ACA
COMPLIANCE GROUP
PERFORMANCE SERVICES

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PERFORMANCE INSIGHT

Highlights from the 19th Annual GIPS® Standards Conference

The October 2015 edition of *Performance Insight* covers the 19th Annual GIPS Standards Conference. The conference was held in San Diego on September 17-18 and had record attendance, with approximately 400 attendees. The following are highlights from several sessions.

GIPS Update

Karyn D. Vincent, Chair of the GIPS Technical Committee, discussed the new firm notification requirement and current key technical projects. Please keep in mind that the discussion below includes proposed technical guidance and is subject to change prior to issuance for public comment.

Firm notification requirement:

Effective 1 January 2015, firms that claim compliance with the GIPS standards must notify CFA Institute of their claim of compliance. This notification must be completed by June 30 of each year. The only required information is the name of the firm, firm contact details, and if the firm has been verified within the past 24 months. Other questions, such as GIPS total firm assets or asset classes managed, are optional. Only the name of the firm, with a link to the firm's website, if provided, is listed on the GIPS standards website. No other firm-specific information, such as the firm's verification status, is included. Firms may also choose to not have their names listed on the website.

As of June 30, 2015, 1,572 firms had submitted the notification form. Eighty-five percent of the firms said they were verified, and 82% are listed on the website. Eighteen percent chose to not be listed.

Now that the June 30 deadline has passed, verification firms must determine that the firm has submitted this form prior to issuing a verification report. Verifiers may test by seeing that the firm is listed on the GIPS standards website. If the firm is not listed on the website the verifier must review the confirmation from CFA Institute that was provided when the form was submitted. Firms were reminded that they must have policies and procedures documented for meeting this new requirement. Several Q&As relating to the firm notification requirement will be issued in the near future.

Portability:

The Guidance Statement on Performance Record Portability provides interpretation of Provision 5.A.8, which includes the tests that must be met to port a composite track record from one firm to another. Additional guidance and clarification is needed on

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a variety of portability issues. For example, Provision 5.A.8.b says that if a firm acquires another firm or affiliation, the firm has one year to bring any non-compliant assets into compliance. What exactly needs to be done within one year? And when does the one-year clock start? To answer these and other questions the Interpretations Subcommittee undertook a lengthy process to update and enhance this guidance. The Interpretations Subcommittee has completed their redraft and the final edits are being made. The goal is to have this final draft to the Technical Committee in Q4 2015 and to have it issued for public comment in early 2016.

Supplemental Information:

The Executive Committee has had a long-standing goal to take a fresh look at the Guidance Statement on the Use of Supplemental Information, primarily because the current guidance on this topic is not consistent throughout all GIPS guidance. Supplemental Information is defined as any performance-related information included as part of a compliant presentation that supplements or enhances the required and/or recommended provisions of the GIPS standards. Supplemental Information must be clearly labeled and identified as supplemental to a particular compliant presentation. Examples of Supplemental Information include carve-out returns excluding cash, model returns (not linked to actual returns), or attribution. However, the Supplemental Information Guidance Statement says that firms are required to provide a compliant presentation prior to or accompanying any Supplemental Information. In addition, it says that firms may also include a statement that the Supplemental Information supplements the XYZ presentation previously provided. Therefore, is Supplemental Information limited to information in a compliant presentation, or can it be in information that is presented outside of a compliant presentation? The Technical Committee's view is that Supplemental Information should be limited to information that is included within a compliant presentation only. Keeping this direction in mind, the Interpretation Subcommittee has begun working on updating this guidance. This will be a longer term project.

Overlay Guidance:

An Overlay Working Group was created to provide guidance for how the GIPS standards can and should be applied to overlay composites. A key question that will be addressed is how overlay assets are treated for inclusion in composite assets and firm assets. Current guidance says that overlay assets must not be included in composite assets or firm assets. To be included in firm assets, and then composite assets, the firm must have conditional or unconditional authority to trade the assets. In many instances the firm overlays a portfolio or a notional amount that is managed by another firm. For example, in an option overwrite strategy, the overlay manager writes covered calls using an equity portfolio that may be managed by another firm. In this case, because the overlay manager does not have conditional or unconditional authority to trade the equity portfolio, the overlay manager does not include the equity portfolio's value in composite or firm assets. However, not being able to include overlay assets in composite or firm assets creates a difficult situation for those firms that primarily are overlay managers – their composite and firm assets will be very small even though they are overseeing a much greater quantity of assets. The goal is to have this new draft Guidance Statement out for public comment in the near term.

Benchmark Guidance:

The Investment Manager Subcommittee was asked to assess the need for creating guidance for the benchmark–related provisions of the GIPS standards. This Subcommittee gathered questions and topics for potential inclusion, and the list of proposed topics was presented to and approved by the Technical Committee. Potential topics include:

- Determining what is an appropriate benchmark for less traditional strategies, such as absolute return, LDI, or downside protection strategies;
- Determining what is a "widely recognized" benchmark that does not require a benchmark description;
- If more than one benchmark is presented, does one have to be identified as a primary benchmark?
- Use of net-of-tax versus gross-of-tax benchmarks.

It was agreed that a Benchmark Working Group would be created to handle this project, and volunteers for this group are currently being sought. This is a longer term project.

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Pooled Funds:

Several years ago a Pooled Funds Working Group was created to address issues related to pooled funds, including addressing this key question – what is a GIPS-compliant firm's responsibility with respect to provision 0.A.9 (firms must make every reasonable effort to provide a compliant presentation to all prospective clients) when presenting performance to a prospective investor in a broadly-distributed (e.g., retail) pooled fund? Over the past few years this Working Group has floated proposed guidance at the GIPS Standards Annual Conference and at various Executive Committee open meetings, and has received a lot of feedback. The Working Group went back to the drawing board and provided a new proposed approach to the Technical Committee. A key change is to create a new term – prospective pooled fund investor – to allow for clear differentiation between investors in a broadly-distributed pooled fund and prospective clients. Another proposed change is to call this guidance the Pooled Fund Advertising Guidelines, versus a Guidance Statement, to highlight the fact that this guidance is aimed at the presentation and reporting aspects of the GIPS standards. Unlike the current GIPS Advertising Guidelines, which a firm may voluntarily choose to follow, compliance with the Pooled Fund Advertising Guidelines would be required for those firms that manage broadly-distributed pooled funds and are responsible for the creation of the funds' official fund offering documents and marketing materials. Certain information would be required to be included in official fund offering documents, such as the KIID or the prospectus, and other fund marketing materials provided to new fund investors. In most cases, if a firm has regulations that specify certain returns for the fund and the benchmark that must be included in the fund offering documents, those returns would suffice and no additional returns would be required. Disclosures would be limited to a description of the fund's investment mandate, objective, or strategy, and a measure of the fund's risk, either numerical or narrative. Again, if regulations already require these items then no additional disclosures would be required. The goal is to issue this document for public comment by the end of the year.

Expanded Use of IRRs:

The USIPC and CIPC (the US and Canadian Country Sponsors of the GIPS standards) conducted research on the use of internal rates of return (IRRs) within the GIPS standards and the investment management industry, with the goal of expanding the use of IRRs outside of private equity and closed-end real estate funds (which must also present time-weighted returns). Currently all composites except private equity must use time-weighted returns. However, there are many private equity –like funds that are closed end for which firms wish to instead use an IRR versus a time-weighted return. Under the current guidance only private equity closed-end funds that invest in private equity, either directly or indirectly through other private equity funds, can present only IRRs. (Closed-end real estate fund composites must present both time-weighted returns and IRRs). The Technical Committee wholeheartedly supports the notion of expanding the use of IRRs. The Executive Committee will determine the next steps with this topic.

Money-Weighted Returns

Carl Bacon presented a session titled *"Money-Weighted Returns: When, Why, and What for?"* He started by pointing out that one purpose of calculating returns is for the sake of comparison. This comparison could be against a benchmark, a competitor, history, or against an expectation or forecast. With that in mind, Bacon discussed the histories and evolutions of different types of methodologies for calculating performance, including money-weighted returns (MWR), or internal rate of return (IRR), and time-weighted returns (TWR). In the absence of cash flows, the TWR will equal the MWR.

The IRR was originally developed as a MWR and used on a forward-looking basis for evaluating investment opportunities. This is an issue in performance measurement, however, as those in our field tend to look back on an ex-post basis when making comparisons. Additionally, inherent in the IRR calculation is a constant rate of return assumption, which ignores the volatility of returns. Volatility is an important consideration when measuring performance history. Bacon also discussed the use of the Dietz approximation methods. In the simple Dietz method, cash flows are assumed to occur at mid-month. In the

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modified Dietz method cash flows are day-weighted. He then introduced the TWR method in which each time period between cash flows is given equal weight irrespective of the amount invested. The classical, or "true" TWR used today values a portfolio at each cash flow (he went on to say that daily valuations would be ideal). He then went through several examples of the TWR calculation before ultimately posing the question of whether time-weighted returns or money-weighted returns should be used when measuring investment performance.

Bacon noted that a time-weighted return neutralizes the timing decision of the cash flows and is viewed as the "manager's return". He believes it is the most appropriate method when the client is responsible for the timing of cash flows. Analysts prefer it because the manager is not typically in control of cash flows and it assists in the comparison with other managers with different cash flow experiences. The money-weighted return, on the other hand, reflects the impact of the timing decision of the flows and is viewed as the "client return". It is most appropriately used when the manager is responsible for the timing of the cash flows. He believes that money-weighted returns are more widely used in venture capital, private equity, and infrastructure mainly because they cannot calculate time-weighted returns due to the valuation issues associated with these asset classes. He also believes these types of managers are comfortable with the money-weighted return because they tend to use it as a forward looking tool.

He also spoke on the disadvantages of the two methodologies. For time-weighted returns, he described sensitivity to error and more data points. There are three major disadvantages he associated with IRR. First, as mentioned above, it requires a constant return assumption which may be useful when looking forward but not helpful when measuring past performance. Next, the return cannot be disaggregated and used for attribution purposes. Finally, it destroys the concept of comparability because different managers have different cash flow experiences which can largely impact the IRR.

So when should IRR returns be used? Bacon joked that it should never be used but then followed up with a few instances where it may make sense. One is when time-weighted returns are not available. This is usually the case for private equity-type investments when investments are illiquid and valuations are not available. He also said that IRR can make sense when the time value of money is an important factor or when you have a portfolio that includes a combination of liquid and illiquid assets.

In closing, Bacon argued that time-weighted returns are essential for comparison even though the results may be counterintuitive at times. He views money-weighted rates of return as an original and out-of-date methodology with numerous technical issues that should only be used when time-weighted rates of return are not available, which are typically for illiquid assets.

Manager Selection: Observations and Lessons Learned

Jeffrey Heisler, Senior Director at TwinFocus Capital Partners, spoke about his experience with manager selection and the due diligence process. The purpose of due diligence in the manager selection process is to gain sufficient confidence that a track record is real and representative of what an investor can expect to realize. There is no single right way to perform due diligence. Heisler spoke about the importance of not just relying on the track record but really understanding all facts and circumstances to evaluate if the manager can produce the same returns in the future. Heisler highlighted several key areas to consider as part of every due diligence process.

The first step in the due diligence process is to understand the manager's philosophy and underlying process. Additionally, firm personnel must be considered to determine if the history can be repeated given the same circumstances that were present during any point in the track record. Another thing to be aware of is any bias (past, present, or future) that could impact the investment decision process. Examples of biases can be constraints on the process, or availability of certain investments or markets.

Next, the manager's experience should be reviewed. Heisler noted that not all experiences are created equal. A long-term track record in a benign market

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may be less telling than a short-term track record that experiences a significant market event. He noted that while professional tenure and firm size are important, they alone are insufficient considerations.

Heisler also spoke about the importance of on-site visits to not only confirm that the manager really exists in brick and mortar form, but also to get a feel for the firm's culture and operations. He noted there are inherent limitations with these visits as they only provide a snapshot of the manager at a point in time but, generally speaking, if you don't get a good feeling when you visit a firm, there may be something there that requires further research.

Transparency is also an important determinant in selecting a manager. When requesting information from the manager, consider whether the delivered information is meaningful, accurate, timely, and consistent. Also assess the manager's willingness to make key personnel available. Key personnel can add valuable information about how the process really works from an insider's prospective. Heisler also expressed the importance of the manager's ability and willingness to help you understand the investment philosophy and process. If the manager is not forthcoming with their investment process and how they achieved their performance track record, they may be hiding something.

Finally, consider the manager's investment in the strategy. The goal is for the manager to have a meaningful, but not too meaningful, investment in the strategy. Preferably a manager will be invested in the strategy along with client accounts and the manager's account will be treated like any other. A track record that is representative of only the manager's own personal account, however, may not provide an accurate view of what an outside investor will receive.

SEC Update

During this session Karol Pollock, the Associate Regional Director – Exams from the Los Angeles Regional Office of the US Securities and Exchange Commission, discussed current initiatives and answered common questions alongside co-panelist Jonathan Boersma, Executive Director, Global Investment Performance Standards at CFA Institute.

New Firms

Q. For newly registered firms, especially private equity firms, how does the SEC initiate that relationship?

A. The exam program at the national level is committed to being more transparent on what examiners are reviewing, which is a change from the past. The SEC will issue letters that contain relevant information to certain types of firms, such as never before examined firms, to explain exam priorities. The SEC also hosts the Compliance Outreach Program, which was formed to promote open communications and coordinate among securities regulators and the industry on mutual fund, investment adviser, and broker-dealer compliance issues. Some of these forums may be held for a specific type of firm or newly registered firms where compliance issues are discussed in a practical way and to share experiences that are relevant to that type of firm. Furthermore, the Los Angeles Regional Office maintains a list of newly registered firms in the region and will send a letter to set up an initial call. It is not an exam but the call usually lasts 1-2 hours and is used to gather information about the business and to inform the firm about exams, including what the SEC reviews, and to answer any questions.

Focus Areas

Q. Are there any recent sweeps or other areas of focus?

A. The 2015 exam priorities, published at the beginning of this year, can be found online:

http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf

This year's priorities were broken down by themes instead of by firm type. The three priority areas are:

1. Examining matters of importance to retail investors and investors saving for retirement, including whether the information, advice, products, and services being offered are consistent with applicable laws, rules, and regulations;
2. Assessing issues related to market-wide risks; and

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3. Using an evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity, such as excessive trading and penny stock pump-and-dump schemes.

   Other areas of interest noted by Pollock are alternative investments, cybersecurity, fixed income, never-before-examined firms, and real estate. More information on these areas of interest can be found in the exam priorities list.

Content Experts

Q. How does the SEC draw upon resources for specialized knowledge during an examination when one-off issues arise?

A. The Commission has made an effort to hire industry experts, called Senior Specialized Examiners (SSEs), who are mostly based in the New York and Washington, DC offices but are national resources for all examiners. The SSEs have recent industry experience and run the specialized working groups (e.g., fixed income specialized working group run by fixed income experts) who hold training workshops.

Analytical Tools

Q. How have analytical tools changed the game?

A. These tools have been a game changer. On every examiner's computer is a tool developed by the quantitative analytics unit. This allows examiners to get all of the data they are reviewing as opposed to a sample of the data. This allows the examiners to review a large volume of data, determine outliers, and focus their review on those outliers.

Performance and GIPS Standards in an Exam

Q. What do examiners review and look for?

A. Examiners spend a lot of time looking at performance presentations and consider their appearance, if performance outperformed the benchmark, and if the benchmark is reasonable. They also spend time reviewing dispersion and why dispersion may be high, which is one way to determine potential composite construction errors.

Q. How are the GIPS standards viewed?

A. Overall, examiners view the GIPS standards favorably as they are a comprehensive and evolved set of standards.

Q. Are there common deficiencies found that are related to performance or GIPS compliance?

A. There are not many issues with calculations, but often examiners find issues with the presentations of performance and sufficient disclosure.

Q. Is verification relied on by the examination staff?

A. During an examination, the staff will take verification into consideration. The examiners will still review performance and the related presentations and may determine that they can rely on the verifier's work. However, if the exam staff determines they can't rely on the verifier's work because issues are found with the presentations then they will review performance in more detail.

Deficiencies

Q. What is the nature of performance deficiencies or errors that would be in a deficiency letter and/or enforcement action?

A. Technically, anything that is a violation of the rules could go to Enforcement; however, the staff will review materiality of the issue, the motive behind the error, the response by the firm, and if the firm corrects the problem. Usually the exam process will solve or address these issues without involving the Division of Enforcement. If there are common deficiencies found by the exam staff across multiple firms, they will issue Risk Alerts that contain best practices to address the issue but also contain issues and solutions on commonly tested areas. Risk Alerts can be found on the OCIE's website under Office Resources: http://www.sec.gov/ocie

Q. What percentage of exams results in deficiency letters versus enforcement actions?

A. It changes year-to-year and may vary by regional office and by exam priorities. The exam program has moved to a broader mission where the visibility of the division has been raised for a few reasons: 1) to help identify trends and common deficiencies, 2) to help monitor risk, 3) to improve compliance programs, and 4) to contribute to fraud prevention. In the Los Angeles office, 15-18% of exams result in enforcement while nearly 90% receive a deficiency letter; however, this can differ nationally.

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Upcoming Events

ACA Performance looks forward to seeing you at the following events.

Conferences

ACA Fall Compliance Conference

October 28-30, 2015
Hyatt Regency Scottsdale Resort
& Spa at Gainey Ranch
Scottsdale, AZ

The ACA Fall Compliance Conference will include two sessions related to performance measurement and reporting.

These two sessions are:

- Performance Calculations and Reporting - Challenges for Private Fund Managers
- Performance Calculation and Reporting - Mitigating Regulatory Risk

Peer group breakout sessions will also be held, to allow attendees to discuss common challenges with fellow compliance and performance professionals.

Click here for more information or here to register.

NCREIF Fall Conference 2015

November 11-13, 2015
Walt Disney World, Swan and Dolphin Hotel
Orlando, FL

ACA Performance Partner Charlie Stout, CAIA, CIPM will be moderating a panel on performance, valuation, and accounting.

ACA Spring Compliance Conference

May 4-6, 2016
Boca Raton Resort & Club, a Waldorf Astoria Resort
Boca Raton, FL

The ACA Spring 2016 Compliance Conference will again include a performance track focused specifically on issues related to performance measurement and the GIPS standards. More information to come.

Webcasts

You can find an archive of complimentary ACA Compliance Group webcasts, including numerous webcasts devoted to performance-related topics here.

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