Implementing the GIPS Standards:

A Bird's Eye View of the Five Major Steps

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Agenda

Step 1: Defining the Firm or the Asset Owner

Step 2: Classification of portfolios

Step 3: Valuation and return calculation

Step 4: Benchmarks

Step 5: GIPS Policies & Procedures Manual, GIPS Reports, GIPS Advertisements

1. Defining the Firm or the Asset Owner

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The first step in complying with the GIPS standards is to understand which of the GIPS 2020 standards will be applicable

GIPS Standards for *Firms*

Firms *compete for business*. Examples of firms include:

- Hedge funds
- Mutual funds
- Private equity

GIPS Standards for *Asset Owners*

Asset Owners *do not compete for business*. Examples of asset owners include:

- Pension funds
- Endowments
- Foundations

This overview presentation focuses on requirements that apply to both Firms and Asset Owners.
For the sake of simplicity, when we say “Firms” we also mean “Asset Owners” for the rest of this presentation.

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How you define the firm or the entity that is going to be GIPS compliant is an important first step in implementing the GIPS standards

There are important considerations on how to define a firm:

- For GIPS purposes, the firm may be defined differently than the legal entity formation documents of the business.
- The firm definition considers how the entity holds itself out to the public.
- The firm definition should be the broadest, most meaningful definition of the firm.

Q: Broadest, most meaningful definition to whom?

A: The people or entity that have provided the money to the firm or asset owner to manage.

Key Point: Defining the firm or entity is important. It creates defined boundaries whereby total firm assets can be determined.

Discretion is a very important item in the GIPS standards. The Global Investment *Performance Standards* has to do with *investment performance*

Discretionary Portfolios + Non-discretionary portfolios = Total firm assets

Q: Investment performance of what?

A: Investment performance of investment management discretion over how assets were deployed (invested)

GIPS in a nutshell

How *investment management decisions* translate to *investment performance*

- All the GIPS policies and procedures, reports, composites and other items are to ensure data demonstrates how investment management decisions translate to investment performance.
- More on this later in the presentation.

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Total Firm Assets and some technical considerations:

- Non-discretionary portfolios must not be included in composites
- Total firm assets must include assets assigned to a sub-advisor provided the firm has discretion over the choice of subadvisor.
- Total firm assets must not include uncalled committed capital.
- Total firm assets must not include advisory-only assets.

2. Classification of Portfolios

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Firms and Asset Owners must classify portfolios into three buckets

Discretionary Portfolios + Non-discretionary portfolios = Total firm assets

Segregated Accounts

Broadly Distributed Pooled Funds

Limited Distribution Pooled Funds

Segregated accounts

Segregated Accounts

- A portfolio that is owned by a single client
- An aggregation of portfolios, organized by investment mandate, objective or strategy is a composite
- If a firm has five strategies, it will have five composites….

Segregated accounts – portfolios and composites

- All portfolios must be arranged into a composite depending on the investment objective, mandate or strategy
- This prevents the cherry picking a particular portfolio and presenting it as representative of performance

If a firm has 400 portfolios and five strategies, those will have to be assigned into the five "buckets". For example:

Strategy 1: US Large Cap Equity Growth Composite (150 portfolios)

Strategy 2: Emerging Market High Yield Fixed Income Composite (50 portfolios)

Strategy 3: Socially Responsible Investments Global Equity Composite (125 portfolios)

Strategy 4: Covered Call Writing Overlay Composite (25 portfolios)

Strategy 5: Asian Market Neutral Composite (50 portfolios)

Key Point 1: You will have returns calculated at the portfolio level and you have returns calculated at the composite level.

Key Point 2: Composites are created based on strategies you offer. And portfolios are classified into the appropriate composite.

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Broadly Distributed Pooled Funds & Limited Distribution Pooled Funds

The distinction is important because each type of fund has different reporting requirements

Broadly Distributed Pooled Funds

Regulated under a framework that permits the general public to purchase fund shares.
Not exclusively offered in one-on-one presentations
E.g. '40 Act mutual funds or UCITS funds

Limited Distribution Pooled Funds

Any pooled fund that is not a Broadly Distributed Pooled Fund

E.g. Private Equity, Limited Partnerships

Pooled funds *may* have to be arranged into composites... Is the particular pooled strategy matching a composite strategy?

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3: Valuation and Return Calculation

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Valuation and Return calculation

- Periodicity (daily, monthly, quarterly)
  - How often are returns calculated?
  - How often is the portfolio or pooled fund valued?
  - What is the fair valuation policy?

Each category has prescribed rules for fair valuation and return calculation:

Composites	LDPF	BDPF
	• included in a composite • not included in a composite	• included in a composite • not included in a composite

Key Point: Every return is calculated based on a formula and every formula is based on inputs.
The GIPS standards drill down to the input level.

Valuation and Return calculation

Some technical considerations that must be considered:

- How are withholding taxes treated?
- Accrual accounting for fixed income investments
- How are large cash flows handled?

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Time-Weighted Return Vs. Money-Weighted Return

- Time-Weighted Return:
  A method of calculating period-by-period returns that reflects the change in value and negates the impact of external cash flows.

- Money-Weighted Return:
  Commonly referred to as the internal rate of return (IRR). This methodology reflects the change in value including the impact of the timing and size of external cash flows. This methodology may be appropriate if the composite or pooled fund:
  - Is closed-end
  - Has a fixed-life
  - Has a fixed-capital commitment
  - Illiquid investments are a significant part of the strategy
  - *Generally, the manager has control over external cash flows*

A firm is likely to use both

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Total Firm Assets

Discretionary Portfolios + Non-discretionary portfolios = Total firm assets

Technical aspects of GIPS:

- Non-discretionary portfolios must not be included in composites
- Total firm assets must include assets assigned to a sub-advisor provided the firm has discretion over the choice of subadvisor
- Must not include uncalled committed capital
- Must not include advisory-only assets

Transaction costs

Returns are reduced by transaction costs and fees among other items. Other items can include custody fees, taxes, exchange fees, brokerage commissions, advisory fees etc. *For now let us focus on two items*:

Actual transaction costs or Estimated transaction costs

(Estimated transaction costs may only be used if actual transaction costs are unknown)

Transaction cost considerations:

"The cost of buying or selling investments. These costs typically take the form of brokerage commissions, exchange fees and/or taxes, and/ or bid-offer spreads from either internal or external brokers. Custodial fees charged per transaction should be considered custody fees and not transaction costs. For real estate and private equity, and other private market investments, transaction costs include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing investments but do not include dead deal costs".

Type of Returns presented and the fees

Return type	Returns
Total fund full gross-of-fees return	11.00%
Investment management fees for externally managed pooled funds.	(0.05%)
Total fund gross-of-fees return	10.95%
Investment management fees for externally managed separate accounts	(0.04%)
Total fund net-of-external-costs-only return	10.91%
Investment management costs	(0.16%)
Total fund net-of-fees return	10.75%

Each of these layers of fees include specific items that must be considered.

Private Market Investments

Real Estate, Private Equity and other Private Market Investments have specific standards on how returns are calculated and fairly valued.

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4: Benchmarks

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Benchmarks

- An important aspect of the GIPS standards is that each of the composites, limited distributed pooled funds and broadly distributed pooled fund have a benchmark to be able to gauge performance.
- Benchmarks can reflect the business model of the firm/asset owner but must also match the investment objective, mandate or strategy of the composite and/or pooled fund.
- A benchmark can be a customized to reflect how the entity conducts business.
- Once you select it, plan on sticking with it for the long haul:
  - Changing benchmarks triggers additional requirements.
  - The idea is to prevent an asset manager from cherry picking the benchmark to show favorable performance

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5: GIPS Reports

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GIPS policies & procedures manual, GIPS reports, and GIPS advertisement

How investment management decisions translate to investment performance.

Let's get theoretical!

The Fundamental Law of Active Management* states that the information ratio is a function of the information coefficient and the square root of breadth.

Formally:

$$IR \approx IC^{*}\sqrt{Breath}$$

What does that mean?

- Information ratio (IR): a measure of risk adjusted performance
- Information coefficient (IC): correlation between forecast returns and actual return. It measures the effectiveness of investment insight.
- Breath: number of independent, active investment decisions made.

*Grinold and Kahn (2000)

GIPS policies & procedures manual, GIPS reports, and GIPS advertisement

The GIPS standards is a way to document how investment decisions lead to investment performance in a particular firm.

- The *GIPS Policies and Procedures Manual* is created to show how investment decisions are carried out in your firm.
- The *GIPS Report* is created to reflect the performance of those investment decisions.

These two (of the three) documents are a byproduct of coming into compliance with the GIPS standards.

The third document is an optional *GIPS advertisement*.

- This is a means to communicate with the world that your firm is compliant with the GIPS standards and may result in marketing advantages vis-à-vis a non-GIPS-compliant firm. You have two ways to compete:

The numbers

The quality of the numbers

All three have very specific rules that one must follow in creating these documents.

Summary

Summary

These are the five steps in implementing the GIPS standards.

1. Defining the Firm or the Asset Owner
2. Classification of Portfolios
3. Valuation and Return Calculation
4. Benchmarks
5. GIPS Policies & Procedures Manual, GIPS Reports, GIPS Advertisements

References

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Thank You

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