Learning Module 4: Introduction to the Global Investment Performance Standards (GIPS)

LOS 4a: explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is benefitted by the standards

The Global Investment Performance Standards establish a standardized set of ethical practices that guide practitioners in analyzing and presenting historical data as a basis for the comparison of investment results.

Why GIPS were Created?

These GIPS standards provide a basis for including all relevant data, as well as avoiding misrepresentations. Prior to GIPS creation, like-for-like performance comparison was a challenge because of the presence of the following misleading practices:

- **Representative Accounts**: Firms use the top-performing portfolio as a representative of the firm's overall investment results.
- **Survivorship Bias**: Firms exclude poor performing portfolios in presenting their performance and present an "average" performance history.
- **Varying Time Periods**: Firms "hand-pick" only the time periods during which the mandate outperformed the specified benchmark.

The **objectives** of the GIPS standards:

1. Promote investor interests and instill investor confidence.
2. Ensure accurate and consistent data.
3. Obtain worldwide acceptance of a single standard for calculating and presenting performance.
4. Promote fair, global competition among investment firms.
5. Promote industry self-regulation on a global basis.

Source: CFA® Program Curriculum

Who can Claim Compliance?

Any investment firm can choose to comply with the Global Investment Performance Standards, and observance is voluntary. However, only management firms that manage assets can claim compliance.

Parties that cannot claim compliance are as follows:

- Plan sponsors.
- Consultants who do not manage assets.
- Software developers.
- Software vendors.

Additionally, to claim compliance, a firm must comply with all Global Investment Performance Standards. Simple compliance with one or a limited portion of parameters is insufficient.

Who Benefits from Compliance?

Clients and prospective clients can have a degree of confidence in the numbers they are using to compare managers that the numbers are representative of the actual experience of those managers and not conveniently crafted records that distort what actually happened.

Investment management firms in compliance with GIPS requirements enjoy a greater level of credibility in the hands of investors. Compliance is seen as proof that the firm upholds a high level of ethical behavior. By adopting GIPS, firms in countries with few-to-no standards can compete with countries whose standards are more developed.

Benefits of compliance with GIPS Standards are as follow:

- GIPS primarily benefits investment firms and the clients of those firms. Compliance with GIPS ensures that a firm's historical results are presented consistently and fairly.

- Conformity allows GIPS-compliant firms to bid against other GIPS-compliant firms throughout the world. Investors can easily compare the results of compliant firms, thereby adding credibility to GIPS-compliant performance data.
- Compliance with the GIPS standards strengthens the firm's internal controls over performance-related processes and procedures.
- Compliance with the GIPS standards enhances the credibility of investment management firms.

Question 1

Which of the following parties can *most likely* claim compliance with GIPS?

A. Plan sponsors.
B. Firms that do manage assets.
C. Both plan sponsors and firms that do manage assets.

Solution

The correct answer is **B**.

Only investment firms that manage assets can claim compliance with GIPS.

Parties that cannot claim compliance are as follows:

- Plan sponsors.
- Consultants who do not manage assets.
- Software developers.
- Software vendors.

Question 2

Which of the following is *least likely* a key objective of GIPS?

A. Obtain global acceptance of a single standard for calculation and presentation of investment performance based upon fair representation and investor confidence.
B. Promote the use of accurate and consistent performance data.
C. Encourage fair, global competition among investment firms by creating barriers to entry.

Solution

The correct answer is **C**.

The correct statement would be "Encourage fair, global competition among investment firms ***without*** creating barriers to entry."

A and B are incorrect. Those two statements are key objectives of GIPS.

LOS 4b: describe the key concepts of the GIPS standards for firms

The following are the key concepts of the GIPS standards that apply to firms:

1. GIPS are ethical standards for an 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.
2. 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 practices in the calculation and presentation of performance.
3. 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 to prevent firms from cherry-picking their best performance.
4. GIPS relies 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. These and other inputs need to be accurate. GIPS standards require firms to adhere to certain calculation methodologies and make specific disclosures and the firm's performance.
5. 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 (gipsstandards.org) as well as in the GIPS Handbook.

As noted, GIPS compliance is voluntary and self-regulated. Due to the nature of this setup, a strong commitment to ethical integrity is required to maintain GIPS compliance. The GIPS Executive Committee encourages firms to recognize the benefit of self-regulation and consider taking action against firms that falsely claim compliance with GIPS.

LOS 4c: explain the construction and purpose of composites in performance reporting

A primary aspect of GIPS is to require composites, which are aggregate portfolios managed with a similar investment approach. Therefore, if a firm presents its record for a particular equity classification, all portfolios meeting pre-established criteria for that class must be represented. A firm cannot include some and exclude others at will.

In addition, composite guidelines prevent firms from using only their best-performing portfolios, thereby skewing presentation results.

Non-discretionary portfolios must not be included in a firm's composites. A discretionary portfolio is one in which buy and sell decisions are made by a portfolio manager. On the other hand, the manager of a non-discretionary portfolio does not have full discretion over how the money is invested.

LOS 4d: describe the fundamentals of compliance, including the recommendations of the GIPS Standards with respect to the definition of the firm and the firm's definition of discretion.

The GIPS standards must be applied on a firm-wide basis. There are two important issues that must be considered by a firm when it complies with the GIPS standards:

i. Definition of the firm.
ii. Definition of discretionary.

Definition of Firm under GIPS

The GIPS standards state "The firm 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."

This implies that:

- Firms must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity.
- Total firm assets must be the aggregate of the fair value of all discretionary and non-discretionary assets under management within the defined firm.
- Firms must include the performance of assets assigned to a sub-advisor in a composite, provided that the firm has discretion over the selection of the sub-advisor.
- Changes in a firm's organization are not sufficient grounds for alternation of historical composite results.

Definition of Discretionary under GIPS

The GIPS standards state “If documented client-imposed restrictions interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy, the firm may determine that the portfolio is non-discretionary.”

Non-discretionary portfolios must not be included in a firm’s composites.

LOS 4e: describe the concept of independent verification

Verification refers to the process by which a firm claiming compliance with GIPS requirements hires an independent third party to evaluate its processes and corroborate the firm’s assertions. Despite the fact that verification is a recommendation rather than a requirement for firms to claim compliance, it increases investor confidence.

Verification must include an entire firm’s practices, not just a small grouping of composites. Authentication should include information related to the proper formulation of composite information and company policies established to calculate and present GIPS-compliant performance. Verification does not validate specific results of historical data.