READING

15

Global Investment Performance Standards

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LEARNING OUTCOMES

Mastery	The candidate should be able to:
☐	**a.** explain the fundamentals of compliance with the GIPS standards, including the definition of the firm, calculating total firm assets, and the conditions under which an investment management firm can claim compliance;
☐	**b.** evaluate the classification of portfolios as discretionary or non-discretionary in accordance with the GIPS standards;
☐	**c.** evaluate the appropriateness of composite construction according to the GIPS standards, including (i) inclusion of new portfolios and termination and switching of portfolios, (ii) treatment of portfolios with external cash flows, and (iii) linked performance of model or simulated portfolios;
☐	**d.** state the requirements and recommendations of the GIPS standards with respect to presentation and reporting;
☐	**e.** state the requirements of the GIPS standards with respect to disclosures;
☐	**f.** determine the portability of performance track records from a past firm or affiliation in accordance with the GIPS standards;
☐	**g.** explain benefits of verification.

INTRODUCTION

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The Global Investment Performance Standards (the GIPS® standards) fulfill an essential role in asset management around the world. They meet the need for globally accepted standards for investment management firms (asset managers) and asset owners in calculating and presenting their results to prospective clients, prospective investors, and those who have direct oversight responsibility for asset owner assets, such as a board of pension fund trustees.

To appreciate the value of industry-wide performance presentation standards, consider some of the many ways in which unscrupulous firms or individual employees might attempt to gather and retain assets by misrepresenting a firm's historical record. In communicating with a prospective client, they could

- present returns only for the best-performing portfolios as though those returns were fully representative of the firm's expertise in a given strategy or style;
- base portfolio values on their own unsubstantiated estimates of asset prices;
- inflate returns by annualizing partial-period results;
- select the most favorable measurement period, calculating returns from a low point to a high point;
- present simulated returns as though they had actually been earned;
- choose a benchmark that casts the selected portfolios in the most favorable light during the measurement period;
- self-select return methodologies to ensure the most favorable return;
- include or exclude portfolios in composites according to their performance rather than objective strategy criteria;
- portray the growth of assets in the style or strategy of interest so as to mask the difference between investment returns and client contributions; or
- use the marketing department's expertise in graphic design to underplay unfavorable performance data and direct the prospect's attention to the most persuasive elements of the sales presentation.

Without established, well-formulated standards for investment performance measurement and presentation, the ability of a prospective client or a prospective investor to make sound decisions in selecting investment managers would be impaired. Individual investors and their advisers, as well as pension plan sponsors, foundation trustees, and other institutional investors with fiduciary responsibility for asset pools, need reliable information. The GIPS standards give them greater confidence that the returns they are shown fairly represent an investment firm's historical record. The GIPS standards also enable them to make reasonable comparisons among different investment management firms before hiring one of them. Evaluating past returns is only one dimension of the manager selection process, but it is an important one, and the due diligence legally and ethically expected of fiduciaries cannot be satisfied without it.

Global standards for performance presentation, including the requirement that a firm show each composite's investment returns alongside the returns of an appropriate benchmark, can lead to an informed discussion about the firm's investment decision-making process. The prospective client might ask, for instance, why the composite outperformed the benchmark in some periods and not in others, inviting the firm's spokespersons to explain past returns and to describe how the investment product is positioned for the future.

Although the GIPS standards can facilitate the comparison of investment managers through the use of properly calculated, fully disclosed historical results, they do not exempt the prospective client from a thorough investigation of the candidate firm's background, resources, and capabilities for the mandate under consideration. Due diligence in selecting an investment manager includes, among many other important elements, examining a firm's regulatory history, the experience and professional credentials of its decision makers, the soundness of its investment philosophy, the nature of its investment and operational risk controls, and the independence of its service providers.

The GIPS standards are ethical standards for investment performance presentation to ensure fair representation and full disclosure of investment performance. Firms that claim compliance with the GIPS standards must adhere to rules governing not only rate-of-return calculations but also the way in which returns are displayed in a performance presentation. They are required to make certain disclosures in a performance presentation; these disclosures assist prospective investors in interpreting and evaluating the reported returns. Prospective and existing clients and investors can have confidence that the information shown in a GIPS Report reflects the results of the presenting firm's past investment decisions. They are also assured that the returns are calculated and presented on a consistent basis and that they are objectively comparable for a given strategy to those reported by other firms claiming compliance with the GIPS standards.

The 2020 Edition of the GIPS Standards has three chapters:

GIPS Standards for Firms

GIPS Standards for Asset Owners

GIPS Standards for Verifiers

Organizations that compete for investment management business must comply with the GIPS Standards for Firms, which is divided into the following eight sections:

1. Fundamentals of Compliance
2. Input Data and Calculation Methodology
3. Composite and Pooled Fund Maintenance
4. Composite Time-Weighted Return Report
5. Composite Money-Weighted Return Report
6. Pooled Fund Time-Weighted Return Report
7. Pooled Fund Money-Weighted Return Report
8. GIPS Advertising Guidelines

There is also an essential glossary of defined terms as well as four useful appendices including samples of GIPS Reports, lists of composites and pooled fund descriptions, and GIPS advertisements. A **GIPS Report** is defined in the GIPS Glossary as either a GIPS Composite Report or a GIPS Pooled Fund Report.

Candidates are responsible for reading the Global Investment Performance Standards (GIPS®) for Firms 2020 in their entirety. The full text of the GIPS for Firms 2020 can be found at https://www.cfainstitute.org/-/media/documents/code/gips/2020-gips-standards-firms.ashx.

This reading supplements the GIPS standards themselves. This reading focuses on the fundamentals of compliance with the GIPS standards; composite construction, including the classification of portfolios as discretionary or non-discretionary; the requirements and recommendations of the GIPS standards with respect to presentation and reporting as well as disclosure; portability of investment results; and the benefits of independent verification.

MANAGEMENT COMMITMENT

Senior management's stated commitment to the spirit and objectives of the GIPS standards and steadfast willingness to invest the necessary time and resources are essential for a firm to achieve compliance with the GIPS standards. The implementation effort is most likely to succeed if senior management makes achieving compliance a high priority, clearly communicates the importance of the initiative throughout the firm, oversees the preparation of a comprehensive project plan, and establishes an adequate budget, with particular attention to consulting and information system requirements.

Some firms may wrongly assume that implementation of the GIPS standards involves "re-crunching" a few numbers and reformatting performance presentation tables. In fact, achieving compliance can be a complex, challenging, and potentially expensive undertaking. Simply adopting the GIPS standards as a means of passing the initial screening in request for proposal (RFP) competitions without addressing their underlying substance may lead to shortcuts that ultimately compromise the firm's application of the GIPS standards, deprive it of valuable internal benefits, and needlessly expose it to reputational and regulatory risk.

A firm must also have a high level of commitment from its compliance, investment management, operating, and marketing staff. Achieving and maintaining compliance with the GIPS standards typically involve an investment firm's portfolio accounting, market data services, information technology, portfolio management, risk-control, marketing, and compliance groups, as well as the performance measurement team. It is a complex process for investment management organizations to define and document policies, gather and validate input data, calculate rates of return, construct and maintain meaningful composites, and present investment results in accordance with the GIPS standards. Careful planning with the active participation of diverse organizational units is a critical element of the implementation project.

The GIPS standards consist of **GIPS Requirements** which *must* be followed in order for a firm to claim compliance, and **GIPS Recommendations**, which are optional but *should* be followed because they represent best practice in performance presentation. 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.

2 FUNDAMENTALS OF COMPLIANCE

Section 1 of the GIPS Standards for Firms outlines the fundamentals of compliance with the GIPS standards. There are 39 required provisions in Section 1 covering issues including the following:

1. Properly defining the firm
2. Providing GIPS Reports to all prospective clients and prospective pooled fund investors
3. Correcting errors in GIPS Reports
4. Use of time-weighted and money-weighted rates of return in GIPS Reports
5. Creating and maintaining policies and procedures to support the firm's claim of compliance
6. Adhering to applicable laws and regulations
7. Ensuring that information presented is not false or misleading
8. Benchmark selection
9. Linking of theoretical and actual performance
10. Portability of returns from one firm to another

The GIPS standards are the authoritative source for candidates and provide official explanations for each section. Several of these provisions are elaborated on in the following sections.

2.1 Defining the Firm and Calculating Total Firm Assets

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 must be applied on a firm-wide basis; firms cannot claim to be in compliance with the GIPS standards with regard to only certain asset classes, investment strategies, products, or pooled funds that they manage. A firm cannot claim compliance with the GIPS standards until it meets the applicable requirements of the GIPS standards for a least a five-year period or since inception of the firm if the firm has been in existence for less than five years.

To comply with the GIPS standards, a firm must be an investment firm, subsidiary, or division *held out to clients or potential clients as a distinct business entity*. The GIPS Glossary defines a **distinct business entity** as a "unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices and that retains discretion over the assets it manages and that should have autonomy over the investment decision-making process." Possible criteria for identifying a distinct business entity are the organization being a legal entity, having a distinct market or client type, or using a separate and distinct investment process.

An investment organization might include multiple GIPS-defined firms if these defined firms are genuinely distinct business entities, such as a private client unit and a hedge fund division of a larger firm. Even two entities within the same parent company offering substantially similar investment products but in separate geographic jurisdictions might be considered distinct business entities. The GIPS standards encourage the broadest, most meaningful definition of the firm. The scope of this meaningful definition should include all geographical (country, regional, etc.) offices operating under the same brand name, regardless of the actual name of the investment management firm.

The way in which the investment management organization is held out to the public is a key factor in defining the firm. For example, if a unit of a larger company specializes in providing investment management services to private clients and is marketed as a specialist in meeting the investment needs of high-net-worth individuals and family offices, then that organizational unit might qualify as a "firm" for the purpose of compliance with the GIPS standards. The unit's entitlement to be considered a firm under the GIPS standards could be further justified if it additionally were incorporated as a subsidiary and had its own dedicated financial analysts, portfolio managers, and traders located in a separate building or area of the company and reporting through a separate chain of command to the parent organization's senior management.

DEFINING THE FIRM

For small investment management boutiques, defining the firm may be a relatively easy task, but it can prove challenging for large firms or subsidiary companies.

Consider the case of a regional bank whose asset management department consists of two separate and distinct divisions, the private client division and the institutional division. The private client division, called Eastern National Bank Private Client Services, offers investment management to private individuals and families. The institutional division, called Eastern Institutional Asset Advisers, serves tax-exempt non-profit organizations, including pension funds and charitable foundations; it does not solicit or handle non-institutional business. Each division has its own investment management team, traders, marketing department, administrative personnel, and accounting department. After a few years of operating in this manner, the institutional division decides to achieve compliance with the GIPS standards, but the private client division makes a business decision not to implement the GIPS standards. The institutional division may nonetheless be in position to become GIPS compliant because it holds itself out to customers as a distinct business unit, with its own autonomous investment management, research, trading, and administrative team.

Based on the information provided, the institutional division appears to satisfy the conditions for defining itself as a firm for the purpose of compliance with the GIPS standards. Sample language might be, "The firm is defined as Eastern Institutional Asset Advisers, the institutional asset management division of Eastern National Bank."

However, if both divisions were to use the same investment process, approved security list, style models, and so on, were not held out to the public as separate business entities, and merely divided assets between private and institutional portfolios, then neither division alone could compellingly claim compliance. If the senior investment personnel of the private client division had authority to dictate the institutional division's investment strategy or tactical asset allocations or to mandate the investment of institutional clients' funds in specific securities, then the institutional division would likely not qualify as a distinct business unit having autonomy over the investment decision-making process and discretion over the assets it manages. If the two divisions were organizationally segregated but shared the same trading desk, the institutional division would have to determine whether its decision-making autonomy is compromised by the trading arrangement; if the traders merely fill the portfolio manager's orders, then the institutional division arguably remains autonomous, but if the traders actively participate in the identification of misvalued securities, a greater impediment to the autonomy argument would exist.

Defining the firm in such a situation calls for the scrupulous exercise of professional judgment, with due attention to the ethical objectives of the Global Investment Performance Standards.

In view of the complexity of modern organizational structures, it may require judgment to determine whether a given unit properly meets the definition of a firm. This decision has immediate and lasting practical consequences. Because the GIPS standards apply firm-wide, the definition of the firm will determine the extent of the initial implementation and ongoing compliance activities. It also establishes the boundaries for determining total firm assets. The phrase **total firm assets** refers to the aggregate fair value of all assets (whether or not discretionary or fee-paying) for which a defined firm has investment management responsibility. Firms must be sure that assets are not double-counted (e.g., for a portfolio that is attached to more than one composite) because counting assets more than once would not fairly represent total firm assets. Total firm assets include assets managed by subadvisers that the firm has authority to select but must not include **advisory-only assets**, uncalled **committed capital**, or overlay exposure.

The GIPS Glossary defines advisory-only assets as assets for which the firm provides investment recommendations but has no control over implementation of investment decisions and no trading authority. There is an important distinction between advisory-only assets, which are excluded from total firm assets, and non-discretionary portfolio assets, which are included. In the case of advisory-only assets, the firm has no direct authority to manage or trade the account. In the case of non-discretionary assets, firms are unable to fully implement the intended investment strategy.

If a firm wishes to report firm-wide advisory-only assets, it may present a separate value or, in addition to total firm assets, a combination of total firm assets and firm-wide advisory-only assets.

Committed capital is defined in the GIPS Glossary as pledges of capital to an investment vehicle by investors (limited partners and the general partner) or the firm. Committed capital is typically drawn down over a period of time. Uncalled committed capital is the amount of committed capital that has yet to be drawn into the investment vehicle.

If a firm wishes to report firm-wide uncalled committed capital, it may present it as a separate value or present a combination of total firm assets and firm-wide uncalled committed capital as a supplement to the required disclosure of total firm assets.

Firms may wish to provide firm-wide overlay exposure, and for overlay strategy composites, the firm is not required to report total firm assets and may instead report firm-wide overlay exposure.

2.2 Providing a GIPS Report to Prospective Clients and Investors

Firms must "make every reasonable effort" to provide a GIPS Report to all prospective clients and to all *limited distribution* pooled fund prospective investors. The GIPS Glossary defines a **prospective client** as any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. The GIPS Glossary defines a **prospective investor** as any person or entity that has expressed interest in one of the firm's pooled funds and qualifies to invest in the pooled fund. Existing clients and investors may also qualify as prospective clients and investors for any strategy that is different from their current investment strategy or pooled fund. Investment consultants and other third parties are included as prospective clients and investors if they represent individuals or entities that qualify as prospective clients or investors.

A GIPS Report is either a GIPS Pooled Fund Report or a GIPS Composite Report. A GIPS Composite Report may be provided to the prospective investor if the pooled fund is included in the composite. The requirement to make every reasonable effort to provide a GIPS Report is met if a prospective client or investor has received a GIPS Report within the previous 12 months. The GIPS standards differentiate between broad distribution and limited distribution pooled funds. The GIPS Glossary defines a **broad distribution pooled fund** as a pooled fund that is regulated under a framework that would permit the general public to purchase or hold the pooled fund's shares and is not exclusively offered in one-on-one presentations. In most jurisdictions, broad distribution pooled funds are well regulated. Because of both the complexity and diversity of laws and regulations applying to broad distribution pooled funds, which typically specify what must be included in the materials for these funds, as well as what must not be included, it is not required that a GIPS Report be provided to broad distribution prospective investors. If a firm wishes to provide a GIPS Pooled Fund Report or GIPS Composite Report that includes the broad distribution pooled fund to a broad distribution pooled fund prospective investor, however, it may do so.

The GIPS standards consider any pooled fund that is not a broad distribution pooled fund to be a **limited distribution pooled fund**.

The GIPS standards require that firms comply with all applicable laws and regulations regarding the calculation and presentation of performance, irrespective of whether the performance is presented in a GIPS Report or a report mandated by the laws of the jurisdiction. In the rare cases when laws and regulations conflict with the GIPS standards, firms are required to comply with the laws and regulations and disclose the manner in which the laws or regulations conflict with the GIPS standards. The GIPS standards also require firms to create policies and procedures to monitor and identify changes in and additions to laws and regulations regarding the calculation and presentation of performance.

Firms must also provide a list of composite descriptions to any prospective client asking for such information, and they must provide upon request a compliant presentation for any composite listed. Discontinued composites must remain on the list for at least five years after their termination date. Firms must also provide a complete list of pooled fund descriptions for limited distribution funds to any limited distribution pooled fund prospective investor that makes such a request, although the list need only include funds for which the prospective investor is eligible. The availability of these lists is intended to discourage firms from cherry-picking strategies to present to prospective clients and investors. Firms must also provide a complete list of broad distribution pooled fund names to any prospective investor upon request. Although this list is not required to include broad distribution pooled fund descriptions, a firm must provide a description of a specific broad distribution pooled fund to any broad distribution pooled fund investor who makes such a request.

2.3 Correcting Errors in GIPS Reports

Firms must correct material errors in GIPS Reports and provide the corrected GIPS Report to the current verifier, any former verifier, and current clients and investors that received the erroneous GIPS Report and make every reasonable effort to provide the corrected GIPS Report to all current prospective clients and investors that received the erroneous GIPS Report. The firm is not required to provide the corrected GIPS Report to former clients, former investors, former prospective clients, or former prospective investors. Material errors may also apply to benchmarks (whether or not the error was caused by the firm), incorrect or missing disclosures, and other requirements.

A firm that has been defined for the purposes of the GIPS standards may very well undergo subsequent changes in its corporate structure or organizational design. However, changes in a firm's organization are not permitted to lead to alteration of historical composite results. In fact, apart from correcting errors, historical composite results may not be altered.

2.4 Use of Time-Weighted and Money-Weighted Returns

Firms must present **time-weighted returns** unless certain criteria are met, in which case the firm may present **money-weighted returns**. The GIPS Glossary defines a time-weighted return as a method of calculating period-by-period returns that reflects the change in value and negates the effects of external cash flows. The GIPS Glossary defines a money-weighted return as the return for a period that reflects the change in value and the timing and size of external cash flows. Firms may present money-weighted returns only if (1) the firm has control over the external cash flows of the portfolios in the composite or the pooled fund *and* either (2a) the portfolio is a closed-end, fixed-life, or fixed-commitment portfolio *or* (2b) illiquid investments are a significant part of the investment strategy.

Time-weighted returns are intended to neutralize the timing impact of external cash flows and allow fair comparison of performance track records of managers with different cash flow experience. Fair comparison of investment management performance is the core of the GIPS standards; however, the GIPS standards recognize that time-weighted returns are not appropriate for all circumstances, in particular for illiquid assets, such as private equity, infrastructure, and real estate, and for specific fund structures, such as closed-end, fixed-life, and fixed-commitment funds for which the presentation of money-weighted returns remains dominant. It should be noted that control of external cash flows is a necessary condition to use money-weighed rates of return, but this alone is not sufficient; the portfolio must also meet one of the other requirements specified by the GIPS standards. Slightly different reporting requirements apply to GIPS Reports using money-weighted returns.

2.5 Maintaining Policies and Procedures

Firms must document the policies and procedures used in establishing and maintaining compliance with the GIPS standards. Those policies and procedures must be applied consistently. Completing and updating the firm's documentation of performance-related policies and procedures may prove to be one of the biggest contributions the GIPS implementation effort makes to effective operations management. Because preparing proper documentation is typically treated as less urgent than other business matters, it is not uncommon for refinements in policies and processes to be documented only in emails and memoranda. If these changes are not integrated into manuals or handbooks, over time, the existing documentation can become inadequate or inaccurate. Implementing the GIPS standards may help managers assemble resources and allocate time to upgrading their existing documentation. Often the effort to document longstanding policies and procedures leads to actions taken that improve internal controls and achieve operational efficiencies.

2.6 False or Misleading Performance Information

Firms must not present performance or performance-related information that is false or misleading. Showing a return calculation with a known uncorrected, material error is an example of providing false performance information, as is a presentation that implies that theoretical returns are based on actual asset performance. Showing total return portfolio performance against a price-only benchmark would be misleading. The "false or misleading" requirement is not limited to materials that reference the GIPS standards. However, the GIPS standards do allow a firm to provide any performance information specifically requested by an existing or prospective client or investor, even if the presentation of that information may be in conflict with the GIPS standards. Such information may be provided only in a one-on-one presentation to the prospective client or investor who made the request.

2.7 Claiming Compliance with the GIPS Standards

A firm cannot represent that it is in compliance with the GIPS standards using "except for" or other such language or make any other statements that might indicate partial compliance: No exceptions to the GIPS standards are permitted. Moreover, statements characterizing the calculation methodology used in a composite presentation as being in accordance with, in compliance with, or consistent with the GIPS standards or similar statements are prohibited.

Statements referring to the performance of a current portfolio as being "calculated in accordance with the Global Investment Performance Standards" are also prohibited except when a GIPS-compliant firm reports the performance of a segregated account to current clients or a pooled fund to current investors.

The GIPS standards represent more than just return calculations. They are ethical standards designed to ensure fair representation and full disclosure, and they rely on the integrity of input data; correctly developed, consistently applied policies and procedures; and appropriate presentation of performance.

A firm must notify CFA Institute of its claim of compliance by submitting the **GIPS Compliance Notification Form**. This form must be filed when the firm initially claims compliance with the GIPS standards, must be updated annually with information as of the most recent 31 December, and must be filed annually by 30 June.

2.8 Recommendations vs. Requirements

Recall that the GIPS standards consist of requirements, which must be followed without exception in order for a firm to claim compliance, and recommendations, which are optional but represent best practice in performance presentation. Firms should comply with the recommendations of the GIPS standards through such actions as updating GIPS Reports quarterly, being verified, and providing a GIPS Report to each current client on an annual basis. The GIPS Glossary uses the word "must" to describe a provision, task, or action that is mandatory or required to be followed or performed. The GIPS Glossary uses the word "should" to describe a provision, task, or action that is recommended to be followed or performed and is considered best practice but is not required.

EXAMPLE 1

Fundamentals of Compliance

1 With regard to the definition of the firm, the GIPS standards:
   - **A** recommend the broadest, most meaningful definition of the firm.
   - **B** require each regional office making investment decisions to be separately defined.
   - **C** do not allow multiple firm definitions within a single investment organization.

2 The GIPS standards:
   - **A** do not allow GIPS-compliant firms to state that any return calculation is in accordance with the GIPS standards.
   - **B** allow GIPS-compliant firms to state that the composite calculation methodology of any composite is in accordance with the GIPS standards.
   - **C** allow GIPS-compliant firms to state that any return calculation of a segregated account presented to a current client is calculated in accordance with the GIPS standards.

3 According to the GIPS standards, firms may present money-weighted returns if:
   - **A** the manager has control of external cash flows.
   - **B** illiquid investments represent a significant part of the investment strategy.
   - **C** the manager has control of external cash flows and illiquid investments represent a significant part of the investment strategy.

Solution to 1

A is correct. The GIPS standards encourage the broadest, most meaningful definition of the firm.

B is incorrect. The GIPS standards encourage the broadest, most meaningful definition of the firm and do not *require* each regional office making investment decisions to be separately defined.

C is incorrect. The GIPS standards do allow multiple GIPS firms within a single investment organization if they are distinct business entities.

Solution to 2:

C is correct. The GIPS standards allow firms to state that the performance of a current client or pooled fund investor is in accordance with the GIPS standards when presented to that current client.

A is incorrect because firms are allowed to state that the performance is in accordance with GIPS when reporting performance of a segregated account to current clients.

B is incorrect because GIPS-compliant firms are not allowed to say the composite calculation methodology of any composite is in accordance with the GIPS standards. Statements that indicate partial compliance are not allowed.

Solution to 3:

C is correct. Firms may present money-weighted returns if they have control of external cash flows and have at least one of four characteristics, one of which is that the fund includes illiquid investments as a significant part of the investment strategy.

A is incorrect. Control of external cash flows is necessary but not sufficient on its own to justify the use of money-weighted returns.

B is incorrect. Firms must have control of external cash flows; illiquid assets alone are not sufficient to justify the use of money-weighted returns.

DISCRETION

3

The firm's definition of discretion is based on its freedom to implement its investment strategies. A portfolio is discretionary if the firm is able to implement the intended investment strategy. For example, the manager of a fully discretionary domestic mid-cap value portfolio is free to purchase any stock issued in the investor's home country that meets the pertinent market capitalization and style criteria. The firm might define mid-cap stocks as those whose market capitalization falls within a certain range. Similarly, the firm might define value stocks in terms of their price-to-earnings multiple, price-to-book ratio, or dividend yield or other characteristics intended to distinguish them from growth stocks. In line with best practice, the firm and the client will agree in advance that the portfolio's investment objective is to outperform a specified benchmark that is an appropriate measure of success in the domestic mid-cap market. For instance, the firm might construct a custom benchmark that is acceptable to the client, or the firm and the client might agree to use a commercially available index that mirrors the domestic mid-cap market.

If the client imposes restrictions on the firm's freedom to make investment decisions to buy, hold, and sell securities or requires approval to be sought before initiating a transaction in the course of implementing the investment strategy, then the firm must consider whether the portfolio is, in fact, discretionary. In general, restrictions that impede the investment process to such an extent that the strategy cannot be implemented as intended may be presumed to render the portfolio non-discretionary.

Investors commonly set forth investment restrictions in investment policy statements (IPSs). In addition to articulating the investor's overall financial objectives, an IPS normally expresses a number of constraints intended to limit the investment risks to which the assets are exposed. For example, the IPS may limit an individual equity portfolio's economic sector exposure to a certain percentage of portfolio assets or a certain relationship to the comparable benchmark weight: "No portfolio shall hold more than 15% of assets or 125% of the corresponding benchmark weight, whichever is greater, in any given sector, such as consumer discretionary stocks or information technology stocks." A fixed-income portfolio may be constrained to hold no securities rated below investment grade and to maintain the portfolio's weighted-average duration within a specified range, such as 75%–125% of the benchmark duration.

These client-mandated restrictions are generally intended to shield the portfolio from losses that might arise from inadequate sector diversification, excessive credit quality risk, or unacceptable levels of interest rate risk. Investors must be careful to formulate constraints that achieve their intended risk-control objectives without unduly impairing the portfolio managers' ability to act on their professional judgment regarding the relative attractiveness of sectors and securities. In other words, a well-written IPS meets the client's need for risk mitigation while respecting the portfolio manager's discretion. The firm should discuss with the client any restrictions that are incompatible with the intended investment strategy. Upon accepting the investment management assignment, however, the portfolio manager is ethically (and perhaps legally) bound by the client's stated policies.

In some cases, the client's investment constraints may inhibit the portfolio manager's flexibility. A personal investor might prohibit investment in securities issued by companies operating in industries he or she considers socially unacceptable, such as alcohol, tobacco, or gaming. A corporate client might prohibit the sale of company stock, or a foundation might similarly ban the sale of "sentimental holdings," securities issued by the company in which its founder made a fortune. Additionally, legal restrictions may apply. For instance, a public fund might be statutorily precluded from investing in non-domestic securities. None of these constraints automatically renders a portfolio non-discretionary. Rather, in these and other cases, the portfolio managers must determine whether these restrictions materially affect the manager's ability to execute the composite strategy. In some cases where there are multiple portfolios with similar constraints (such as the prohibition of alcohol, tobacco, or gaming stocks cited previously), it may be appropriate to classify a portfolio as discretionary and include it in a composite with other, similarly constrained portfolios.

Recognizing that degrees of discretion exist, the firm must consider the interactions among client-directed constraints, the portfolio's strategy or style, and the investment process, notably including the financial instruments used. For example, a client's investment policy might prohibit the use of derivative securities, such as futures, swaps, and options. In this case, the firm must consider whether the restriction is pertinent. To take up the example of the domestic mid-cap stock portfolio again, the fact that the client prohibits the use of derivatives may be irrelevant if the manager simply buys, holds, and sells common stocks. If the use of derivative securities is central to the firm's implementation of the investment mandate, however, then the client's policy may render the portfolio non-discretionary.

In some cases, the pattern of external cash flows might make a portfolio non-discretionary. For example, if a client frequently makes large withdrawals, perhaps on a regular schedule, the portfolio managers might have to maintain such a high level of liquidity that they cannot truly implement the investment strategy as they do for other portfolios with a similar stated investment mandate, objective, or strategy.

The firm's definition of discretion establishes criteria by which the firm determines which portfolios must be included in a composite. If an actual, fee-paying segregated account is discretionary, it must be included in at least one composite; if it is not discretionary, it must not be included in any composite. What is discretionary to one firm might be non-discretionary to another. Likewise, what is considered discretionary to the client might be considered non-discretionary to the firm and vice versa. The firm must make the determination of discretionary status consistent with its definition of discretion. This determination must be documented and consistently applied over time.

EXAMPLE 2 DISCRETION

1 According to the GIPS standards, discretion is determined by the:

- **A** firm.
- **B** client.
- **C** GIPS standards.

2 A firm defines discretion as the ability to implement its investment strategy for each portfolio in full. According to the GIPS standards, which of the following situations is *most likely* to be considered non-discretionary for this firm?

- **A** Client A disallows the use of derivatives in its portfolios.
- **B** Client B does not allow investment in "sin" stocks, such as alcohol, gambling, and armament companies.
- **C** For Client C, the firm must request and receive approval for each trade in the portfolio (no request has been declined within the last year).

Solution to 1

A is correct. Discretion is defined and determined by the firm; the firm must have a clear written definition of discretion.

B is incorrect. Discretion is defined and determined by the firm. On the one hand, the client might consider a heavily restricted strategy as discretionary, whereas the firm might determine that the restrictions are so severe that, in effect, the strategy is non-discretionary. On the other hand, legally, a relationship might technically be non-discretionary; however, the firm might determine that it has sufficient flexibility to implement its investment strategy to classify it as discretionary.

C is incorrect. There is no universal definition of discretion; each firm must establish its own definition of discretion. What is discretionary to one firm may not be to another.

Solution to 2

C is correct. Requiring approval for each trade is *most likely* to be considered non-discretionary. The firm cannot implement its investment strategy in full if approval for certain trades are declined. The fact that no approval has been declined in the last year does not necessarily result in discretion unless the firm can demonstrate that the approval is simply a technical process in which approval is automatically given.

A is incorrect. Disallowing the use of derivatives is not *most likely* to cause a loss of discretion in situations where an asset manager does not use derivatives or there exists composite definitions that reflect this restriction on derivative instruments.

B is incorrect. Restrictions on holding certain types or classes of stocks do not normally indicate a lack of discretion, particularly if the composite strategy reflects this restriction or the asset manager's benchmark also reflects this restriction.

4

COMPOSITE CONSTRUCTION

A composite is an aggregation of one or more **portfolios** managed according to a similar investment mandate, objective, or strategy. The GIPS Glossary defines a portfolio as an individually managed group of investments. A portfolio may be a **segregated account** or a **pooled fund**. The GIPS Glossary defines a segregated account as a portfolio owned by a single client and a pooled fund as a fund whose ownership interests may be held by more than one investor. The composite return is the asset-weighted average of the performance of all portfolios in the composite. Creating meaningful composites is essential to the fair representation, consistency, and comparability of performance over time and among firms. Pooled funds must be included in composites if they meet a composite definition.

In order to promote fair representations of performance, the GIPS standards require firms to create and maintain composites for all strategies for which the firm manages segregated accounts or markets as a segregated account. Firms must include *all* actual fee-paying, discretionary, segregated accounts in at least one composite defined by investment mandate, objective, or strategy. Firms must maintain and make available information about all the strategies they manage using composites or pooled funds.

4.1 Creating Composites

The firm must create composites for the firm's strategies that are managed for or offered as a segregated account. The firm is not required to create a composite that includes only one or more pooled funds unless the firm offers the strategy as a segregated account. In order to prevent firms from presenting only their best-performing portfolios to prospective clients, the GIPS standards require firms to include all segregated accounts that meet certain criteria in at least one composite. The first requirement for composite construction reads, "All actual, fee-paying, discretionary segregated accounts must be included in at least one composite." It goes on to clarify that non-fee-paying portfolios may be included in a composite provided that they are discretionary and subject to the same policies and procedures as fee-paying portfolios, but non-discretionary portfolios must not be included in a firm's composites.

COMPOSITE CONSTRUCTION: PORTFOLIO DOCUMENTATION

The GIPS standards require that all data and information necessary to support all items included in a compliant presentation must be captured and maintained. At the outset of the implementation project, it is useful to develop a complete list of the firm's portfolios. The list can then be used to check that all documentation, such as investment management contracts, custody agreements, investment policy statements (IPSs), and compliance documents, are available and up to date. This exercise creates a good opportunity for managers and administrative staff to confirm that portfolios are discretionary and to verify target asset mixes, acceptable asset ranges, portfolio size, tax status, investment restrictions, and other characteristics pertinent to the portfolios' assignment to composites. It is also advisable to conduct a formal review and update of the master portfolio list annually. Doing so will help ensure that documentation is kept current and that portfolios are assigned to the correct composites, particularly if clients have modified portfolio mandates and constraints during the year. The review will also point out the need for the creation of new composites if a significant number of portfolios no longer fit the definition of existing composites or if a new investment strategy is launched.

Defining and constructing meaningful composites is a vital step toward achieving the ideal of fair representation and the goal of providing prospective clients with useful comparative information. Under the GIPS standards, composites must be defined according to investment mandate, objective, or strategy; composites must include all segregated accounts that meet the composite definition as documented in the firm's policies and procedures; and the composite description, including detailed criteria that determine the assignment of portfolios to the composite, must be made available upon request. The firm must not exclude portfolios from composites based solely on legal structure differences. Well-defined composites will be objectively representative of the firm's products and consistent with the firm's marketing strategy. It is a guiding principle of composite definition that firms are not permitted to include portfolios with different investment mandates, objectives, or strategies in the same composite.

The GIPS Glossary defines **composite definition** as detailed criteria that determine the assignment of portfolios to composites. Criteria may include but are not limited to investment mandate, style or strategy, asset class, the use of derivatives, leverage or hedging, targeted risk metrics, investment constraints or restrictions, and portfolio type (e.g., segregated account or pooled fund, taxable versus exempt).

The GIPS Glossary defines **composite description** as general information regarding the investment mandate, objective, or strategy of the composite. The composite description may be more abbreviated than the composite definition but must include all key features of the composite and must include enough information to allow a prospective client to understand the key characteristics of the composite's investment mandate, objective, or strategy, including the following:

- The material risks of the composite's strategy
- How leverage, derivatives, and short positions may be used, if they are a material part of the strategy
- If illiquid investments are a material part of the strategy

To differentiate between a composite definition and a composite description, it might be helpful to think of a composite description as focused on the description of the strategy represented by the composite. In contrast, a composite definition includes not only the composite description but also the detailed criteria that determine whether and when a portfolio is included in a composite.

Composite descriptions are disclosed in GIPS Composite Reports and on the list of composite descriptions. Composite definitions must be documented in the firm's policies and procedures.

EXAMPLE OF A COMPOSITE DESCRIPTION

Environmental, Social, and Governance (ESG) European Equity Composite

The Environment, Social, and Governance (ESG) European Equity Composite includes all segregated accounts and pooled funds that invest in European equity securities issued by companies that make a positive contribution to the environment and society through sustainable and socially responsible practices. Only securities of companies that meet our proprietary ESG score threshold are allowed. The strategy aims to provide long-term capital appreciation together with a growing income stream through investment in a portfolio of core equity holdings diversified by economic sector, industry group, and geography. Direct investments in illiquid, environmentally beneficial infrastructure projects are allowed to a maximum exposure of 10%. The strategy cannot use leverage or derivative instruments of any type. The ESG process may result in a more concentrated strategy than a fully diversified strategy. The benchmark is the XYZ European ESG Index in euros.

Further sample composite descriptions can be found in Appendix D in the GIPS Standards for Firms.

DEFINING COMPOSITES

One of the greatest challenges in implementing the GIPS standards is devising the set of composites that will most meaningfully represent the firm's products. The GIPS standards require each actual, fee-paying, discretionary segregated account to be included in at least one composite. What appears to be a straightforward exercise—defining composites and assigning portfolios to them—may prove rather difficult in practice.

A useful guideline is to build a set of composites that will accurately represent the firm's distinct investment strategies. With too few composites, a firm risks grouping diverse portfolios together into a single, overly broad composite subject to a wide dispersion of portfolio returns. With too many composites, in addition to incurring unnecessary costs, the firm runs the risk of creating narrowly defined composites that are too similar to other composites, contain too few portfolios or assets to be useful, or compromise client confidentiality.

Assuming that the implementation team has already defined the "firm" and "discretion" and compiled a master list of portfolios, the following is a commonsense strategy for reaching agreement on composite definitions.

1 Review the firm's organizational structure and investment process to see whether distinctive strategies can be readily identified. For instance, an equity adviser might have units specializing in one or more active management strategies as well as index fund construction and quantitatively driven enhanced indexing.
2 Review the firm's existing marketing materials, including, if possible, marketing materials from competitors and recently received requests for proposals (RFPs). The objective is to determine how the industry defines products similar to those the firm offers.
3 Construct a provisional framework using descriptive captions to identify possible composites.
4 Taking into consideration clients' investment policies, test how well the firm's actual, fee-paying, discretionary portfolios would fit the provisional framework. The inevitable identification of exceptions—that is, the discovery that portfolios that must be included in some composite do not really fit any composite—will lead to the redefinition of proposed composites or the creation of new composites. Several iterations may be needed.
5 Review the proposed set of composites for compliance with the GIPS standards.
6 Document the composite definitions in detail, and circulate the definitions for final review by all affected parties in the firm.

Of course, the most effective process for defining composites may differ from one firm to another in view of such variables as organizational structure, culture, and investment strategies. Nonetheless, composite definitions have lasting consequences, and it is highly desirable to have a plan for reaching consensus.

Firms may define composites on the basis of the portfolios' benchmarks, as long as the benchmarks reflect the investment strategy and the firm has no other composites with the same characteristics. This approach is particularly appropriate if the portfolios are limited to holding stocks that are held in the index.

If a firm manages portfolios with **Overlay Strategy**, the firm is required to create an overlay composite for an overlay strategy when the overlay strategy is managed separately from the underlying portfolio and the firm offers the overlay strategy as a segregated account. Firms are not required to create an overlay strategy composite when the overlay strategy is implemented as part of a broader strategy but may do so. The GIPS Glossary defines an overlay strategy as a strategy in which the management of a certain aspect of an investment strategy is carried out separately from the underlying portfolio. Overlay strategies are typically designed either to limit or maintain a specific risk exposure that is present in the underlying portfolio or to profit from a tactical view on the market by changing a portfolio's specified risk exposure.

Reporting currency must not be used as a criterion for composite definition unless it affects the investment strategy. Portfolios with different base currencies may be included in the same composite, but their assets and returns must be expressed in the same currency as the composite. A hedging strategy will most likely require establishing additional composites; for example, global equities 100% hedged to the US dollar will most likely create a return profile very different from that of global equities 100% hedged to the Swiss franc.

Finally, portfolios sharing distinctive risk–return profiles may reasonably be grouped together. For example, enhanced index funds with similar benchmark-specific targeted excess returns and tracking error tolerances might naturally be clustered in a single composite.

Fixed-income composites can likewise be meaningfully and usefully defined in many dimensions. For example, composites might conform to (1) asset classes or market segments, such as government debt, mortgage-backed securities, convertible bonds, or high-yield bonds; (2) investment strategies, such as fundamental credit analysis, sector rotation, or interest rate anticipation; or (3) investment styles, such as indexing or core-plus. In whatever way a firm chooses to define the composites representing its investment products, they must be composed of portfolios managed in accordance with similar investment strategies or objectives.

4.2 Inclusion of New and Terminating Portfolios in Composites

The GIPS standards governing composite construction require all actual portfolios that are fee-paying and discretionary to be included in at least one composite. New portfolios must be included in a composite on a timely and consistent basis after the portfolio comes under management. Firms are required to establish, document, and consistently apply a policy of including new portfolios in the appropriate composites on a timely basis. Preferably, new portfolios should be included as of the beginning of the next full performance measurement period after the firm receives the funds. For example, if a portfolio is funded on 20 May, the composite should include the new portfolio as of the beginning of June. It may take time, however, to invest the assets of a new portfolio in accordance with the desired investment strategy, particularly when the portfolio is funded in kind (that is, with securities other than cash and cash equivalents) and the portfolio has to be repositioned to align with the firm's strategy or when the securities to be purchased are relatively illiquid (e.g., in emerging markets). Accordingly, the GIPS standards give firms some discretion to determine when to add the new portfolio to a composite. In such cases, the firm must establish a policy on a composite-by-composite basis and apply it consistently to all new portfolios.

In addition to winning new business, firms routinely close portfolios for a variety of reasons, including the loss of a client relationship. Under the GIPS standards, a firm must include a terminated portfolio in the historical performance of the appropriate composite through the last full measurement period that the portfolio was under management. In many cases, the firm loses its discretion over the portfolio upon being notified of a pending termination. The client may instruct the firm to stop buying securities immediately and to commence the liquidation of holdings in preparation for an outbound cash transfer on a specified date. Alternately, the client may halt trading and transfer control of the portfolio to a transition management organization to facilitate the transfer of assets to a new firm. When the firm being terminated thus loses its discretion over the portfolio, it should include the portfolio in the composite through the last full measurement period prior to notification of termination. For example, if a firm is informed on 20 May that its management contract is being terminated effective 31 May and is instructed to stop trading immediately, then the firm should include the portfolio in its composite through 30 April. It is incumbent upon the GIPS-compliant firm to have defined and documented its policies governing the removal of terminated portfolios from composites and, of course, to apply those policies consistently.

The GIPS provisions for composite construction additionally address the issue of minimum asset levels. A firm might decide that a particular composite will not include any portfolios whose value is below a specified level because the investment strategy can be fully implemented only for portfolios above a certain size. The GIPS standards indicate that if a firm sets a minimum asset level for portfolios to be included in a composite, the firm must not include portfolios below that asset level in that composite. The same provision further states that any changes to a composite-specific minimum asset level must not be applied retroactively.

The GIPS standards also recommend that firms should not present a composite presentation to a prospective client who is known not to meet the composite's minimum asset level. It is to be presumed that the firm has sound reasons for establishing a minimum asset level for a given strategy. Accordingly, it would not be in the prospective client's best interest to be shown a compliant presentation of a composite that does not represent a strategy available to that prospective client.

4.3 Switching Portfolios between Composites

The GIPS standards also stipulate that portfolios cannot be switched from one composite to another unless documented changes in the portfolio's investment mandate, objective, or strategy or the redefinition of the composite make it appropriate. The historical performance of the portfolio must remain with the original composite. This provision is important; if the GIPS standards permitted firms to transfer portfolios from one composite to another at will, an unethical firm might identify and exploit opportunities to improve the reported performance of selected composites by repopulating them with the portfolios whose investment results were most advantageous during the measurement period.

A portfolio can be switched from one composite to another if the client revises the mandate, objective, or strategy governing the investment of portfolio assets and the guideline changes are documented. For instance, a client might decide to modify the portfolio mandate from mid-cap value to large-cap value or from domestic equity to global equity with a corresponding change in the benchmark while retaining the same investment adviser to restructure and manage the "same" portfolio in accordance with the new strategy. Or perhaps a client might decide to allow the use of previously prohibited derivative securities, triggering a change in the investment strategy and making it suitable to assign the portfolio to a composite made up of portfolios that use derivatives.

Alternatively, a portfolio can be reassigned to another composite if the original composite is redefined in such a way that the portfolio no longer fits it. For example, a composite might initially be defined broadly to cover emerging market equities, and at a later date, the strategy may be explicitly broadened to include frontier market equities. A current portfolio whose mandate prohibits investments in frontier markets would no longer be eligible for inclusion in the redefined composite. This portfolio would be eligible to be transferred to a newly created composite that specifically excludes frontier markets. The entire performance history of the portfolio may be reflected in the new composite, although its past performance must also remain with the original composite. The GIPS standards are clear that changes to a composite definition must not be applied retroactively.

4.4 Treatment of Portfolios with External Cash Flows

The GIPS standards allow firms to temporarily remove a portfolio from a composite because of a **significant cash flow**, provided a policy to do so is established in advance. The GIPS Glossary defines a significant cash flow as the level at which the firm determines that one or more client-directed external cash flows may temporarily prevent the firm from implementing the composite strategy. Basically, a significant cash flow means that for a short period, the portfolio cannot follow the composite strategy while the cash flow (in or out) is being absorbed or processed; therefore, any performance during this period is not representative of the composite strategy. However, firms should be careful: If they have a single-portfolio composite and that portfolio experiences a significant cash flow, temporarily removing that portfolio from the composite will create a hiatus or gap in the track record. Alternatively, firms may use temporary new accounts to remove the effect of a significant cash flow—again provided that an appropriate policy is established in advance. The GIPS standards recommend that temporary new accounts be used to remove the effects of a significant cash flow, but because of the technical difficulties involved in implementing temporary new accounts, in practice it is more common to temporarily remove portfolios that are affected by significant cash flows from the composite.

ADDING, REMOVING, AND SWITCHING PORTFOLIOS

GIPS-compliant firms must have written policies setting forth when portfolios may be added to or removed from composites. These policies should be composite specific. A policy statement might read as follows:All new portfolios funded with cash or securities on or before the 15th day of the month shall be added to the appropriate composite at the beginning of the following month. All new portfolios funded with cash or securities after the 15th day of the month shall be added to the appropriate composite at the beginning of the second month after funding. All portfolios shall be deemed "non-discretionary" on the date notice of termination is received and removed from the composite at the end of the month prior to notification. The historical performance of terminated portfolios shall remain in the appropriate composite.

Policies similar to the previous example allow firms a reasonable amount of time to implement the strategy without delaying inclusion of the portfolio in the appropriate composite. Each firm should develop a policy that conforms to its own investment process while meeting the GIPS standards' requirement to include portfolios in composites on a timely basis. The firm's policy for adding or removing portfolios should also include language strictly limiting the switching of portfolios from one composite to another. The following is a sample statement for a policy:Portfolios shall not be moved from one composite to another unless the composite is redefined or documented changes in the client's guidelines require restructuring the portfolio in such a way that another composite becomes more appropriate. The portfolio shall be removed from the original composite at the end of the last calendar month before the event causing the removal occurred and shall be added to the appropriate new composite at the beginning of the calendar month following the date on which the portfolio is substantially invested. The historical performance of the portfolio shall remain in the appropriate composite.

4.5 Carve-Outs

The GIPS standards describe the proper treatment of asset class segments "carved out" of multiple-strategy portfolios. The GIPS Glossary defines a **carve-out** as a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multiple-strategy portfolio managed to a broader mandate. Typically, carve-outs are used by asset managers to demonstrate a competency to manage a strategy where standalone portfolios do not exist or are low in number with a short track record but for which portions of larger portfolios do exist. An example might be German equities within a European equity mandate.

The GIPS standards state that any carve-out included in a composite must include cash and any related income. Cash may be accounted for separately (often these are described as sub-portfolios) or allocated synthetically to the carve-out on a timely and consistent basis. Carve-outs that are managed including their own cash allocation within a broader portfolio are considered to be portfolios in their own right in the context of the GIPS standards.

Crucially, the GIPS standards require that any carve-out included in a composite must be representative of a standalone portfolio managed according to that strategy. Standalone portfolios typically include some degree of cash, which is, in effect, an overweight allocation to a non-correlated asset. This allocation can have a significant impact over time. If the carve-out does not include cash, it will not suffer the "cash-drag" effect that surfaces for typical portfolios over long periods of time given generally rising markets. This is why the GIPS standards are so explicit about including cash.

There are other potential issues associated with carve-outs: It can be difficult to allocate currency hedges appropriately, allocation decisions in a broader portfolio are made in the context of a broader benchmark rather than the narrower benchmark of the carve-out, and carve-outs tend to be more concentrated with greater specific risk than standalone portfolios.

If the firm chooses to create a composite based on a carve-out from an existing strategy, the GIPS standards require the firm to consistently carve out that segment, including allocated cash, from all portfolios managed to that strategy and include those carve-outs in the composite. This can be very difficult to accomplish.

When the firm obtains standalone portfolios managed in the same strategy as the carve-outs with allocated cash, the firm must create a separate composite for the standalone portfolios that gives any prospective client access to the "true" performance of the strategy and the ability to compare the performance of the composite based on carve-outs with the performance of the composite based on standalone portfolios managed to the same strategy.

If carve-outs with allocated cash are included in the composite, the firm must include the carve-out in the composite name, disclose that the composite includes carve-outs with allocated cash, disclose the policy to allocate cash to carve-outs, present the percentage of composite assets represented by carve-outs with allocated cash as of each annual period end, and disclose that the GIPS Composite Report for the composite of standalone portfolios is available upon request if it exists. In addition, the composite returns for each annual period and the composite assets as of each annual period end for which the composite of standalone portfolio exists must be included in the GIPS Composite Report of the composite that includes carve-outs with allocated cash. Collectively, these onerous requirements and disclosures are designed to discourage the misleading use of carve-outs with allocated cash where more appropriate standalone composites are available.

4.6 Model or Simulated Performance

Firms must not link **theoretical performance** with actual performance. The GIPS Glossary defines theoretical performance as performance that is not derived from a portfolio or composite with actual assets invested in the strategy presented. In the process of developing, testing, and refining new investment strategies, firms frequently construct model portfolios and use historical security prices to simulate theoretical performance in past measurement periods. Composites cannot include simulated, backtested, hypothetical, indicative, *ex ante*, forward-looking, or model portfolios. The firm must not combine different composites, pooled funds, or carve-outs to create a simulated strategy and present it as a composite.

EXAMPLE 3 COMPOSITE CONSTRUCTION

1 According to the GIPS standards, if a pooled fund qualifies to be included in a composite of segregated accounts:

A it may be included in the composite.

B it must be included in the composite.

C it must not be included in the composite.

2 According to the GIPS standards, carve-outs:

A must be included in composites that consist only of carve-outs.

B can be included in composites only if they manage their own actual cash allocation.

C can be included in composites if they manage their own cash allocation or if cash is allocated synthetically on a timely and consistent basis.

3 According to the GIPS standards, can firms link theoretical performance with actual performance?

A No

B Yes, provided that performance consists of model portfolios using historical security prices

C Yes, provided that the theorical performance is based on the combined performance of actual composites

Solution to 1

B is correct. Pooled funds must be included in composites if they meet a composite definition.

A is incorrect. Pooled funds must be included if they meet a composite definition. Note the firm is not required to create a composite that includes only pooled funds unless the firm wishes to offer the strategy as a segregated account. In this question, segregated accounts exist; therefore, the pooled fund must be included in the composite.

C is incorrect. Pooled funds must be included if they meet a composite definition.

Solution to 2

C is correct. Carve-outs can be included in composites if cash is accounted for separately or allocated synthetically to the carve-out on a timely and consistent basis.

A is incorrect. The GIPS standards require that composites of standalone-only composites be created but do not require the creation of carve-out-only composites.

B is incorrect. Carve-outs with synthetically allocated cash are allowed.

Solution to 3

A is correct. Firms must not link theoretical performance with actual performance.

B is incorrect. Firms must not link model portfolios (theoretical performance) with actual performance.

C is incorrect. The firm must not combine different composites to create a simulated strategy. Such performance would be regarded as theoretical, which cannot be linked with actual performance.

5 PRESENTATION AND REPORTING

There are four reporting sections in the GIPS standards that detail the requirements and recommendations for reporting using the following types of returns:

- Composite time-weighted return
- Composite money-weighted return
- Pooled fund time-weighted return
- Pooled fund money-weighted return

Each of the four reporting sections is self-contained and includes requirements and recommendations relevant to that particular report. For the most part, the requirements for composite and pooled fund time-weighted returns are replicated, as are the requirements for composite and pooled fund money-weighted returns. With a few notable differences, disclosures are consistent across all four reports. Firms must include the information from the respective section depending on whether they are preparing a Composite Time-Weighted Return Report, a Composite Money-Weighted Return Report, a Pooled Fund Time-Weighted Return Report, or a Pooled Fund Money-Weighted Return Report.

After constructing the composites, gathering the input data, and calculating returns, the firm must incorporate this information along with the required disclosures in GIPS Reports based on the requirements in the GIPS standards for presenting investment performance. No finite set of requirements can cover all potential situations or anticipate future developments in industry structure, technology, products, or practices. The GIPS standards rely on the ethics and integrity of GIPS-compliant firms to determine when additional information and disclosures are called for.

5.1 Elements of the GIPS Standards Related to Presentation and Reporting

The GIPS standards contain numerous provisions for required and recommended elements of GIPS Reports. The provisions related to presentation and reporting can be found in the following sections of the GIPS standards:

- For GIPS Composite Reports that present time-weighted returns: Sections 4A and 4B
- For GIPS Composite Reports that present money-weighted returns: Sections 5A and 5B
- For GIPS Pooled Fund Reports that present time-weighted returns: Sections 6A and 6B
- For GIPS Pooled Fund Reports that present money-weighted returns: Sections 7A and 7B

The most broadly applicable provisions are discussed in the following subsections. Unless a provision is explicitly referenced as applicable to a specific GIPS Report (e.g., Composite Time-Weighted Return Report or Composite Money-Weighted Return Report), candidates can reasonably assume that the provision is applicable to all reports.

Returns

Requirements For GIPS Composite Reports presenting time-weighted returns, the firm must present at least five years of performance (or performance since the inception date of the composite if it is less than five years old). The firm must present an additional year of performance each year building up to a minimum of 10 years of GIPS-compliant performance. An appropriate total return benchmark return for each period must be included.

Returns must be clearly labeled as gross-of-fee or net-of fee returns.

For money-weighted reports, the firm must present the annualized composite since-inception money-weighted return for the composite and for the benchmark (unless the firm determines there is no appropriate benchmark) through the most recent annual period end.

For money-weighted reports, if a **subscription line of credit** is used, the firm must present the composite since-inception money-weighted return both with and without the subscription line of credit through the most recent annual period end. The firm is not required to present returns without the subscription line of credit when the principal was repaid within 120 days using committed capital drawn down through a capital call and no principal was used to fund distributions. The GIPS Glossary defines a subscription line of credit as a loan facility that is put in place to facilitate administration when the firm is calling for funds from investors. Alternatively, it can be used in lieu of calling funds from investors. These requirements are in place to clarify any impact of leverage caused by subscription lines of credit.

Recommendations The GIPS Standards recommend that the firm should present both gross-of-fee and net-of fee returns.

For time-weighted reports, the GIPS standards recommend that firms present cumulative returns for composite or pooled funds and the benchmark for all periods, equal-weighted composite returns, quarterly and monthly returns, annualized returns for periods greater than 1 year, and more than 10 years of performance.

It is recommended that for money-weighted reports, the firm present annualized since-inception money-weighted returns as of each annual period end.

Number of portfolios, measure of dispersion and risk

Requirements For each annual period, firms must present the number of portfolios in the composite at period end provided the composite had six or more portfolios at period end. Additionally, firms must present for each annual period a measure of the **internal dispersion** of the returns of the individual portfolio within a composite if the composite contains six or more portfolios for the entire period. Because there are different ways to convey dispersion, the GIPS standards require firms to disclose which measure of internal dispersion they present. This important requirement is intended to allow prospective clients and their advisers to see how consistently the firm implemented its strategy across individual portfolios. A wide range of results should prompt the recipient of the performance presentation to inquire about possible causes of the variability of returns to portfolios that are purportedly managed in accordance with the same strategy. It may suggest, among many other possibilities, that the composite is defined too broadly to provide meaningful information. The dispersion of the annual returns of individual portfolios within a composite can be measured in various ways; measures include but are not limited to high/low, interquartile range, and the standard deviation of returns (equal or asset weighted). The GIPS Glossary defines internal dispersion as a measure of the spread of the annual returns of individual portfolios within a composite.

For time-weighted reports where monthly returns are available, the firm must present the three-year annualized *ex post* standard deviation (using monthly returns) of the composite or pooled fund and of the benchmark as of each annual period end. The rationale is to give prospective clients an indication of the risk of an investment strategy as executed by the firms under consideration. Because all GIPS-compliant performance presentations include the same risk measure and that measure is based on historical experience rather than subjective inputs, the GIPS standards allow for some degree of comparability among firms that claim compliance.

Recommendations For all periods for which an annualized *ex post* standard deviation of the composite and the benchmark are presented, the GIPS standards recommend that firms present the annualized returns of the composite and the benchmark for the same periods. If additional *ex post* risk measures are relevant, the GIPS standards recommend that these also be included.

Assets and asset valuation

Requirements The firm must present the value of total firm assets and assets in the composite as of each annual period end.

If the composite presents net-of-fees returns calculated using actual investment management fees, the percentage of composite assets as of each annual period end held by non-fee-paying portfolios must also be presented.

The firm must also present the percentage of the total fair value of composite or pooled fund assets that were valued using subjective unobservable inputs as of the most recent annual period end, if material.

Recommendations The firm should present the percentage of composite assets consisting of proprietary assets.

The firm should present the percentage of assets in the composite that were valued using preliminary, estimated values as of each annual period end.

Currency

Requirements All required and recommended information in the GIPS Report must be presented in the same currency.

Expense ratio

Requirements For pooled fund reports, the firm must present the pooled fund expense ratio appropriate to prospective investors.

Committed capital

Requirements If the firm has committed capital, the firm must not include uncalled committed capital when calculating total firm assets.

If the portfolios in the composite have committed capital, the firm must present the following as of the most recent annual period end:

- Since-inception paid-in capital
- Since-inception distributions
- Cumulative committed capital
- Total value to since-inception paid-in capital (investment multiple or TVPI)
- Since-inception distributions to since-inception paid-in capital (realization multiple or DPI)
- Since-inception paid-in capital to cumulative committed capital (PIC multiple)
- Residual value to since-inception paid-in capital (unrealized multiple or RVPI)

If the firm chooses to present the amount of uncalled committed capital (separately from the calculation of total firm assets), the firm must also present committed capital for the same periods and clearly label uncalled committed capital as such.

Recommendations If the portfolios in the composite have committed capital, the firm should present as of each annual period end the same items listed previously as required for the most recent annual period end.

Supplemental information

Requirements Any **supplemental information** included in the GIPS Report must relate directly to the composite or pooled fund, must not contradict or conflict with the required or recommended information in the GIPS Report, and must be clearly labeled as supplemental information. Supplemental information is defined in the GIPS Glossary as any performance-related information included as part of a GIPS Report that supplements or enhances the requirements and/or recommendations of the GIPS standards. Meeting the intent of the GIPS standards may necessitate including information in GIPS Reports beyond existing requirements and recommendations. Supplemental information should provide prospective clients and investors with the proper context to fully understand the performance presentation. Supplemental information does not include information that is already required or recommended or non-performance-related information that is essentially narrative describing the firm's investment process, economic conditions, and general information about the firm.

Typical supplemental information includes the following:

- Attribution analysis for the composite and portfolios within the composite
- Segment returns
- Composite or portfolio-level holdings, country weightings, and sector weightings
- Peer group rankings

5.2 Disclosures

Disclosures allow firms to elaborate on the data provided in the presentation and give the reader the proper context in which to understand the performance. To comply with the GIPS standards, firms must disclose certain information in all GIPS Reports regarding their performance and the policies adopted by the firm. Although some disclosures are required for all firms, others are specific to certain circumstances and may not be applicable in all situations. This section discusses certain major disclosures, but it is not meant to be an exhaustive description of all disclosures that may be required to comply with the GIPS standards. Firms are not required to make negative assurance disclosures.

Once a firm meets all the applicable requirements of the GIPS standards, it must appropriately use the claim of compliance to indicate compliance with the GIPS standards. The GIPS standards specify the precise wording of the claim of compliance to be used only in a GIPS Report. The wording differs depending on whether a firm has been verified and additionally examined.

The compliance statement in a GIPS Report for a firm that has been verified is as follows:

> [Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates]. The verification report(s) is (are) available upon request.

A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements 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 does not provide assurance on the accuracy of any specific performance report.

The compliance statement in a GIPS Report for a firm that has not been verified is as follows:

> [Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has not been independently verified.

The firm must not exclude any portion of the compliance statement.

The firm must also disclose the following: "GIPS is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein."

Definition of the firm

The definition of the "firm" used to determine the firm's total assets and firm-wide compliance is a required disclosure. A clear explanation of the way in which the firm is defined enables the prospective client to understand precisely which investment organization (or unit of a larger entity) is presenting results, is claiming compliance, and will be responsible for managing the client's assets if hired. If a firm is redefined, it must disclose the date and describe the redefinition. If a parent company contains multiple firms, the GIPS standards recommend that each firm within the parent company disclose a list of the other firms contained within the parent company.

Composite and pooled fund information

Firms must disclose the composite or pooled fund description and must indicate the availability, upon request, of the firm's complete list of composite descriptions, limited pooled fund descriptions, and broad distribution pooled funds. This information enables prospective clients to determine whether the GIPS Report they have been shown is the most appropriate for their needs and to request GIPS Reports of any other composites or pooled funds of interest. Recall that the list must include not only all of the firm's current composites but also any that have been discontinued within the last five years; thus, poor performance in terminated composites or unsuccessful strategy launches cannot be hidden. Discontinued pooled funds are not available for investment and do not have to be shown.

Firms must also disclose the **composite creation date**, the date on which the firm first grouped one or more portfolios to form the composite. This is not necessarily the earliest date for which composite performance is reported. This information allows the prospective client to determine whether this is a long-established strategy or perhaps one that was created recently, perhaps for the purposes of the current presentation. Firms must also disclose the **composite inception date**, which is the initial date of the composite's track record, a quite different concept from that of the composite creation date. If a firm has redefined a composite, the firm must disclose the date and description of the redefinition. Similarly, firms must disclose any changes to a composite's name.

Further requirements apply in certain cases:

- If the firm imposes a minimum asset level for a portfolio to be included in the composite, this minimum asset level must be disclosed. This information alerts prospective clients to the investment manager's assumption that the strategy cannot be implemented in smaller portfolios.
- If the firm has adopted a significant cash flow policy for a specific composite, then the firm must disclose how it defines significant cash flows for that composite and the periods to which the significant cash flow policy applies.

Valuation policy

Firms must disclose if the composite's or pooled fund's valuation hierarchy materially differs from the valuation hierarchy recommended in the GIPS standards and must present the percentage of the total fair value of composite assets that were valued using subjective unobservable inputs as of the most recent annual period end, if material. Firms must also disclose that policies for valuing portfolios, calculating returns, and preparing GIPS Reports are available upon request. To cite obvious examples, GIPS-compliant firms should be prepared to respond to prospective clients' questions about their valuation methods and sources, return calculation methodology, or treatment of large external cash flows. The GIPS standards recommend but do not require that firms disclose material changes to calculation policies and/or methodologies.

If the firm adheres to any industry valuation guidelines in addition to the GIPS valuation requirements, the firm should disclose which guidelines have been applied.

Currency

Firms must disclose the currency used to express performance.

Benchmark description

In view of their importance for evaluating performance, it is not surprising that benchmarks are subject to disclosure requirements. The GIPS Glossary defines the **benchmark description** as general information regarding the investments, structure, and characteristics of the benchmark. In a GIPS Report, firms must disclose the benchmark description, which must include the key features of the benchmark or the name of the benchmark for a readily recognized index. If returns are calculated less frequently than monthly, firms must disclose the periodicity of the benchmark. If a custom benchmark or a combination of multiple benchmarks is used, the firm must disclose the benchmark components, weights, rebalancing process, and calculation methodology and clearly label the benchmark to indicate that it is a custom benchmark. For example, a firm might construct a custom security-based benchmark composed of securities that conform to the firm's investment process and the composite's strategy. Or, as another example, a firm's balanced composite might have a blended benchmark reflecting the strategic asset mix with reference to which the portfolios are managed. The benchmark in this case might be constructed by weighting capital market indexes with desirable characteristics, such as asset class representativeness and investability.

BENCHMARK PRESENTATION

Eastern Institutional Asset Advisers presents the performance of its Global Balanced Composite. The strategic asset mix of the portfolios in the composite is 50% global equity and 50% global bonds. The composite has a blended benchmark composed of capital market indexes weighted in accordance with the strategic asset allocation. Eastern Institutional Asset Advisers includes the following disclosure in the Global Balanced Composite's performance presentation:

> The benchmark for the Global Balanced Composite is composed of 50% XYZ World Index and 50% ABC Government Bond Index. The benchmark is rebalanced monthly.

If the firm determines that no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented. If the firm changes the benchmark, the firm must disclose the date and description of the change. The GIPS standards recommend that firms disclose material differences between the composite investment mandate, objective, or strategy and the strategy represented by the benchmark. If the firm includes more than one benchmark, the firm must present and disclose all required information for all benchmarks presented. The firm must disclose if benchmark returns are net of withholding tax if this information is available. When using benchmarks that have limitations, such as peer groups, the firm should disclose these limitations. The firm must not use a price-only benchmark; it is clearly misleading to present composite and pooled fund returns against a benchmark that excludes income.

It is permissible to have more than one benchmark in a GIPS Report, but all benchmarks in the GIPS Report must adhere to the requirements applicable to benchmarks.

Fees

Numerous provisions address the topic of fees. The GIPS Glossary defines the **gross-of-fees return** as the return on investments reduced by any transaction costs and the **net-of-fees return** as the gross-of-fees return reduced by the investment management fees (including performance-based fees and carried interest).[1] Transaction costs are the costs of buying or selling investments. These costs typically take the form of brokerage commissions, exchange fees and taxes, and 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, private equity, and other private market

1 Performance-based investment management fees are typically contingent on the portfolio's exceeding a specified level of return, either an absolute return or a return relative to a benchmark. Carried interest, commonly used in private equity and real estate investing, refers to the profits allocated to general partners from the profits made by the investment vehicle.

investments, transaction costs include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and recapitalizing investments but do not include dead deal costs. Gross-of-fees returns, net-of-fees returns, or both may be presented. When presenting gross-of-fees returns, firms must disclose if they deduct any other fees in addition to transaction costs. Similarly, when presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction costs and the investment management fee and if the net-of-fees returns are net of any performance-based fees or carried interest. Also, if presenting net-of-fees returns, the firm must disclose if model or actual investment management fees are used. If model fees are used and gross-of-fees returns are not presented, the model fees used and the methodology used to calculate the model fees must be disclosed.

The firm must disclose the **fee schedule** appropriate to the prospective clients or prospective investors. As explained in the GIPS Glossary, the term "fee schedule" refers to the firm's current schedule of investment management fees or bundled fees appropriate to prospective clients or prospective investors. If the fee schedule includes performance-based fees or carried interest, the firm must disclose the performance-based fee description or carried interest description. If estimated transaction costs are used, the firm must disclose that fact, the estimated costs, and how they were determined. The firm must disclose if gross-of-fees or net-of-fees returns are used to calculate presented risk measures. If the composite contains portfolios with bundled fees, the firm should disclose the type of fees included in the bundled fee.

Leverage and derivatives

It is an important, albeit challenging, provision that firms must disclose the presence, use, and extent of leverage, derivatives, and short positions, if material. The disclosure must include a description of the frequency of use and characteristics of the instruments sufficient to identify risks. As a practical matter, it is admittedly difficult to explain in writing the use of leverage or derivative securities and the risks of their use, especially for the benefit of prospective clients or prospective investors who may not have been exposed previously to complex investment strategies. A clear explanation, however, will help prospective clients or prospective investors interpret the historical performance and evaluate the additional risk resulting from the use of leverage or derivatives.

For example, a fixed-income manager might use interest rate futures contracts as an efficient and economical means of adjusting the sensitivity of corporate bond portfolios to anticipated changes in interest rates. The firm might provide the following description of its use of derivatives: "Crystal Capital routinely uses US Treasury bond futures contracts to change the portfolios' modified duration. Because of their call features and credit risk, the corporate bonds held in the portfolio may experience price changes that do not closely match movements in the US Treasury bond futures contracts, resulting in portfolio valuations that differ from the targeted outcome."

Conflicts between the GIPS standards and laws and regulations

Firms must disclose if the presentation conforms with laws and/or regulations that conflict with the requirements of the GIPS standards. The manner in which any laws or regulations conflict with the GIPS standards must also be disclosed

Material changes

Firms are recommended to disclose material changes to valuation and calculation policies and methodologies, as well as the key assumptions used to value investments.

Significant events

Firms are required to disclose all significant events that would help a prospective client or prospective investor interpret the GIPS Report. For example, a firm must advise the prospective client or prospective investor if past results in a given strategy were achieved substantially by a portfolio manager who has since left the firm or if all key members of the research team supporting the strategy have resigned. This disclosure must be included for a minimum of one year and for as long as it is relevant to interpreting the track record.

Miscellaneous

For any performance presented for periods prior to the minimum effective compliance date that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

If the firm changes the type of return presented for the composite (e.g., changes from money-weighted returns to time-weighted returns), the firm must disclose the change and the date of change.

Firms must disclose the use of a subadviser and the periods a subadviser was used.

The firm should disclose how research costs are reflected in returns.

If a parent company contains multiple firms, each firm within the parent company should disclose a list of the other firms contained within the parent company.

Certain disclosures must be included for a minimum of one year and may subsequently be removed if the firm determines that the disclosure is no longer relevant to interpreting the track record, including the following:

- Changes to the name of the composite/pooled fund
- Retroactive benchmark change
- Correction of a material error
- Change in the type of return
- Significant events that would help a prospective client/investor interpret the GIPS report

Meeting the objectives of fair representation and full disclosure may call for providing more information than the GIPS standards minimally require. Practitioners are well advised to prepare compliance checklists to ensure that the disclosure requirements and, where feasible, the recommendations of the GIPS standards are met for the firm as a whole and for each composite or pooled fund presented.

EXAMPLE 4 DISCLOSURE, PRESENTATION, AND REPORTING.

1 According to the GIPS standards for money-weighted reports, firms must present:
   - A the annualized since-inception money-weighted return as of the most recent period end.
   - B the annualized money-weighted return for the five years as of the most recent period end.
   - C the annualized since-inception money-weighted return as of each annual period end.

2 The agreed benchmark for a particular composite strategy is price only. Can the firm include the price-only benchmark in the GIPS Report?
   - A No
   - B Yes, provided there is no total return alternative
   - C Yes, provided the benchmark is clearly labeled as price only

Solution to 1

A is correct. The GIPS standards require that firms present the annualized since-inception money-weighted return as of the most recent period end.

B is incorrect. The GIPS standards require at least five years of performance for time-weighted reports, not money-weighted reports.

C is incorrect. The GIPS standards recommend but do not require the annualized since-inception money-weighted return as of each annual period end.

Solution to 2

A is correct. The firm cannot present a price-only benchmark in a GIPS Report unless it is presented as supplemental information and in addition to a total return benchmark.

B is incorrect. The fact that there is no total return alternative does not alter the fact that total return performance compared with a price-only benchmark is misleading.

C. is incorrect. Clearly labeling the price-only benchmark does not solve the problem of providing only a price-only benchmark.

PORTABILITY

6

The "portability" of past performance is a complex and sometimes contentious subject, but the GIPS standards allow performance from a past firm to represent the historical performance of the new or acquiring firm and for that performance to be linked to the performance of the new or acquiring firm, on a specific composite or pooled fund basis, if the following requirements are met:

- substantially all the investment decision makers are employed by the new or acquiring firm;
- the decision-making process remains substantially intact and independent within the new or acquiring firm;
- the new or acquiring firm has records that document and support the reported performance; and
- there is no break in the track record.

A break may occur in a track record if an investment team transfers from one firm to another and for a period of time was not able or did not have discretion to make investment decisions. The track record of the past firm may be available with the records to support the performance—thus, it is *portable*—but the performance of the managers while at the first firm may not be linked to their performance at the new firm because of the gap or break in the track record. The performance prior to the break must be presented separately.

If a GIPS-compliant firm acquires another firm or affiliation, the firm is given one year to bring any non-compliant assets into compliance. One year might appear to be a long grace period, but portability is a complex area that frequently requires an entire year to resolve adequately.

EXAMPLE 5 PORTABILITY

1 The requirements for portability from a past firm to represent the historical performance of a new firm have been met on some but not all firm composites. The historical performance for the qualifying composites:

A may be linked to the performance of the new firm.

B must be linked to the performance of the new firm.

C must not be linked to the performance of the new firm.

2 In a friendly "lift-out" of an equity management team from one asset management firm (Silver Management, Inc.) to another (Gold Managers, Ltd.), the equity team wants to link its old track record to the new firm for specific composites only. All the investment decision makers from Silver Management, Inc., transferred, and the decision-making process remains intact and independent. The records supporting the old track record are complete and available to Gold Managers, Ltd. For a period of one month during the transfer from Silver Management, Inc., to Gold Managers, Ltd., trading was suspended and effectively non-discretionary. Can the team's old track record be linked to the new track record as desired?

A Yes

B No, because all composites managed by the equity team must be linked, not just specific composites

C No, because there must not be a break in the track record and the suspension of trading would cause a break

Solution to 1

A is correct. The GIPS standards allow linking on a qualifying composite-by-composite or qualifying pooled-fund-by-pooled-fund basis.

B is incorrect. The GIPS standards do not require linking if the portability conditions are met.

C is incorrect. The GIPS standards allow linking on a qualifying composite-by-composite or qualifying pooled-fund-by-pooled-fund basis; it does not matter that the entire past firm did not meet the conditions of portability.

Solution to 2

C is correct. The break in the track record is an issue; in all other respects, the track record is portable.

A is incorrect. The track record cannot be linked across a break in performance.

B is incorrect. The track record of specific composites can be linked, but there is no requirement to link all composite strategies of the team.

7 VERIFICATION

The GIPS standards include a separate chapter for verifiers. This chapter includes guidance that verifiers must follow when conducting verifications and performance examinations. The GIPS Glossary defines **verification** as a process by which an independent verifier conducts testing of a firm on a firm-wide basis, in accordance with the required verification procedures of the GIPS standards, and defines a **performance examination** as a process by which an independent verifier conducts testing of a specific composite or pooled fund in accordance with the required performance examination procedures of the GIPS standards. Verification and performance examinations must be performed by a qualified independent third party. Firms must understand the verifier's policies for maintaining independence and must consider the verifier's assessment of independence. Verification tests whether a firm's policies and procedures for complying with the GIPS standards related to composite and pooled fund maintenance, as well as calculation, presentation, and distribution of performance, have been, in all material respects, designed in compliance with the GIPS standards and implemented on a firm-wide basis. The minimum period for which verification can be performed is one year or since the firm's inception if less than one year.

Firms may choose to have a performance examination of a composite or pooled fund to provide additional assurance. A performance examination tests, for a specific composite, whether the firm has constructed the composite and calculated the composite performance in compliance with the GIPS standards and whether the firm has prepared and presented the GIPS Composite Report in compliance with the GIPS standards. A performance examination tests, for a specific pooled fund, whether the firm has calculated the pooled fund performance in compliance with the GIPS standards and whether the firm has prepared and presented the GIPS Pooled Fund Report in compliance with the GIPS standards. A performance examination may be performed only either concurrently with or subsequent to the completion of a verification.

Verification is intended to provide the firm and its prospective and current clients and pooled fund investors additional confidence in its claim of compliance with the GIPS standards. Verification does not ensure the accuracy of any particular composite presentation. However, in addition to making the claim of compliance on a firm-wide basis more credible, the verification process may benefit the firm in other ways: increased knowledge and expertise among the performance measurement team, consistently higher quality of performance presentations to current and prospective clients and investors, improved internal processes and procedures, improved and complete documentation, and greater confidence on the part of senior management that the firm is actually compliant. Of course, there are also the potential marketing advantages because many requests for proposals ask whether the performance presented complies with the GIPS standards and whether the firm has been independently verified. Above all, verification supports the guiding principles of fair representation and full disclosure of investment performance.

At the completion of the verification process, the firm must provide a management representation letter to the verifier confirming compliance with the GIPS standards. Based on the procedures performed, the verifier will express an opinion on whether the firm's policies and procedures for complying with the GIPS standards related to composite and pooled fund maintenance, as well as calculation, presentation, and distribution of performance, have been, in all material respects, designed in compliance with the GIPS standards and implemented on a firm-wide basis. If the verifier concludes that the firm is not in compliance, it must not issue a verification report. The firm must not state that it has been verified unless a verification report has been issued. After the verification is complete, the verifier should issue a recommendation letter to the firm describing specific findings, recommendations, and other areas for improvement arising from the verification.

The GIPS standards recommend firms undergo verification, but performance examinations are neither required nor recommended as part of the GIPS standards. Although voluntary, a majority of firms choose to be independently verified. Performance examinations, however, are less common and extremely rare outside the United States.

EXAMPLE 6 VERIFICATION

1 Independent verification:

A ensures the returns of a specific composite are accurate.

B tests, for a specific composite, whether the firm has constructed the composite and calculated the composite performance in compliance with the GIPS standards and whether the firm has prepared and presented the GIPS Composite Report in compliance with the GIPS standards.

C tests whether a firm's policies and procedures for complying with the GIPS standards related to composite and pooled fund maintenance, as well as calculation, presentation, and distribution of performance, have been, in all material respects, designed in compliance with the GIPS standards and implemented on a firm-wide basis.

Solution

C is correct. Verification tests whether a firm's policies and procedures for complying with the GIPS standards related to composite and pooled fund maintenance, as well as calculation, presentation, and distribution of performance, have been, in all material respects, designed in compliance with the GIPS standards and implemented on a firm-wide basis.

A is incorrect. Independent verification does not ensure the returns of a specific composite are accurate.

B is incorrect. This answer describes a performance examination, not a verification.

SUMMARY

The Global Investment Performance Standards meet the need for globally accepted standards for investment management firms (asset managers) and asset owners in calculating and presenting their results to prospective clients, prospective investors, and oversight bodies. This reading has made the following points:

- The GIPS standards are ethical standards that promote fair representation and full disclosure of an investment firm's performance history.
- The GIPS standards include provisions for fundamentals of compliance, input data, calculation methodology, composite construction, reporting, presentation and disclosure, advertising guidelines, and verification requirements.
- The GIPS standards must be applied on a firm-wide basis, and a firm may claim compliance only when it has satisfied all the requirements of the GIPS standards.
- Total firm assets include discretionary and non-discretionary assets, fee-paying and non-fee-paying assets, and assets managed by sub-advisers that the firm has authority to select but must exclude advisory-only assets, uncalled committed capital, and overlay exposure.
- Firms must make every reasonable effort to provide a GIPS Report to all prospective clients and to all limited distribution pooled funds' prospective investors.
- Firms must notify CFA Institute of its claim of compliance by submitting the GIPS Compliance Notification Form.
- Firms must present time-weighted returns unless certain criteria are met, in which case the firm may present money-weighted returns. Firms may present money-weighted returns only if the firm has control over the external cash

flows of the portfolios in the composite or the pooled fund and the composite or the pooled fund has at least one of the following characteristics: closed-end, fixed-life, fixed-commitment, or illiquid investments are a significant part of the investment strategy.

- 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 strategies. There is no universal definition of discretion; each firm must document its own definition of discretion.
- A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. Creating meaningful composites is essential to the fair representation, consistency, and comparability of performance over time and among firms.
- A composite or pooled fund description is general information regarding the investment mandate, objective, or strategy of the composite or pooled fund strategy.
- Composite definition includes the composite description and detailed criteria that determine whether and when a portfolio is included in a composite.
- All actual, fee-paying, discretionary portfolios must be included in at least one composite. Portfolios are discretionary if client-imposed restrictions do not prevent the firm from implementing the intended investment strategy. Pooled funds must be included in a composite if they meet a composite definition.
- Firms must include new portfolios in composites on a timely and consistent basis. Terminated portfolios must be included in the historical performance of the appropriate composite up to the last full measurement period they were under management. A firm cannot switch portfolios from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of a composite makes it appropriate.
- The GIPS standards allow firms to remove portfolios from composites owing to a minimum asset level policy or significant cash flow policy, providing the policy was established *ex ante*.
- The GIPS standards state that any carve-out included in a composite must include cash and any related income. Cash may be accounted for separately (often these are described as sub-portfolios) or allocated synthetically to the carve-out on a timely and consistent basis.
- When a firm obtains standalone portfolios managed using the same strategy as a carve-out with allocated cash, the firm must create a separate composite for the standalone portfolios.
- If carve-outs with allocated cash are included in a composite, the firm must include the carve-outs in the composite name, disclose that the composite includes carve-outs with allocated cash, disclose the policy to allocate cash to carve-outs, present the percentage of composite assets represented by carve-outs with allocated cash as of each annual period end, and disclose that the GIPS Composite Report for the composite of standalone portfolios is available upon request if it exists. In addition, the composite returns for each annual period and the composite assets as of each annual period end for which the composite of standalone portfolios exists must be included in the GIPS Composite Report of the composite that includes carve-outs with allocated cash.
- Firms must not link theoretical performance with actual performance.
- The GIPS standards for composite presentation and reporting require for time-weighted returns that at least five years of annual compliant performance (or since-inception performance if the firm or composite has been in existence for

a shorter period) must initially be shown. The compliant performance record must then be extended each year until at least 10 years of results are presented. When money-weighted returns are presented, the annualized since-inception money-weighted return through the most recent annual period end is required.

- The GIPS standards include detailed disclosure requirements related to the firm, performance calculations, benchmarks, fees, composites, composite and pooled fund performance presentations, and other items. Additional disclosures are also recommended.
- The GIPS standards specify required items to be included in a GIPS Report presenting time-weighted returns, including composite or pooled fund and benchmark total returns for each annual period presented, the number of portfolios in the composite (if more than five) at annual period end, the amount of assets in the composite at annual period end, the amount of total firm assets at the end of each annual period, a measure of dispersion of individual portfolio returns within the composite, and the three-year annualized *ex post* standard deviation of composite and benchmark returns. Other items may be required in certain cases, and additional items are recommended.
- The GIPS standards specify required items to be included in a GIPS Report presenting money-weighted returns, including annualized composite since-inception money-weighted returns for the composite and for the benchmark (unless the firm determines there is no appropriate benchmark) through the most recent annual period end, the number of portfolios in the composite (if more than five) at annual period end, the amount of assets in the composite at annual period end, and the amount of total firm assets at the end of each annual period, and if a subscription line of credit is used, the firm must present the composite since-inception money-weighted returns both with and without the subscription line of credit through the most recent annual period end. Other items may be required in certain cases, and additional items are recommended.
- Acceptable measures of internal dispersion for composites include but are not limited to high/low, interquartile range, and standard deviation.
- If a firm uses a custom benchmark or a combination of multiple benchmarks, it must disclose the benchmark components, weights, and rebalancing process. The frequency of rebalancing can affect the reported benchmark return. Firms are not allowed to present only price-only benchmarks.
- Performance of a past firm or affiliation may be linked to or used to represent the historical performance of a new or acquiring firm if all the following requirements are met on a composite- or pooled-fund-specific basis: Substantially all the investment decision makers are employed by the new or acquiring firm, the decision-making process remains substantially intact and independent within the new or acquiring firm, the new or acquiring firm has records that document and support the performance, and there is no break in the track record.
- If a GIPS-compliant firm acquires another firm or affiliation, the firm is given one year to bring any non-compliant assets into compliance.
- Verification is a process by which an independent verifier assesses whether a firm's policies and procedures for complying with the GIPS standards related to composite and pooled fund maintenance, as well as calculation, presentation, and distribution of performance, have been, in all material respects, designed in compliance with the GIPS standards and implemented on a firm-wide basis.
- If a verifier concludes that a firm is not in compliance, it must not issue a verification report.

- The verification process may benefit a firm in terms of increased knowledge and expertise for the performance measurement team, consistently higher quality of performance presentations, improved internal processes and procedures, improved and complete documentation, greater confidence for senior management that the firm is actually compliant, and potential marketing advantages.
- Firms may choose to have a performance examination of a composite or pooled fund to provide additional assurance, provided a firm verification has also been conducted.

PRACTICE PROBLEMS

1 Which of the following firms may claim compliance with the GIPS standards?

A A two-year-old investment firm that has met all applicable requirements since its inception

B An investment firm that has met all applicable requirements for the most recent two years of its five-year existence

C A firm that presents itself publicly as a distinct business entity that provides investment recommendations to clients

2 To be in compliance with the GIPS standards, total firm assets *must* include:

A advisory-only assets.

B committed capital yet to be called.

C assets managed by sub-advisers hired by the firm.

3 Which of the following types of accounts is *most likely* to be prohibited from composite inclusion under the GIPS standards?

A Fee-paying, non-discretionary segregated accounts

B Discretionary, and non-fee-paying segregated accounts

C Pooled funds for strategies not marketed for segregated accounts

4 An existing client has requested, in writing, that her fully discretionary account be moved to a different, more aggressive strategy offered by a GIPS-compliant firm. In this case, the account:

A and its historical performance must be moved from the original strategy's composite to the new strategy's composite.

B must be moved from the original strategy's composite to the new strategy's composite, retain the historical performance in the original composite.

C must remain a constituent of the original strategy's composite, since the account is fully discretionary with an exemplary performance record.

5 In the event a discretionary portfolio experiences a cash flow deemed "significant" under the firm's significant cash flow policy, a GIPS-compliant firm:

A must use a temporary new account to remove the effect of the significant cash flow.

B must follow its existing policy and, if required, temporarily remove the portfolio from the composite.

C can suspend temporarily the significant cash flow policy and leave the portfolio in the composite if it is the composite's only constituent and where the removal of the portfolio would cause a gap in the performance record.

6 Under the GIPS standards, any client-directed restrictions on the management of a portfolio:

A must lead to a consistent discretionary versus non-discretionary classification for all of a firm's strategies.

B should cause a portfolio to be classified as non-discretionary, even if the constraint has minimal impact on the implementation of the intended strategy.

C could be material to the implementation of some strategies and immaterial to others, leading to different discretionary versus non-discretionary classifications for a firm's strategies.

7 A firm has a micro-cap equity strategy that has included only one portfolio since its inception five years ago. A new client interested in the same micro-cap strategy has a number of restrictions in his investment policy statement that the portfolio manager has determined will materially affect the manager's ability to execute the composite strategy. A GIPS-compliant firm must classify the new portfolio as:

A discretionary and include it in the existing composite.

B non-discretionary and exclude it from all firm composites.

C as either non-discretionary or discretionary and include it in a new micro-cap equity composite that reflect the client's restrictions.

8 Which of the following composite returns *must* be presented in a Composite Time-Weighted Return Report?

A Annual returns

B Net-of-fee returns

C Gross-of-fee returns

9 Which of the following items *may* be presented on a Pooled Fund Money-Weighted Return Report and labeled as supplemental information?

A Fund expense ratio

B Peer group rankings

C Proprietary assets as a percentage of fund assets

10 The compliance statement in a GIPS Composite Report:

A can be condensed at the discretion of the firm.

B indicates whether the firm has been independently verified or not.

C gives a report recipient assurance that the performance report is accurate.

11 In a GIPS Composite Report, firms *must* disclose:

A the historical fee schedules used to calculate net-of-fees returns.

B whether net-of-fees returns reflect the deduction of transaction costs.

C whether net-of-fees returns are based on model or actual management fees.

12 In a GIPS Report, firms *must* disclose the presence, use, and extent of any:

A significant use of leverage in the investment strategy.

B futures, options, or swaps, along with their characteristics.

C speculative short positions, excluding any hedges of long positions.

13 Which of the following is a GIPS requirement addressing the portability of an acquired firm's historical performance record to a new or acquiring firm?

A At least one of the investment decision makers is employed by the new or acquiring firm.

B The investment decision-making process remains substantially intact and independent within the new or acquiring firm.

C The new or acquiring firm has records that document and support at least 80% of the historical performance record of the acquired firm.

14 GIPS-compliant firms may have a performance examination conducted:

A on a specific pooled fund.

B in lieu of a firm-wide verification.

C by the firm's compliance department.

15 According to the GIPS standards, a firm-wide verification:

A must be performed every five years, at a minimum.

B can be performed for quarterly periods selected by the manager.

C benefits the firm by making its claim of GIPS compliance more credible.

The following information relates to Questions 16–19

Grey, Bank, & Turner (GBT) began as a multinational financial company focused on retail and commercial lending and personal investment management services for private individuals. Ten years ago, the firm created an investment management subsidiary called Palace Institutional Advisers (PIA) to provide investment management services to institutional investors. Gary Black is the director of performance at PIA and leads the project to bring PIA into compliance with the Global Investment Performance Standards (GIPS).

Black's first objective is to determine whether PIA can qualify as its own firm to comply with GIPS requirements for the definition of a firm. PIA shares an office location with GBT, offers similar investment strategies as GBT, and has a client type distinct from GBT. Frank Smith, the CEO of GBT, asks Black to include some composites managed by GBT within the PIA firm definition in order to increase the overall reported assets under management.

Next, Black identifies the accounts to include in PIA's High-Yield Bond Composite. The composite will include a qualifying account at the beginning of the first full month under management and exclude an account at the end of the last full month under management. Black identifies the accounts that meet the composite definition in Exhibit 1. The date that discretion was gained or lost is represented by the open and close dates.

Exhibit 1 High-Yield Bond Composite Account Activity

Account	Open Date	Close Date
1	18 March 2016	Still open
2	25 July 2016	13 December 2022
3	15 September 2016	Still open
4	5 December 2022	Still open

The High-Yield Bond Composite team's lead portfolio manager left the firm in June 2020. The departure of the lead portfolio manager was considered a significant event and remains relevant to the track record. The position was quickly filled with another senior member of the team.

16 Which of the following *best* supports defining PIA as a separate firm for GIPS purposes?

A Client type

B Office location

C Investment strategies

17 Implementing Smith's request to include GBT composites violates the GIPS requirements applicable to:

A PIA's proposed firm definition.

B GBT's partial claim of compliance.

C PIA's adoption of the broadest, most meaningful definition of the firm.

18 Based on Exhibit 1 and the High-Yield Bond Composite inclusion and exclusion rules, the accounts included in the December 2022 composite return are:

A Accounts 1 and 3.

B Accounts 1, 2, and 3.

C Accounts 1, 3, and 4.

19 Is PIA required to disclose the departure of the lead portfolio manager in the High-Yield Bond Composite disclosures?

A Yes

B No, because the lead portfolio manager departed over one year ago

C No, because disclosure for significant events is recommended, not required

The following information relates to Questions 20–23

Radford Street Capital is an investment management firm specializing in equity investments. The firm has one strategy, the US All-Cap Equity Strategy. Radford Street Capital has been in operation and serving retail clients for five years as of 31 December 2022 and is composed of an investment team that previously managed the same strategy at another firm, Delta One Capital.

The team has managed the strategy for a combined total of 9.5 years. All staff involved in managing the strategy at the prior firm moved to Radford Street Capital at its inception and took, with the permission of Delta One Capital, all records that document and support the performance. The decision-making process has remained intact from inception, and there was no break in performance.

In December 2021, Radford Street Capital created an institutional division to offer the same US All-Cap Equity Strategy managed by the investment team. The retail and the institutional divisions are together held out to the public as a single business entity. The institutional composite is made up of a single non-fee-paying account fully funded with the firm's own capital. A material portion of the composite assets at period end are valued using subjective, unobservable inputs. Because of different client characteristics, Radford Street Capital decided to publish two separate composites: a retail composite and an institutional composite.

Radford Street Capital's marketing department asked for a GIPS Composite Report based on the retail composite's performance presentation. The marketing department also asked the senior analyst to link the investment team's prior performance record at Delta One Capital. The senior analyst agreed and, in addition, proposed that the GIPS Composite Report be verified.

20 To comply with the GIPS standards, Radford Street Capital's current firm definition *must* include the:

A retail division only.

B institutional division only.

C retail and institutional divisions.

21 For a GIPS-compliant performance presentation, the institutional composite *must* provide:

A a measure of internal dispersion.

B returns clearly identified as gross of fees for each annual period.

C a benchmark that reflects the investment mandate, objective, or strategy of the composite.

22 For a GIPS-compliant performance presentation, Radford Street Capital's institutional composite *must* present the:

A three-year annualized *ex post* standard deviation.

B number of portfolios in the composite for all periods.

C percentage of composite assets valued by subjective, unobservable inputs.

23 Is Radford Street Capital required to link the performance record of its US All-Cap Equity Strategy from Delta One Capital to its retail composite?

A Yes

B No, because Radford Street Capital must not link these performance records

C No, because Radford Street Capital is not required but may choose to link these performance records

SOLUTIONS

1 A is correct. A firm that has met the applicable requirements since the inception of the firm may claim compliance with the GIPS standards, even if the period of compliance is shorter than five years.

B is incorrect because a firm cannot claim compliance with the GIPS standards until it meets the applicable requirements of the GIPS standards for at least a five-year period (if it has been in existence for five years).

C is incorrect because a firm claiming compliance with the GIPS standards must retain discretion over the assets it manages and should have autonomy over the investment decision-making process. In this case, the firm provides only investment recommendations.

2 C is correct. Total firm assets must include assets managed by sub-advisers selected by the firm. The total firm assets value is the aggregate fair value of all assets (whether or not discretionary or fee paying) for which a defined firm has investment management responsibility. By selecting a sub-adviser, the firm is demonstrating investment management responsibility.

A is incorrect because total firm assets must not include "advisory-only" assets. The GIPS Glossary defines advisory-only assets as assets for which the firm provides investment recommendations but has no control over implementation of investment decisions and has no trading authority.

B is incorrect because total firm assets must not include uncalled committed capital. Committed capital is defined as pledges of capital to an investment vehicle by investors (limited partners and the general partner) or the firm. Committed capital is typically drawn down over a period of time. Uncalled committed capital is the amount of committed capital that has yet to be drawn into the investment vehicle.

3 A is correct. Non-discretionary segregated accounts must not be included in a firm's composites, regardless of whether the account is fee paying.

B is incorrect because non-fee-paying portfolios may be included in a composite provided that they are discretionary and subject to the same policies and procedures as fee-paying portfolios. However, composite inclusion for non-fee-paying portfolios is not required.

C is incorrect because pooled funds must be included in a composite if the firm offers the strategy in question as a segregated account and may be included in a composite if the firm does not offer the strategy as a segregated account.

4 B is correct. The GIPS standards stipulate that portfolios cannot be switched from one composite to another unless documented changes in the portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes it appropriate. The historical performance of the portfolio must remain with the original composite.

A is incorrect because the historical performance of the portfolio must remain with the original composite after the strategy change.

C is incorrect because if the portfolio's investment strategy has changed, it would be inappropriate to leave it in the composite for the original strategy when there is a composite for the new strategy.

5 B is correct. Under the GIPS standards, firms can temporarily remove a portfolio from a composite owing to a significant cash flow, provided a policy to do so has been established in advance.

A is incorrect because the use of temporary new accounts to remove the effect of significant cash flows is an optional alternative to a significant cash flow policy that temporarily removes portfolios from composites.

C is incorrect because a firm must follow any existing significant cash flow policy each and every time it is called for. If the only portfolio in a composite experiences a significant cash flow and must be removed under the policy, the composite's performance record will have a gap.

6 C is correct. A portfolio is discretionary if the firm is able to implement the intended investment strategy. A specific client-directed constraint may be very impactful to the implementation of some strategies and irrelevant to others. The constraint should lead to a portfolio being classified as non-discretionary only if it materially affects the manager's ability to implement the intended strategy.

A is incorrect because a constraint should lead to a portfolio being classified as non-discretionary only if it materially affects the manager's ability to implement her intended strategy, which could vary for different strategies.

B is incorrect because a constraint should lead to a portfolio being classified as non-discretionary only if it materially affects the manager's ability to implement her intended strategy.

7 C is correct. Client restrictions do not automatically render a portfolio non-discretionary. The firm must determine if the restrictions materially affect the manager's ability to execute the composite strategy. A new composite could be created that reflects the client's restrictions.

A is incorrect because client restrictions significantly inhibit the manager's ability to implement the micro-cap equity strategy, so the new portfolio cannot be included in the existing composite.

B is incorrect because client restrictions do not automatically render a portfolio non-discretionary. The firm must determine if the restrictions materially affect the manager's ability to execute the composite strategy and may create a new composite that reflects the client's restrictions.

8 A is correct. For Composite Time-Weighted Return Reports, the firm must present at least five years of annual performance (or performance since the inception date of the composite if it is less than five years old). The firm must present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.

B is incorrect because net-of-fee returns may be presented but must be clearly labeled. The GIPS standards recommend that the firms present both gross-of-fee and net-of fee returns.

C is incorrect because gross-of-fee returns may be presented but must be clearly labeled. The GIPS standards recommend that the firms present both gross-of-fee and net-of fee returns.

9 B is correct. Supplemental information is performance-related information included as part of a GIPS Report that supplements or enhances the requirements or recommendations of the GIPS standards. Required or recommended information is not supplemental information. Peer group rankings are an example of typical supplemental information.

A is incorrect because presenting the pooled fund expense ratio that is appropriate to prospective investors is a GIPS requirement, so it is not supplemental information.

C is incorrect because presenting proprietary assets as a percentage of fund assets is a GIPS recommendation, so it is not supplemental information.

10 B is correct. There are two different compliance statements: one that must be used by verified firms and one that must be used by firms that have not been verified.

A is incorrect because a firm must not exclude any portion of the GIPS compliance statement.

C is incorrect because verification does not provide assurance on the accuracy of any specific performance report, and this is included in the GIPS compliance statement.

11 C is correct. If presenting net-of-fees returns, the firm must disclose whether model or actual investment management fees are used.

A is incorrect because only the firm's current fee schedule must be disclosed.

B is incorrect because all returns must reflect the deduction of transaction costs, so that does not need to be disclosed. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to transaction costs and the investment management fee and if the net-of-fees returns are net of any performance-based fees or carried interest.

12 A is correct. Firms must disclose the presence, use, and extent of leverage, if material. The disclosure must include a description of the frequency of use and characteristics of the instruments sufficient to identify risks.

B is incorrect because the presence, use, and extent of derivatives must be disclosed only if material.

C is incorrect because the presence, use, and extent of short positions must be disclosed only if material. The GIPS standards do not provide any specific measures for determining whether a short position is "material."

13 B is correct. The investment decision-making process must remain substantially intact and independent within the new or acquiring firm in order to meet the portability requirements. If the process is substantially changed at the new firm, then the performance from the past firm will not be representative of the ongoing strategy.

A is incorrect because substantially all the investment decision makers must be employed by the new or acquiring firm in order to meet the portability requirements.

C is incorrect because the new or acquiring firm must have records that document and support all the reported performance in order to meet the portability requirements.

14 A is correct. A performance examination is a process by which an independent verifier conducts testing of a specific composite or pooled fund in accordance with the required performance examination procedures of the GIPS standards.

B is incorrect because a performance examination may be performed only concurrently with or subsequent to the completion of a firm-wide verification.

C is incorrect because verification and performance examinations must be performed by a qualified independent third party. The firm's compliance department is not an independent third party.

15 C is correct. Verification is intended to provide the firm and its prospective and current clients and pooled fund investors additional confidence in the firm's claim of compliance with the GIPS standards.

A is incorrect because firm-wide verification is recommended but not required by the standards.

B is incorrect because the minimum period for which a verification can be performed is one year or since the firm's inception if less than a year.

16 A is correct: To comply with the GIPS standards, a firm must be an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business entity. Possible criteria for identifying a distinct business entity are the organization being a legal entity, having a distinct market or client type, or using a separate and distinct investment process. The fact that PIA specializes in investment management for institutional investors whereas GBT provides retail and commercial lending, as well as investment management to private individuals, gives PIA a distinct client type relative to GBT, providing support that PIA qualifies as a distinct business entity.

B is incorrect. PIA's sharing an office location with GBT does not support treating PIA as organizationally and functionally segregated from GBT. If PIA were in a separate building, operating from a different office location would further support that it qualifies as a distinct business entity.

C is incorrect. PIA implements strategies similar to those of GBT. This fact could call into question whether PIA retains autonomy over the investment management decisions of its strategies, potentially preventing PIA from qualifying as a distinct business entity.

17 A is correct. Smith asks Black to include certain composites managed by GBT into PIA's proposed firm definition. Doing so would violate PIA's proposed firm definition, which is based on PIA being a distinct business entity that provides investment management to institutional investors.

B is incorrect. PIA, not GBT, is the firm intending to claim compliance. If Smith were to request that only certain composites of GBT were to claim compliance, it would result in a partial claim of compliance, which is prohibited. In this case, however, Smith is asking Black to include certain GBT composites within PIA's firm definition.

C is incorrect. PIA is not *required* to adopt the broadest, most meaningful definition of the firm. This standard is a recommendation, not a requirement.

18 A is correct. The High-Yield Bond Composite's inclusion and exclusion rules are as follows: The composite will include qualifying portfolios at the beginning of the first full month under management and exclude accounts at the end of the last full month under management. Based on these rules, Accounts 1 and 3 will be included in the December 2022 composite return. See the table below for details.

Account	Open Date	Close Date	Include/Exclude?
1	18 March 2016	Still open	Include
2	25 July 2016	13 December 2022	Exclude, closed
3	15 September 2016	Still open	Include
4	5 December 2022	Still open	Exclude, not open for full month

B is incorrect. Account 2 was not under management for the entire month of December 2022 and, therefore, is not eligible for inclusion in the composite under the High-Yield Bond Composite's inclusion and exclusion rules.

C is incorrect. Account 4 opened on 5 December 2022 and, being not open for the first month under management, is not eligible for inclusion in the composite under the High-Yield Bond Composite's inclusion and exclusion rules.

19 A is correct. PIA must disclose all significant events that would help a prospective client interpret the GIPS report and that are still relevant. In this case, the departure of the lead portfolio manager is a significant event, and it is still relevant to interpreting the track record.

B is incorrect. The disclosure must be included for a minimum of one year and for as long as it is relevant to interpreting the track record. Although the lead portfolio manager departed over a year ago, this information is still relevant to understand the longer-term track record.

C is incorrect. Significant event disclosure is required, not recommended.

20 C is correct. To comply with the GIPS standards, the firm must be an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business entity. The retail and the institutional divisions are held out together to the public as Radford Street Capital and, therefore, must be included in Radford Street Capital's firm definition.

A is incorrect. Radford Street Capital cannot be just the retail division, because the retail and institutional divisions are held out together to the public.

B is incorrect. Radford Street Capital cannot be just the institutional division, because the retail and institutional divisions are held out together to the public.

21 C is correct. If provided, a composite or pooled fund benchmark must reflect the investment mandate, objective, or strategy of the composite. The firm may determine that no appropriate benchmark exists and, if so, must disclose why no benchmark is presented.

A is incorrect. A measure of internal dispersion is not required if the composite contains five or fewer portfolios. The institutional composite contains only one portfolio and, therefore, is not required to present a measure of internal dispersion. However, the firm is required to disclose that the internal dispersion measure is not applicable.

B is incorrect. There is no requirement to present gross returns.

22 C is correct. The firm is required to present the percentage of composite assets at period end valued by subjective, unobservable inputs, if material.

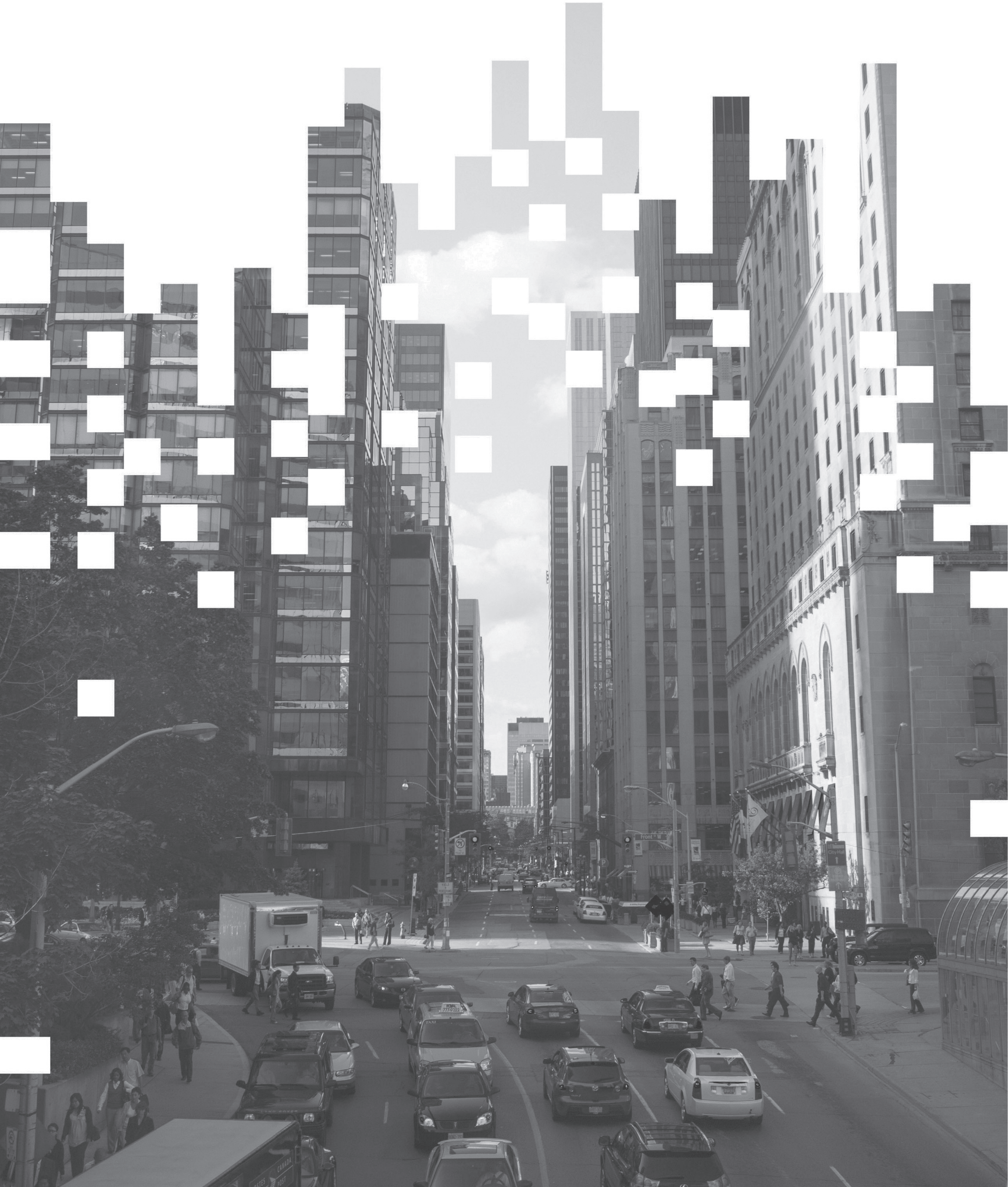
A is incorrect. The three-year *ex post* standard deviation is not required, because there is only one year of performance for the institutional composite.

B is incorrect. The GIPS standards do not require the number of portfolios to be disclosed if the composite contains five or fewer portfolios at period end. The institutional composite has only one account for all periods. However, the firm is required to disclose that the composite contains five or fewer portfolios

23 C is correct. Radford Street Capital meets all portability requirements and, therefore, may (but is not required to) link the performance of the two firms: (1) All staff involved in managing the strategy at Delta One Capital moved to Radford Street Capital at its inception, (2) the decision-making process remains intact, (3) Radford Street Capital has the necessary records that document and support the Delta One Capital performance, and (4) there is no break in performance.

A is incorrect. Radford Street Capital is not required to link performance even if all portability requirements are met.

B is incorrect. Radford Street Capital may link performance if all portability requirements are met, and in this case, they are.



Glossary

Advisory-Only Assets Assets for which the firm provides investment recommendations but has no control over implementation of investment decisions and no trading authority.

Benchmark Description Must include the key features of the benchmark or the name of the benchmark for a readily recognized index.

Broad Distribution Pooled Fund A pooled fund that is regulated under a framework that would permit the general public to purchase or hold the pooled fund's shares and is not exclusively offered in one-on-one presentations.

Carve-Out Defined in the GIPS Glossary as a portion of a portfolio that is by itself representative of a distinct investment strategy.

Committed Capital Defined in the GIPS Glossary as pledges of capital to an investment vehicle by investors (limited partners and the general partner) or the firm.

Composite Creation Date The date on which the firm first grouped one or more portfolios to form the composite.

Composite Definition Detailed criteria that determine the assignment of portfolios to composites.

Composite Description General information regarding the investment mandate, objective, or strategy of the composite.

Composite Inception Date The initial date of the composite's track record.

Distinct Business Entity A unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices and that retains discretion over the assets it manages and that should have autonomy over the investment decision-making process.

Fee Schedule Refers to the firm's current schedule of investment management fees or bundled fees appropriate to prospective clients or prospective investors.

GIPS Compliance Notification Form The form that must be filed when the firm initially claims compliance with the GIPS standards and must be updated annually.

GIPS Report A presentation for a composite or pooled fund that contains all the information required by the GIPS standards and may also include recommended information or supplemental information.

GIPS Requirements *Must* be followed in order for a firm to claim compliance.

GIPS Recommendations Are optional but *should* be followed because they represent best practice in performance presentation.

Gross-of-Fees Return The return on investments reduced by any transaction costs.

Internal Dispersion Internal dispersion of annual returns of individual portfolios within a composite can be measured in various ways, including but not limited to high/low, interquartile range, and the standard deviation of returns (equal or asset weighted).

Limited Distribution Pooled Fund Any pooled fund that is not a broad distribution pooled fund.

Money-Weighted Returns The returns for a period that reflect the change in value and the timing and size of external cash flows.

Net-of-Fees Return The gross-of-fees return reduced by the investment management fees (including performance-based fees and carried interest).

Overlay Strategy A strategy in which the management of a certain aspect of an investment strategy is carried out separately from the underlying portfolio.

Performance Examination The process by which an independent verifier conducts testing of a specific composite or pooled fund in accordance with the required performance examination procedures of the GIPS standards.

Pooled Fund A fund whose ownership interests may be held by more than one investor.

Portfolio An individually managed group of investments.

Prospective Client Any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite.

Prospective Investor Any person or entity that has expressed interest in one of the firm's pooled funds and qualifies to invest in the pooled fund.

Segregated Account A portfolio owned by a single client.

Significant Cash Flow The level at which the firm determines that one or more client-directed external cash flows may temporarily prevent the firm from implementing the composite strategy.

Subscription Line of Credit A loan facility that is put in place to facilitate administration when the firm is calling for funds from investors.

Supplemental Information Any performance-related information included as part of a GIPS Report that supplements or enhances the requirements and/or recommendations of the GIPS standards.

Theoretical Performance Performance that is not derived from a portfolio or composite with actual assets invested in the strategy presented.

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

Total Firm Assets The aggregate fair value of all assets (whether or not discretionary or fee-paying) for which a defined firm has investment management responsibility.

Verification The process by which an independent verifier conducts testing of a firm on a firm-wide basis, in accordance with the required verification procedures of the GIPS standards.