R59 Introduction to the Global Investment Performance Standards (GIPS)

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Introduction

This reading focuses on:

- Why the GIPS standards were created, who can claim compliance, and who benefits from compliance.
- Key concepts of the GIPS standards – composites, the definition of the firm, and the definition of investment discretion.
- The purposes and benefits of verification.

The 2020 Edition of the GIPS Standards has three chapters:

1. GIPS Standards for Firms
2. GIPS Standards for Asset Owners
3. GIPS Standards for Verifiers

Note: Most of the material presented here is taken from the curriculum.

I. Why Were the GIPS Created?

GIPS standards were created to make it easier to compare different investment management firms. Without a standard, different firms would select the method which would make their performance look better.

The GIPS standards are a practitioner-driven set of ethical principles that establish a standardized, industry-wide approach for investment firms to follow in calculating and presenting their historical investment results to prospective clients. The GIPS standards ensure fair representation and full disclosure of investment performance. In other words, the GIPS standards lead investment management firms to avoid misrepresentations of performance and to communicate all relevant information that prospective clients should know in order to evaluate past results.

Misleading practices in the absence of GIPS included:

- **Representative accounts**: Showcasing only the top-performing portfolio to represent the firm's overall investment results.
- **Survivorship bias**: Excluding poorly performing portfolios and presenting an average performance history.
- **Varying time periods:** Presenting performance for a selected time-period during which the mandate produced excellent returns.

The objectives of the GIPS standards are:

- To promote investor interests and instill investor confidence.
- To ensure accurate and consistent data.
- To obtain worldwide acceptance of a single standard for calculating and presenting performance.
- To promote fair, global competition among investment firms.

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- To promote industry self-regulation on a global basis.

I.I Who Can Claim Compliance?

Any firm that actually manages assets can claim compliance once it has satisfied all requirements of the standards. Firms that compete for business must comply with the GIPS Standards for firms.

Consultants cannot claim compliance unless they actually manage assets for which they are making a claim of compliance. Similarly, software and the vendors supplying the software to investment management firm cannot claim compliance.

Asset owners can make a claim of compliance if they compete for business. If they do not compete for business but report their performance to an oversight body, they may choose to comply with the GIPS standards for asset owners.

How to claim compliance?

Compliance is a firm-wide process that cannot be achieved on a single product or composite. A firm has only two options with regard to compliance with the GIPS standards:

- Fully comply with all requirements of the GIPS standards and claim compliance through the use of the GIPS Compliance Statement; or
- Not comply with all requirements of the GIPS standards and not claim compliance with, or make any reference to, the GIPS standards.

Complying with the GIPS standards is voluntary. It is not typically required by legal or regulatory authorities.

I.II Who Benefits from Compliance?

The GIPS standards benefit:

- asset managers and their prospective clients
- asset owners and their oversight bodies

Following the GIPS standards allows asset managers to assure prospective clients that the historical track record they report is both complete and fairly presented. Compliance enables the GIPS-compliant firm to participate in competitive bids against other compliant firms throughout the world. Achieving and maintaining compliance may also strengthen the firm's internal controls over performance-related processes and procedures.

Investors (prospective clients) have a greater level of confidence in the integrity of performance presentations of a GIPS-compliant firm. Investors can easily compare performance presentations from different investment management firms. Compliance with the GIPS standards does not eliminate the need for due-diligence, but it enhances the credibility of investment management firms that have chosen to undertake this responsibility.

Asset owners provide performance information to their oversight bodies that allows them to

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make investment decisions and evaluate the performance of the funds under their supervision. If asset owners hire external managers who comply with the GIPS standards, then reporting to the oversight body with the same principles makes it easy to understand the sources of risk and excess return in the funds under supervision.

Instructor's Note: CFA Institute recommends reading the Preface and the Introduction to the Global Investment Performance Standards for Firms, for additional insight into the history, purpose, and key concepts of the GIPS standards. This document can be found at this link – Click here. For your benefit the 'Key concepts' section from this document is presented below.

Key concepts of the GIPS standards that apply to firms

- The GIPS standards are ethical standards for investment performance presentation to ensure fair representation and full disclosure of investment performance.
- 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.
- Firms must comply with all applicable requirements of the GIPS standards, including any Guidance Statements, interpretations, and Questions & Answers (Q&As) published by CFA Institute and the GIPS standards governing bodies.
- The GIPS standards do not address every aspect of performance measurement and will continue to evolve over time to address additional areas of investment performance.
- The GIPS standards require firms to create and maintain composites for all strategies for which the firm manages segregated accounts or markets to segregated accounts.
- The GIPS standards rely on the integrity of input data, the quality of which is critical to creating accurate performance presentations. The underlying valuations of portfolio holdings drive performance. It is essential for these and other inputs to be accurate. The GIPS standards require firms to adhere to certain calculation methodologies to allow for comparability across firms.

II. Composites

One of the key requirements of the GIPS standards is the use of composites. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. Composites prevent firms from cherry picking only the best performing accounts while reporting performance.

Assume a firm manages portfolios based on one of the following strategies:

- Strategy A: Aggressive growth. Under this strategy the firm selects small-cap stocks with strong growth potential over the next few years.

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- Strategy B. Large cap value. Under this strategy large-cap value stocks are selected.

Give this scenario the firm should create a composite for Strategy A, and another composite for Strategy B.

A composite must include all actual, fee-paying, discretionary portfolios managed in accordance with the same investment mandate, objective, or strategy. By "actual" we mean these should be real and not dummy/model portfolios to simulate the returns. Portfolios for which the client does not pay a fee must not be included. For instance, there may be charitable organizations that do not pay a fee for their assets being managed. These should not be included. By "discretionary", we mean the investment management firm has the right to determine and purchase suitable securities for a portfolio. If there is a portfolio where the client determines what securities should be purchased, then it is non-discretionary.

The determination of which portfolios to include in the composite should be done according to pre-established criteria (i.e. on an ex-ante basis), not after the fact. This prevents a firm from including only the best-performing portfolios.

To claim compliance all fee-paying discretionary accounts managed by the firm must be included in at least one composite.

Instructor's Note: For additional details, please read Section 3.A. of the Global Investment Performance Standards for Firms on composites.

III. 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.

Definition of the firm: The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. 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."

Definition of discretion: 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. 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-

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

Instructor's Note: For additional details on the fundamentals of compliance, please read Section 1 of the 2020 GIPS Standards for firms.

IV. Verification

Firms that claim compliance with the GIPS standards are responsible for their claim of compliance and maintaining that compliance. Once a firm claims compliance with GIPS, they may voluntarily hire an independent third-party to perform verification. Just as GIPS compliance is voluntary, verification is also voluntary.

Verification is a process by which an independent verification firm (verifier) conducts testing of a firm on a firm-wide basis in accordance with the required verification procedures of the GIPS standards. Verification provides assurance on whether 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 have been implemented on a firm-wide basis.

Verification is performed with respect to an entire firm. It is not done on composites, or individual departments.

Verification must be performed by an independent third party. A firm cannot perform its own verification.

Third-party verification brings additional credibility to a firm's claim of compliance. To understand why a firm would pay to be verified if it is voluntary, assume there are two firms, A and B. Firm A claims GIPS compliance and firm B claims GIPS compliance with third-party verification from a reputed firm. As an investor, which firm would you be more comfortable with? Obviously firm B, and that gives firm B an advantage over firm A.

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Summary

LO.a: Explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is benefitted by the standards.

The GIPS standards were created to avoid misrepresentation of performance and to make it easier to compare different investment management firms.

Any firm that actually manages assets can claim compliance once it has satisfied all requirements of the standards. Asset owners can make a claim of compliance if they compete for business. If they do not compete for business but report their performance to an oversight body, they may choose to comply with the GIPS standards for asset owners.

The GIPS standards benefit:

- asset managers and their prospective clients
- asset owners and their oversight bodies

LO.b: Describe the key concepts of the GIPS standards for firms.

Firms that compete for business must comply with the GIPS Standards for firms. Compliance is a firm-wide process that cannot be achieved on a single product or composite. A firm has only two options with regard to compliance with the GIPS standards:

- Fully comply with all requirements of the GIPS standards and claim compliance through the use of the GIPS Compliance Statement; or
- Not comply with all requirements of the GIPS standards and not claim compliance with, or make any reference to, the GIPS standards.

Complying with the GIPS standards is voluntary. It is not typically required by legal or regulatory authorities.

LO.c: Explain the purpose of composites in performance reporting.

A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. Composites prevent firms from cherry picking only the best performing accounts while reporting performance. When used in performance reporting, composites help clients evaluate how well a company has performed with different investment styles.

LO.d: 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.

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.

<u>Definition of the firm</u>: The GIPS standards state "The firm should adopt the broadest, most

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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."

Definition of discretion: 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.

LO.e: Describe the concept of independent verification.

Verification is a process by which an independent verification firm (verifier) conducts testing of a firm on a firm-wide basis in accordance with the required verification procedures of the GIPS standards. Verification provides assurance on whether 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 have been implemented on a firm-wide basis.

Verification is performed with respect to an entire firm. It is not done on composites, or individual departments.

Verification must be performed by an independent third-party. A firm cannot perform its own verification.

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