PERFORMANCE PERSPECTIVES
with David Spaulding

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GIPS 2010 UPDATE

The final version of the revised Global Investment Performance Standards (GIPS®) has been released; go to http://www.gipsstandards.org/standards/current/2010_edition_gips.html to obtain a copy.

Space won't permit a very detailed review here, but I'll touch on some of the key changes. In addition, we will host a webinar on Thursday, March 18 at 11:00 EST. We charge a nominal fee to participate; verification clients and Performance Measurement Forum members can join in at no cost.

Early adoption encouraged?

It is funny how something appearing so simple as *early adoption* would engender confusion. Harken back five years ago and recall that early adoption was encouraged…no strings attached. But it's not so simple this time.

First, is it even encouraged? If you open your 2005 version you'll find in black-and-white that it was; but nowhere in the new version will you find such a statement. But, I have it on "good authority" that it is, in fact, encouraged.

During the GIPS Executive Committee's final review meeting in January I asked about this topic, and Jonathan Boersma indicated that a firm couldn't remove any item from the 2005 edition without being fully compliant; otherwise, they wouldn't be compliant with either version. Firms <u>can</u> adopt new requirements in advance, though, as they wish.

An example of something that you can't drop would be the after-tax rules that are going away in January 2011; if you're currently using these rules, you need to continue to do so until you either fully adopt the 2010 edition or by January 2011.

I would think that wording changes must also be delayed until you're fully compliant; for example, the compliance statement itself is changing but you can't make the change until you're fully compliant; at least that's my interpretation.

Heightened awareness of verification

Previously firms were encouraged to indicate they had been verified; now it's going to be mandatory. You will either indicate that your firm has been verified (and therefore for what period(s)) or whether you haven't been.

And because verification itself is often confusing, firms that have undergone verification will be required to explain what it is; you must include the following statement:

"Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation."

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Examinations are getting additional attention, too. I have commented at length about the topic of examinations in my blog,[1] and so won't repeat myself here other than to say that I disagree with this heightened visibility.

Calculation changes

There are several changes being made on the calculation front.

Firms must disclose if model or actual fees are used for net-of-fee returns. In addition, firms must disclose if the net-of-fee returns are net of any performance-based fees. The standards don't provide a definition of what "model" means. This is unfortunate as it can lead to confusion and perhaps abuse. It's my understanding that firms have two choices when it comes to calculating net-of-fee returns: actual or highest fee (and highest is intended to be highest actual, though many firms simply use highest from the fee schedule). If the EC means something else by "model," they should alert us.

Real estate closed-end fund composites must now in addition to showing time-weighted returns, also show since-inception internal rates of return, using quarterly cash flows at a minimum. Until now, private equity has been the only asset class for which SI-IRR was mandated. In addition, these composites must include the host of statistics (e.g., since inception paid-in-capital, cumulative committed capital) which has been part of the private equity requirements since 2006.

Private equity's SI-IRR must now be calculated using daily treatment of cash flows, where in the past, monthly was permitted.

You may wonder why private equity has to treat cash flows on a daily basis while real estate can do this quarterly. It's my understanding that the real estate market simply isn't ready for daily, so perhaps we can expect this to change with GIPS 2015?

Compliant firms must report three-year annualized ex-post standard deviation of the composite and benchmark for all annual periods going forward. If the firm doesn't feel standard deviation is appropriate for their composite, they must still report it and (a) explain why and (b) provide a three-year ex-post statistic for the risk measure they feel <u>is</u> appropriate.

Fair value

A somewhat major (though probably not for many firms) change is the switch from "market" to "fair" valuation. The disclosure draft had a proposed hierarchy to be used, which has become a recommendation:

a. Investments must be valued using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available. If not available, then investments should be valued using:

b. Objective, observable quoted prices for similar investments in active markets. If not available or appropriate, then investments should be valued using:

c. Quoted prices for identical or similar investments in markets that are not active (markets in which there are few transactions for the investment, the prices are not current, or price quotations vary substantially over time and/or between market makers). If not available or appropriate, then investments should be valued based on:

1 www.InvestmentPerformanceGuy.blogspot.com

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d. Market-based inputs, other than quoted prices, that are observable for the investments. If not available or appropriate, then base on:

e. Subjective unobservable inputs for the investment where markets are not active at the measurement date. Unobservable inputs should only be used to measure fair value to the extent that observable inputs and prices are not available or appropriate. Unobservable inputs reflect the firm's own assumptions about the assumptions that market participants would use in pricing the investments and should be developed based on the best information available under the circumstances.

Although this hierarchy isn't mandated, the firm must disclose if a composite's valuation hierarchy materially differs from it. In addition, the firm must "disclose the use of subjective unobservable inputs" to value portfolio investments if the "investments valued using subjective unobservable inputs are material to the composite."

Disclosures

There are a few new disclosures as well as changes to existing disclosures.

Today, if applicable, firms report the treatment of withholding taxes; this is now only necessary if it's "material." Firms must disclose and describe any known material differences in exchange rates or valuation sources used among the composite's portfolios, and between the composite and the benchmark. In addition to disclosing the presence, use, and extent of leverage and derivatives, firms must do the same now with short positions (if material). All of these items use the term "material," which the firm will be expected to define (something for your policies & procedures!).

Firms must disclose the benchmark's description.

Slight wording changes: today firms disclose that a *list and description of composites* is available upon request; this has been changed to be that a *list of composite descriptions* is available upon request. Also, today you disclose that information regarding your calculation and reporting is available; this has been expanded: you will now be required to indicate that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available.

For custom benchmarks, firms will be required to disclose their components, weights, and rebalancing process.

Please take the time to review the document yourself; we suggest that you go through the "red-lined" version to better see what has changed. Also, please join us next month for the webinar. John Simpson and I will also conduct seminars on the changes in the coming months. I, for example, will be speaking at First Rate's Performance Conference next month. If possible, we'll alert you of other events.

IF IT LOOKS LIKE A DUCK, WALKS LIKE A DUCK, AND QUACKS LIKE A DUCK…

I just got off the phone with a client who is investing in a new vehicle that sure acts and looks like a private equity closed end product, save for it not being private equity. And so, what rules do they follow? Unfortunately, they have to show time-weighted returns. Yes, they can always show since-inception IRR (SI-IRR) as *supplemental* information, but why don't the same rules apply here as they do for private equity? To me, this makes no sense.

Upcoming classes:

CIPM™ Principles Exam Preparation Class

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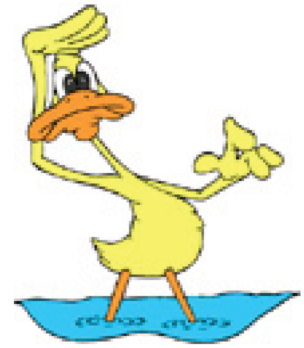

Some of the details:

- closed-end partnership
- clients commit a certain amount of capital
- manager controls cash flows
- limited life
- invests in publicly traded securities.

I, as well as others, tried to get this newest version of GIPS to be broadened in its sensitivity to such scenarios and mandate SI-IRR, but alas the GIPS EC chose not to do this. And while I'm pleased that they've expanded the SI-IRR requirement to cover closed end real estate deals, why did they elect to still require them to show time-weighted returns?

The lack of consistency is, to me, problematic and confusing. And often yields incorrect returns and extra work. I understand why (as noted above) real estate funds get to treat cash flows quarterly while private equity will be required to treat them on a daily basis, but why the other difference (i.e., the requirement for TWRR for real estate)? And why not simply have a generic product defined for which SI-IRR is the required method? Hopefully the next version of GIPS will address this in a more complete and consistent manner.

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DATE	EVENT	LOCATION
March 15-16, 2010	CIPM™ Principles Exam Preparation Class	New Brunswick, NJ (USA)
March 17-19, 2010	CIPM™ Expert Exam Preparation Class	New Brunswick, NJ (USA)
March 22-23, 2010	Fundamentals of Performance Measurement Training	Boston, MA (USA)
March 24-25, 2010	Performance Measurement Attribution Training	Boston, MA (USA)
April 20-21, 2010	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
April 22-23, 2010	Performance Measurement Attribution Training	Chicago, IL (USA)
May 17-18, 2010	Fundamentals of Performance Measurement Training	New York, NY (USA)
September 13-14, 2010	CIPM™ Principles Exam Preparation Class	Los Angeles, CA (USA)
September 15-17, 2010	CIPM™ Expert Exam Preparation Class	Los Angeles, CA (USA)
September 27-28, 2010	Fundamentals of Performance Measurement Training	Boston, MA (USA)
September 29-30, 2010	Performance Measurement Attribution Training	Boston, MA (USA)
October 19-20, 2010	Fundamentals of Performance Measurement Training	San Francisco, CA (USA)
October 21-22, 2010	Performance Measurement Attribution Training	San Francisco, CA (USA)
November 16-17, 2010	Fundamentals of Performance Measurement Training	Chicago, IL (USA)
November 18-19, 2010	Performance Measurement Attribution Training	Chicago, IL (USA)
December 7-8, 2010	Fundamentals of Performance Measurement Training	New Brunswick, NJ (USA)
December 9-10, 2010	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

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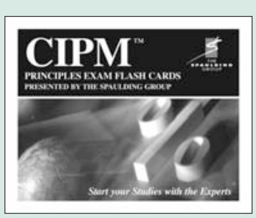

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