would stop a manager from offering up as a representative account the best-performing account instead of the average account? Government regulations attempt to guard against the unscrupulous money manager or advisor. But institutional investors want not only honest, but also comparable and independently tested performance returns for use when evaluating the suitability of a manager.

To this end, the GIPS standards outline the process for creating performance composites. Each *composite* represents the aggregate performance history of all accounts managed in a particular strategy, and is used to support the marketing of the strategy to prospective investors. The GIPS standards provide guidance for:

- Accounting data inputs to the performance calculations.
- Methodology used to calculate the returns.
- Construction methodology for composites of portfolios.
- Disclosures of information about the strategy, the composite, and the firm.
- Presentation and advertising of performance information to prospects.

The GIPS standards are typically used when performance information is communicated between an investment firm and prospective institutional investors, such as a corporate pension fund, university endowment, or charitable foundation. But the GIPS standards' sphere of influence is broader than this. All aspects of performance measurement, including return calculation, performance attribution, and client reporting of performance to both individual and institutional investors, are influenced by the GIPS standards. The GIPS standards are a form of industry self-regulation. While there is no law that an investment firm must create its marketing materials according to the GIPS standards, compliance with the GIPS standards has become a de facto requirement in many parts of the world.

ABOUT THE BOOK

This book contains nine chapters grouped into the following three parts:

- *Part One.* Explanation of the GIPS standards and how to comply with them by creating composites representing the performance of the firm's strategies.
- *Part Two.* The methodology for calculating returns used to quantify the manager's historical performance and statistics gauging the risks taken to achieve these returns.
- *Part Three.* Guidance for reporting performance and maintaining compliance with the GIPS standards. The section on how to prepare

GIPS-compliant presentations and other marketing materials describes best practices for maintaining compliance, special requirements applicable to firms managing nontraditional portfolios, as well as the independent verification process.

Understanding how to report performance in compliance with the GIPS standards is only one component of the performance measurement body of knowledge. The scope of the book is limited to the performance measurement and presentation techniques required for GIPS compliance. For example, portfolio and composite performance calculations are explained but we do not delve into security-level performance calculations.

Although this book provides worked examples illustrating particular techniques for analyzing performance, there is an important qualification accompanying these examples: *We do not mean to imply that the methodology presented here is the only way to calculate returns.* The GIPS standards provide some flexibility for tailoring return calculations to the needs of the situation. Many of the other statistics documented in this book can also be calculated in different ways. The book is not intended as an encyclopedic listing of all the ways returns can be calculated. Instead, we describe the most commonly used methodologies for deriving the returns used for marketing purposes.

Contents

PART One

Explanation of the GIPS Standards

CHAPTER 1

Fundamentals of Compliance

The institutional investor searching for a new investment manager will consider many factors before making a choice. The manager's reputation, the breadth of the firm's offerings, and the manager's fee schedule all play a role in this decision. While past performance cannot guarantee future results, this information provides valuable insight about an investment manager. One factor that is almost always considered in a search is the investment manager's historical track record. With only a few exceptions, investment managers have historically had minimal, if any, regulations or guidance that instructs the firm on how to calculate and report investment performance to prospective investors. The Global Investment Performance Standards (GIPS®), administered by CFA Institute, fill that void.

SCOPE OF THE GIPS STANDARDS

The Global Investment Performance Standards are a set of voluntary standards for calculating and reporting investment performance to a prospective investor. Institutional investors, such as pension plans and endowments, will often consider hiring only managers who have calculated and presented their performance in compliance with the GIPS standards. The GIPS standards provide investors with assurance that performance records are comparable and that they are prepared based on the ethical principles of fair representation and full disclosure.

The GIPS standards do not attempt to address every performance measurement issue that a money manager may face. For example, the GIPS standards are not intended to govern performance presented as part of internal reporting within the investment management firm or for client reporting to existing clients. The GIPS standards are primarily concerned with marketing performance history to prospective clients.

There is no global law that requires a firm to comply with the GIPS standards. (But if an investment manager claims compliance, the local regulator can and often does test that claim.) The GIPS standards are a form of industry self-regulation. An investment manager that chooses to comply with the GIPS standards must comply with all of the applicable *requirements* of the GIPS standards on a firmwide basis. The GIPS standards also include a series of *recommendations* that are considered industry best practices. A firm that complies with the GIPS standards may select which, if any, of these recommendations the firm will adopt and follow.

HISTORY OF THE GIPS STANDARDS

Several decades ago, the Association for Investment Management and Research (AIMR®, now known as CFA Institute) recognized the need for performance standards. In 1987, the AIMR Performance Presentation Standards (AIMR-PPS®) were issued and over the next decade became widely adopted in the United States, primarily by managers of institutional assets. At the same time, other countries were beginning to take notice of these standards. Recognizing that the AIMR-PPS standards were directed mainly at the U.S. and Canadian markets, several countries used the AIMR-PPS standards as a starting point and tailored them for local use. To facilitate the ability of money managers to do business across borders and address the proliferation of country-specific standards, in 1995 AIMR undertook the process of creating a set of performance standards that could be used by all firms globally. The end result of this effort was the issuance of the first edition of the GIPS standards in February 1999.

Several countries adopted the GIPS standards as their local standard as issued, making no changes. However, other countries that already had their own standards were hesitant to replace their current standards with the GIPS standards, particularly if the local standards had been widely adopted and extensively interpreted, as was the case in the United States and Canada. To take the first step toward unifying the different standards used globally, a concept of *Country Versions of GIPS* (CVG) was created. Each CVG would have as its core the GIPS standards themselves, but would allow for additional requirements and recommendations over and above those included in the GIPS standards. In 2000, the AIMR-PPS standards became a CVG. The process to become a CVG was quite simple for the AIMR-PPS standards, since the GIPS standards were primarily based on the concepts in the AIMR-PPS standards.

When the GIPS standards were originally created, it was agreed that they would be reviewed and updated every five years. This first five-year review resulted in the issuance of the 2005 edition of the GIPS standards in February of that year. This edition began the process of eliminating all CVGs as a key