COMMON PRACTICES OF

GIPS®-COMPLIANT FIRMS

ACA
COMPLIANCE GROUP
PERFORMANCE SERVICES

acacompliancegroup.com/gips

Crista DesRochers, CIPM
ACA Performance Services

AUGUST 2016

TABLE OF CONTENTS

WHAT DO OTHER FIRMS DO?

INTRODUCTION

A firm that claims compliance with the Global Investment Performance Standards (GIPS®) has many decisions to make regarding the policies it uses to attain and maintain compliance with the GIPS standards. Each firm has unique circumstances that must be factored into policy selection decisions. The type of strategies a firm manages, its composite and performance calculation systems, and internal resources are just a few of the factors that should be considered for each policy decision. Many of our clients contact us when they are considering implementing a new policy or changing an existing policy. The most common question we receive from clients is, "What do other firms do?" As a result of being asked this question many times, we gathered information about the firms we verify in order to provide answers to commonly asked questions that are based on real data versus anecdotal information.

The information that follows is based on the more than 230 firms that have had at least one verification completed by ACA Performance Services as of March 31, 2016 and manage at least $1 billion in assets. The firms manage assets ranging from $1 billion to over $700 billion, and include assets of all kinds, from traditional equity and fixed income to alternative assets. All references to "firms" are to firms that claim compliance with the GIPS standards.

COMPOSITE CONSTRUCTION

A composite includes portfolios that are managed according to a specific investment mandate, objective, or strategy. Firms must establish detailed criteria for determining how portfolios are assigned to composites. A composite must include all portfolios that meet the respective composite's criteria. Firms must determine whether portfolio size, cash flow activity, or portfolio type impacts the assignment of portfolios to each composite.

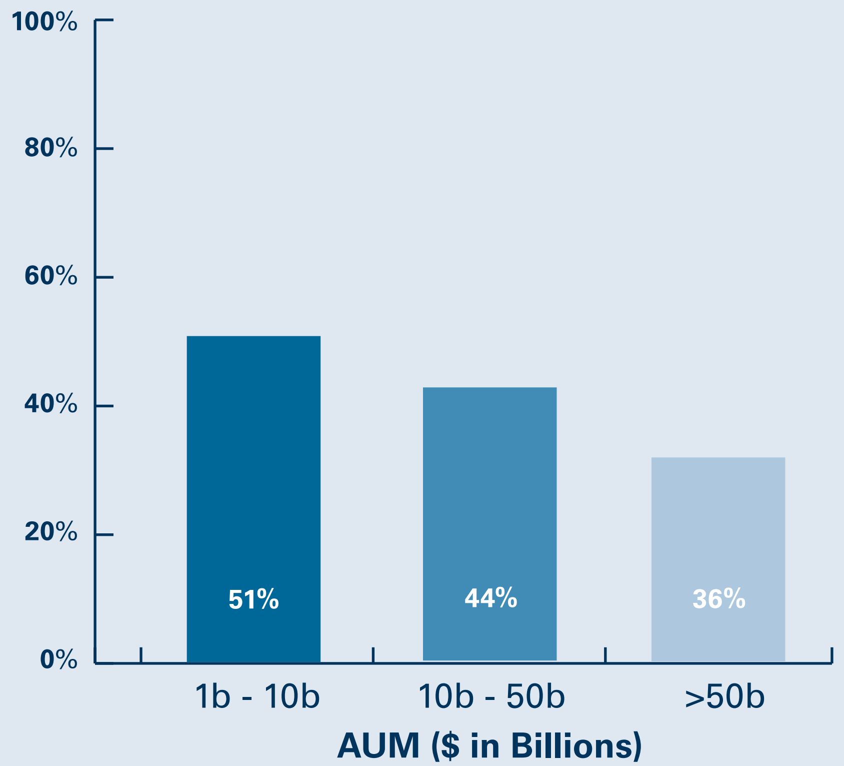
Composite Minimums

A firm may set a minimum asset level for portfolios to be included in a composite. The composite minimum is set by the firm on a composite-specific basis and must represent the minimum amount of money needed to implement the intended strategy.

By establishing a composite minimum, the firm has determined that portfolios that do not meet the composite minimum are not discretionary. If a firm establishes a composite minimum, it must be applied consistently across all portfolios for that composite. If a portfolio falls below the composite minimum, it must be removed from the composite following the firm's documented policy.

Composite minimums can help decrease noise in a composite by eliminating smaller portfolios that may not be managed the same as larger portfolios. However, composite minimums can be difficult to apply consistently and, depending on a firm's systems, can be a very manual process. Forty-seven percent of our clients have a composite minimum for at least one composite.

WHAT PERCENTAGE OF FIRMS USE COMPOSITE MINIMUMS?



Larger firms are less likely to use composite minimums. For firms over $10 billion, 59% do not have a composite minimum for any composite. Larger firms tend to manage larger portfolios and may not accept portfolios below a certain size. In addition, if composites include some very large portfolios, smaller portfolios typically do not have a material impact on the composite-level return. Firms may decide that implementing and maintaining a composite minimum provide no value for the effort required to implement a composite minimum policy.

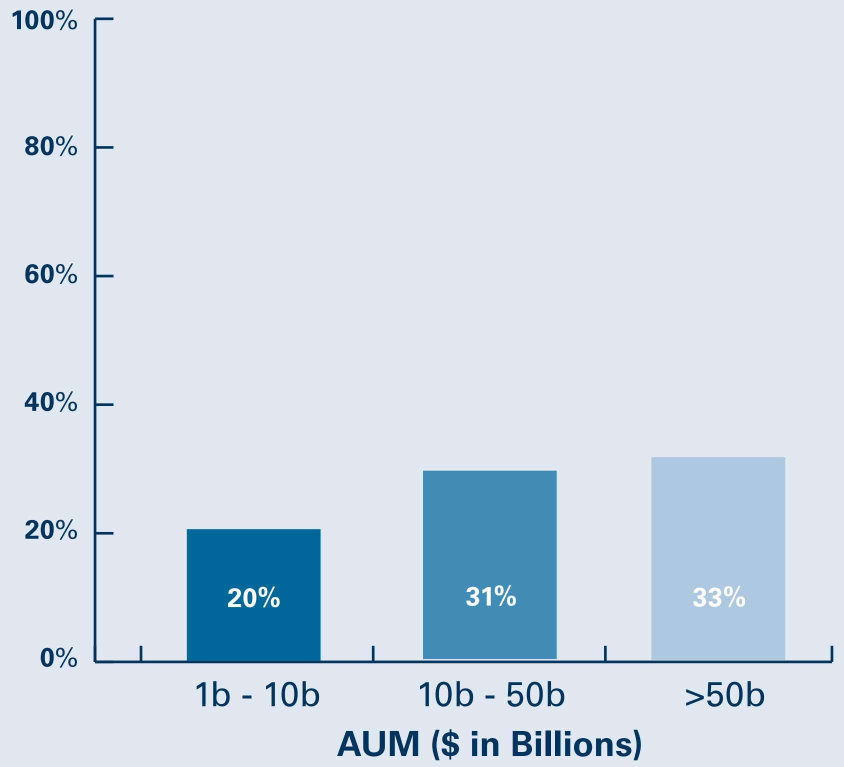
Significant Cash Flows

Firms may choose to implement a significant cash flow policy for all composites or for selected composites. A significant cash flow is the level at which a firm determines that a client-directed cash flow causes a portfolio to become temporarily non-discretionary.

Firms that choose to adopt a significant cash flow policy for certain composites must define the significant cash flow level on a composite-specific basis. When a client-directed cash flow meets or exceeds the composite's significant cash flow level, the portfolio is removed from the composite as it is considered temporarily non-discretionary. Like a composite minimum, a significant cash flow policy can be difficult to implement consistently and, depending on a firm's systems, can be a highly manual process.

We have seen firms move away from implementing significant cash flow policies over the last several years. Although firms are not supposed to establish a significant cash flow policy to eliminate the impact of cash flows on portfolio returns, this is often what motivates firms to establish a significant cash flow policy. However, with more firms moving to daily performance calculations, the impact of all cash flows is reduced so that a significant cash flow policy is not as critical as it is for firms that use a Modified Dietz calculation.

WHAT PERCENTAGE OF FIRMS USE A SIGNIFICANT CASH FLOW POLICY?



Firms over $10 billion are more likely to have established a significant cash flow policy for at least one composite. Over 30% of these firms have chosen to do so, versus 24% of all firms.

The significant cash flow level must be determined as either a specific monetary amount or as a percentage of portfolio assets, based on the most recent valuation. All of our clients that have adopted a significant cash flow policy use a percentage of portfolio assets to determine the significant cash flow level. Significant cash flow levels range from 5% to 50%, with 20% being the most common level.

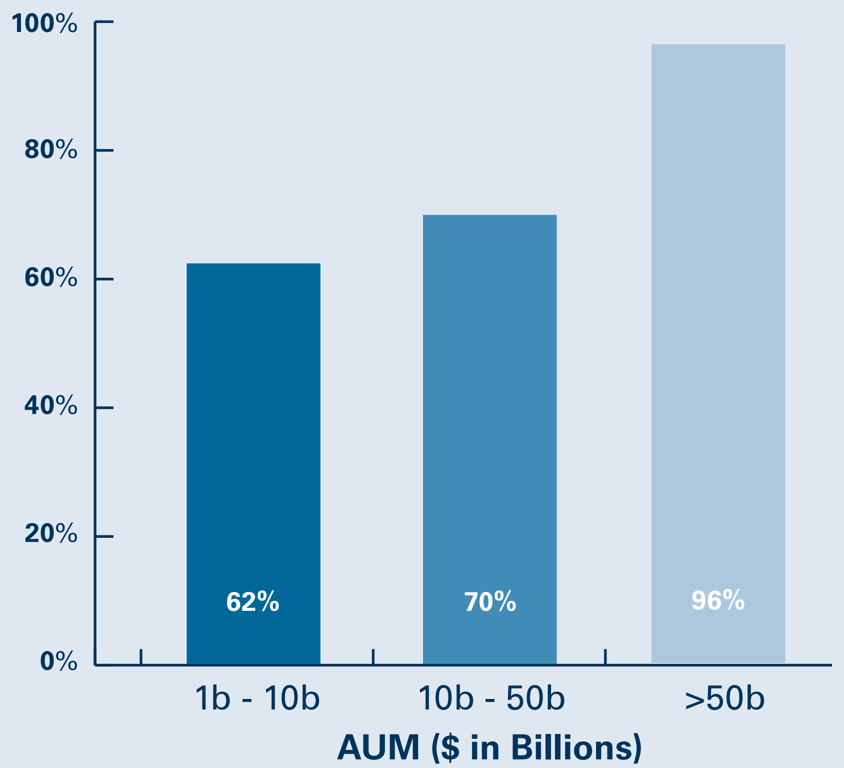
Proprietary Mutual Funds

Forty-five percent of our clients manage at least one proprietary mutual fund. A proprietary mutual fund is a mutual fund for which the firm serves as the investment advisor. The firm may manage the mutual fund itself or may hire one or more sub-advisors. We do not consider mutual funds that are managed by a firm on behalf of another firm to be proprietary mutual funds.

All actual, fee-paying, discretionary portfolios within the defined firm must be included in at least one of the firm's composites. This applies to separately managed, segregated portfolios as well as pooled funds. Pooled funds, including mutual funds and unit trusts, may be treated as separate composites or combined with other portfolios of the same strategy, style, or objective into one or more composites. Firms must decide, on a composite-specific basis, if mutual funds will be included with other portfolios in composites.

Over 70% of our clients include proprietary mutual funds in composites with separately managed portfolios. The others include them in stand-alone, mutual fund-only composites. The primary benefit of including mutual funds in composites with separately managed portfolios is that composites will be larger, which is beneficial from a marketing perspective. However, firms should be careful to ensure that the mutual fund performance is truly representative of the strategy separately managed portfolios would receive, since mutual funds will often drive composite performance because they often are the largest portfolios in composites.

WHAT PERCENTAGE OF FIRMS INCLUDE MUTUAL FUNDS IN COMPOSITES WITH SEPARATELY MANAGED PORTFOLIOS?



Looking at firms over $10 billion, 83% include proprietary mutual funds in composites with separately managed portfolios. We find that mutual funds at larger firms are often included in composites with large institutional portfolios because they are all managed similarly, so there is no basis for including mutual funds in different composites.

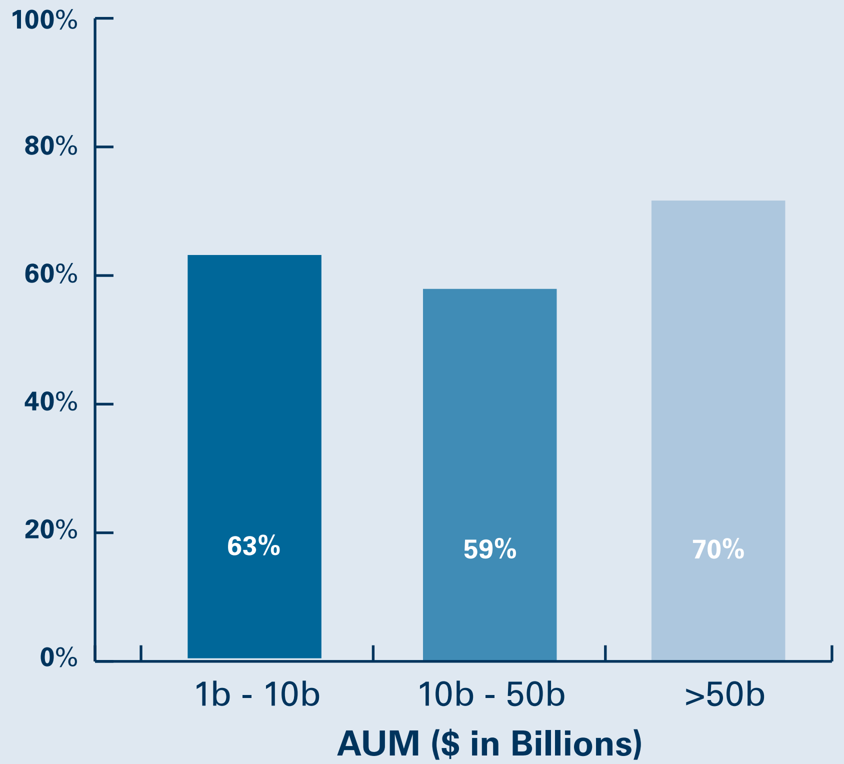
Calculating Performance for Mutual Funds

When mutual funds are included in composites, firms typically want to calculate a gross return for the fund that is comparable to other portfolios in the composite, i.e., it is net of only trading expenses. Returns calculated for mutual funds using fund net asset values (NAVs) reflect the deduction of all expenses incurred by the fund.

Firms often gross up a fund's NAV return by the fund's total expense ratio and calculate a gross return that reflects only the deduction of trading expenses. The fund's net return can then be calculated by reducing the grossed-up return by only the management fee. This is particularly important when a firm includes mutual funds in composites with separately managed portfolios. This calculation ensures the gross returns are net of only trading expenses and the net returns are net of only trading expenses and management fees.

The other option for calculating mutual fund returns is to treat the fund like any other separately managed portfolio and run the fund on the firm's performance system. Almost 65% of our clients that manage mutual funds start with fund NAVs to calculate fund returns versus placing the fund on their performance system.

WHAT PERCENTAGE OF FIRMS USE NAV-BASED FUND RETURNS?



CALCULATION POLICIES

A GIPS-compliant firm has many choices to make when calculating portfolio-level and composite-level returns and other composite-level data. A firm's performance systems and resources often drive calculation policy selections.

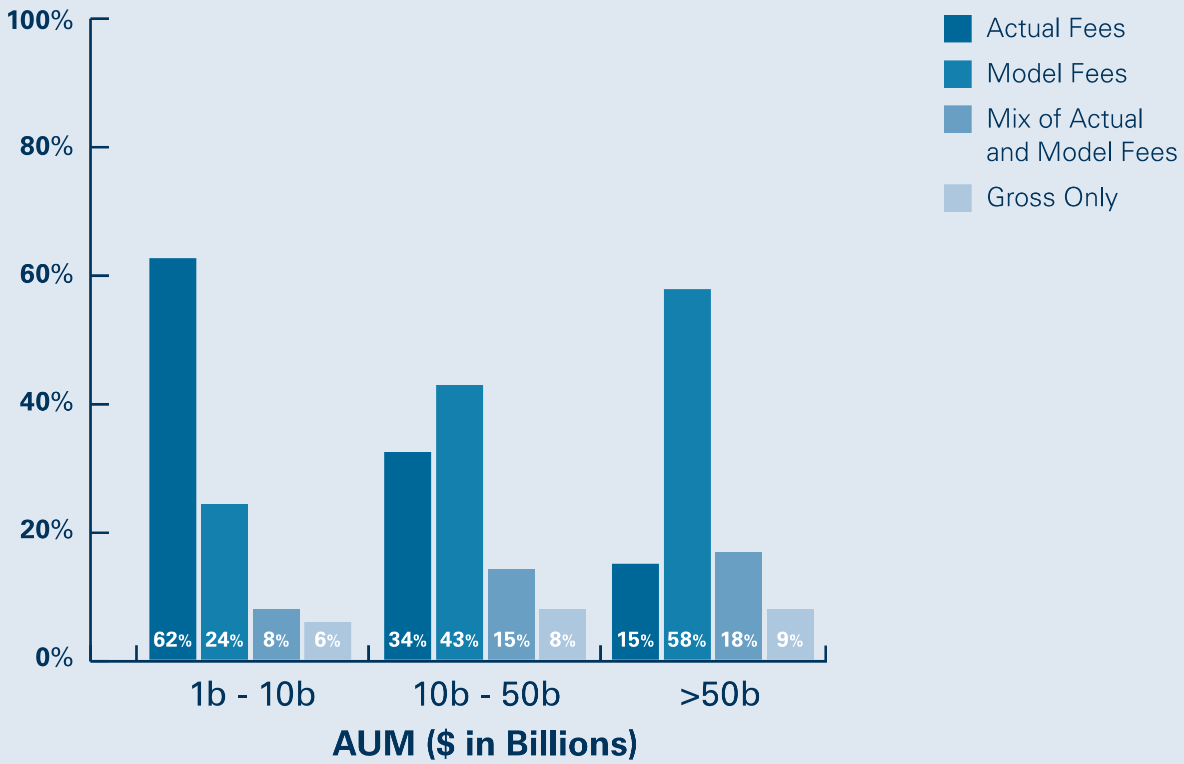
Model Versus Actual Investment Management Fees

A firm may use actual or model investment management fees to calculate net composite returns. Often a firm's performance system limitations will drive this decision. For example, a firm may not have the ability to obtain actual fees incurred by all portfolios within the firm on a timely basis. The net return calculation methodology is composite-specific, so a firm may choose to use model fees for some composites and actual fees for others.

Keep in mind that if model fees are used, a firm must ensure that the net composite returns calculated using model fees are equal to or lower than those that would have been calculated if actual fees were used. The main advantage of using model fees is that it is very easy to calculate net composite returns. The main disadvantage is that the firm may be understating net returns because the model fee may be significantly higher than the actual fees of portfolios in the composite, due to negotiated fees and breakpoints.

Less than half of our clients use actual fees to calculate net composite returns.

WHICH METHODOLOGY IS USED TO CALCULATE NET COMPOSITE RETURNS?



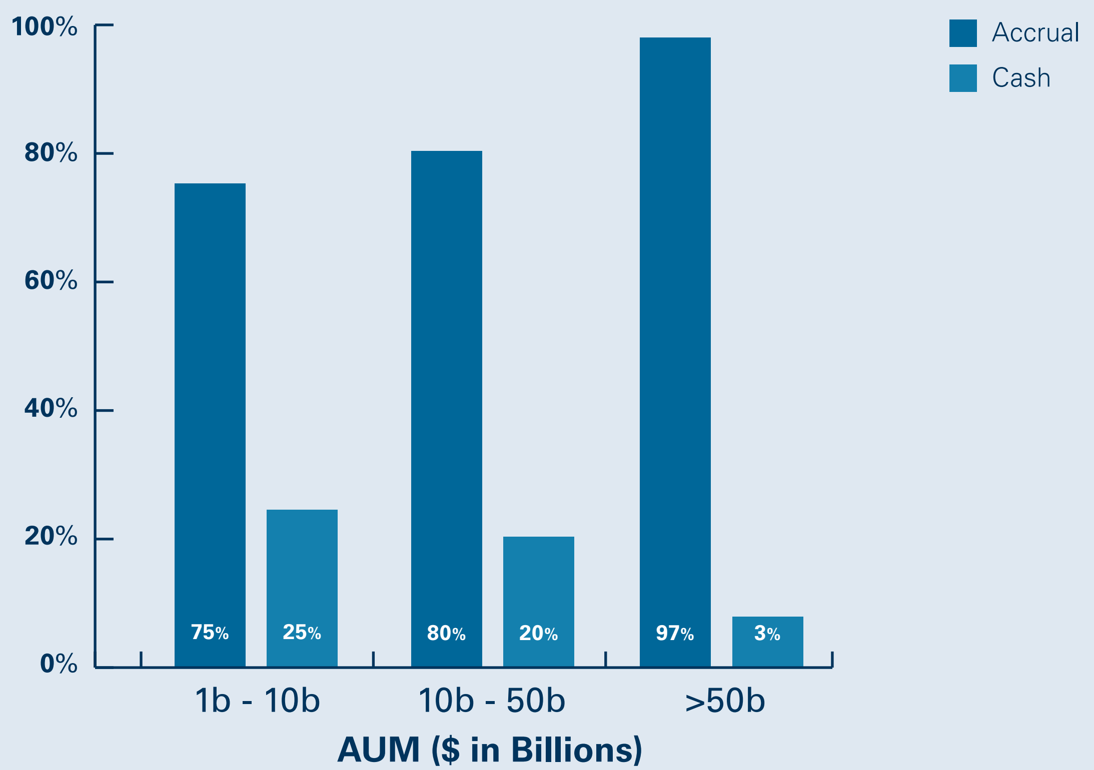
Larger firms are less likely to calculate net returns using actual fees. For those firms that manage over $10 billion, 28% use actual fees to calculate net composite returns, while 64% use only model fees or a combination of actual and model fees. The remaining 8% present gross-only returns. Presentations that do not include net composite returns may be used only in one-on-one presentations.

Accounting Method for Dividends

Firms are required to accrue income for fixed income securities and must include accrued income in portfolio values when calculating performance. Firms have a choice for how they recognize dividends on stocks. A firm may choose to accrue dividends, as recommended by the GIPS standards, or recognize the dividends as they are paid (cash basis).

Larger firms are much more likely to accrue dividends. Often a firm's performance system and pricing resources impact the firm's decision on which method is used.

WHICH ACCOUNTING METHOD IS USED FOR DIVIDENDS?

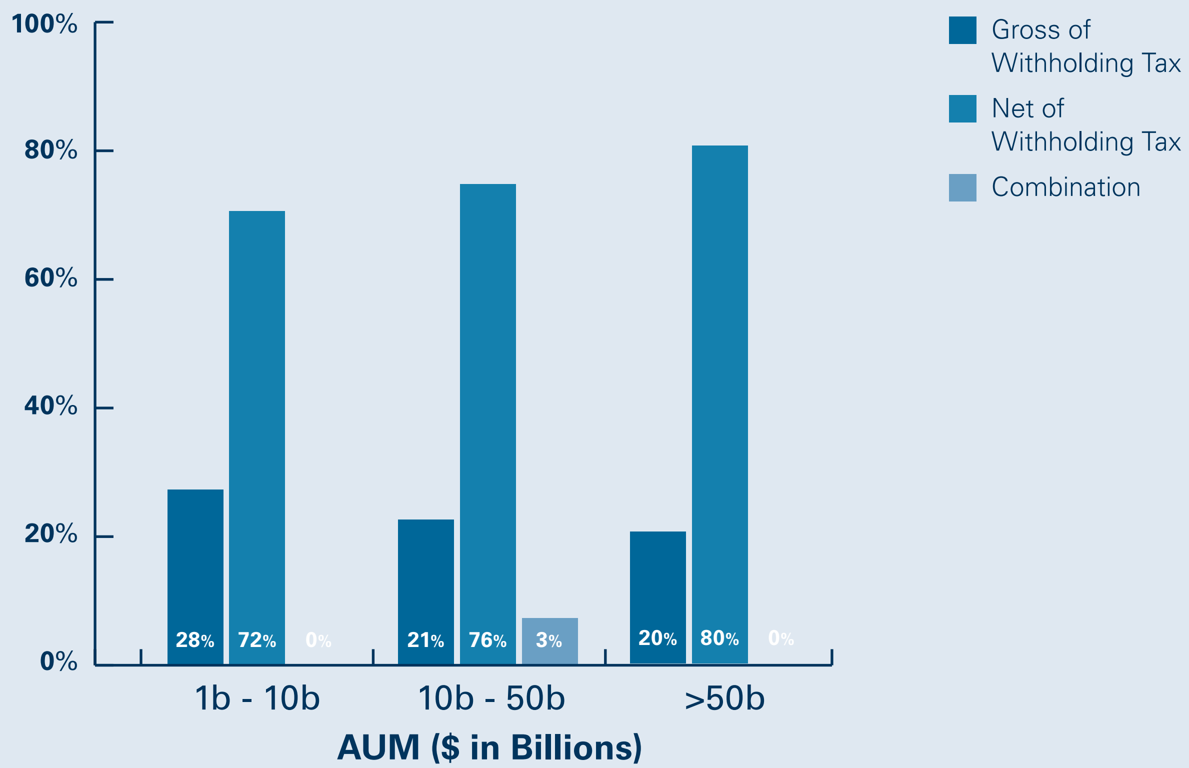


Foreign Withholding Taxes

A firm that manages foreign equity securities must determine how to treat foreign withholding taxes. The firm may choose to calculate returns net of foreign withholding taxes or gross of foreign withholding taxes. If the firm chooses net, dividends are reduced by the taxes withheld. If a firm chooses gross, the whole dividend is credited to the account and the tax withholding is posted as a cash flow.

A firm's decision is often driven by a firm's performance system capabilities and how information is received from custodians. We found that three-quarters of our clients that manage at least one international strategy choose to calculate performance net of foreign withholding taxes.

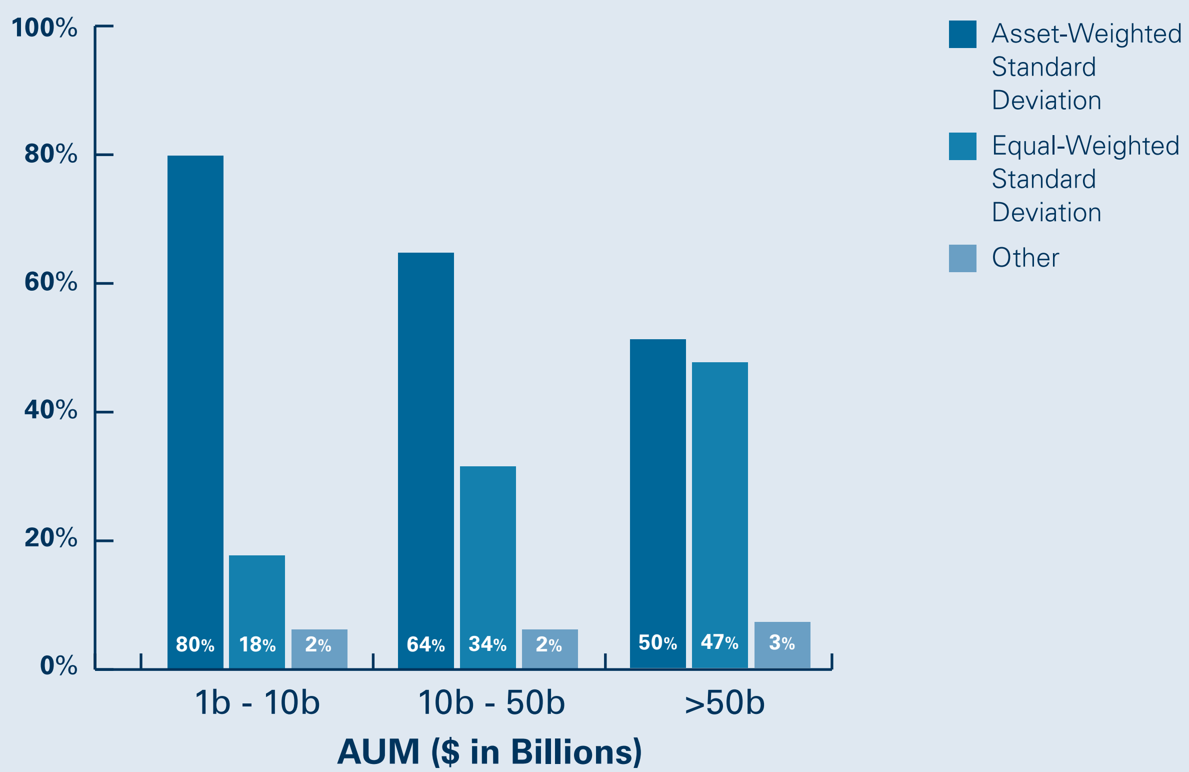
DO FIRMS CALCULATE RETURNS GROSS OR NET OF FOREIGN WITHHOLDING TAXES?



Internal Dispersion

A firm must calculate and present a measure of internal dispersion if the composite contained more than five portfolios for the entire year. A firm may choose to present internal dispersion for annual periods that contain fewer than six portfolios for the entire year, but is not required to do so. The GIPS standards do not dictate which measure of internal dispersion must be used, nor do they require a specific calculation method. A majority of our clients use asset-weighted standard deviation as the internal dispersion measure.

WHICH INTERNAL DISPERSION MEASURE IS USED?



The prevalence of asset-weighted standard deviation is driven by the standard calculations included in many performance systems. When the internal dispersion measure was initially required under the predecessor AIMR Performance Presentation Standards (AIMR-PPS™) in 1997, many performance systems assumed that an asset-weighted standard deviation was the appropriate internal dispersion measure because composites are required to be calculated using asset-weighted portfolio returns.

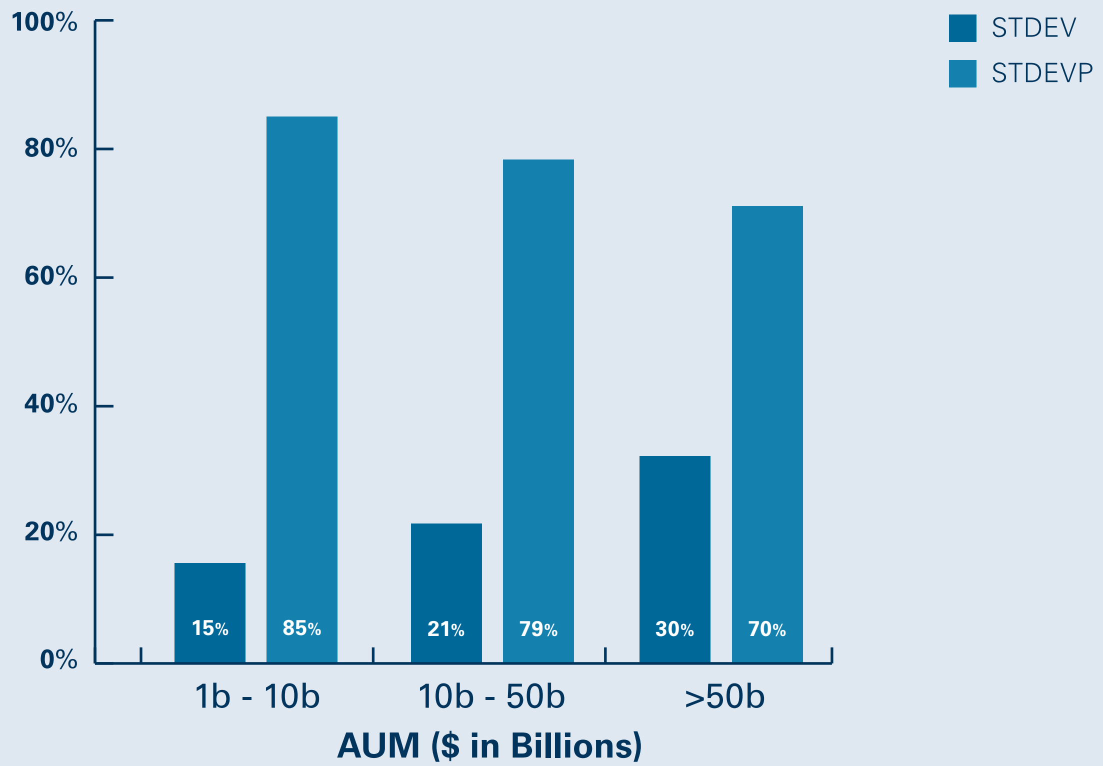
However, we believe that the best measure of internal dispersion is an equal-weighted standard deviation. This provides much better information about whether portfolios within the composite are managed similarly. An asset-weighted standard deviation can be greatly impacted by large portfolios within the composite, and a composite that includes accounts with a wide range of returns may have a very small asset-weighted standard deviation because of the impact of a single large portfolio.

3-Year Annualized Ex-post Standard Deviation

For each annual period ended on or after January 1, 2011, firms are required to present the 3-year annualized ex-post standard deviation of the composite and the benchmark using monthly returns. Because this is a relatively new requirement, some systems do not calculate this statistic, and therefore firms may have to perform the calculation manually.

We are often asked which formula is most commonly used. Microsoft Excel has two standard deviation functions. The calculation may be based on a sample (STDEV) or a population (STDEVP). Over 80% of our clients calculate the 3-year annualized ex-post standard deviation using the population (STDEVP in Excel) versus a sample (STDEV in Excel). Either method is acceptable.

WHICH FORMULA IS USED TO CALCULATE THE 3-YEAR ANNUALIZED EX-POST STANDARD DEVIATION?



COMPLIANT PRESENTATIONS

A compliant presentation is a presentation for a composite that includes all information required by the GIPS standards for that composite, and may also include other information. GIPS-compliant firms are required to make every reasonable effort to provide compliant presentations to all prospective clients.

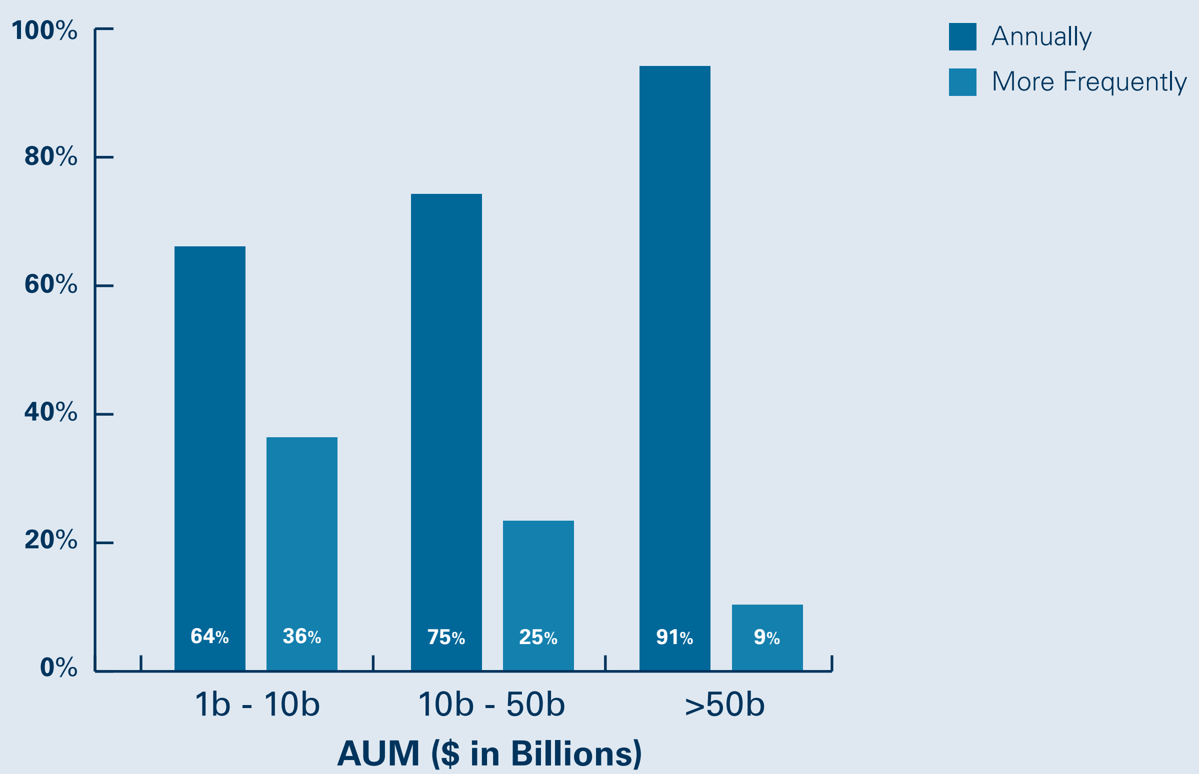
Compliant Presentation Updates

Firms must update compliant presentations at least annually, to include information for the most recent year. A firm may choose to update compliant presentations more frequently than annually, to include current-year information, such as quarterly or year-to-date returns. While updating compliant presentations more frequently than annually is allowed, we encourage our clients to carefully consider this option in order to limit the firm's risk of error.

After a compliant presentation is distributed, any changes to the presentation must be considered under the firm's error correction policy. This is true even if the firm labels the presentation as preliminary. If there is a material error in the compliant presentation, the firm must correct the presentation, disclose the error, and distribute corrected presentations. Non-material errors must be handled in accordance with the firm's previously established error correction policies. Reducing the frequency of updates reduces the risk of triggering error correction procedures.

We encourage clients to update compliant presentations annually, and to present current-year information, such as quarterly or year-to-date returns, in marketing materials outside of the compliant presentation.

HOW OFTEN DO FIRMS UPDATE COMPLIANT PRESENTATIONS?



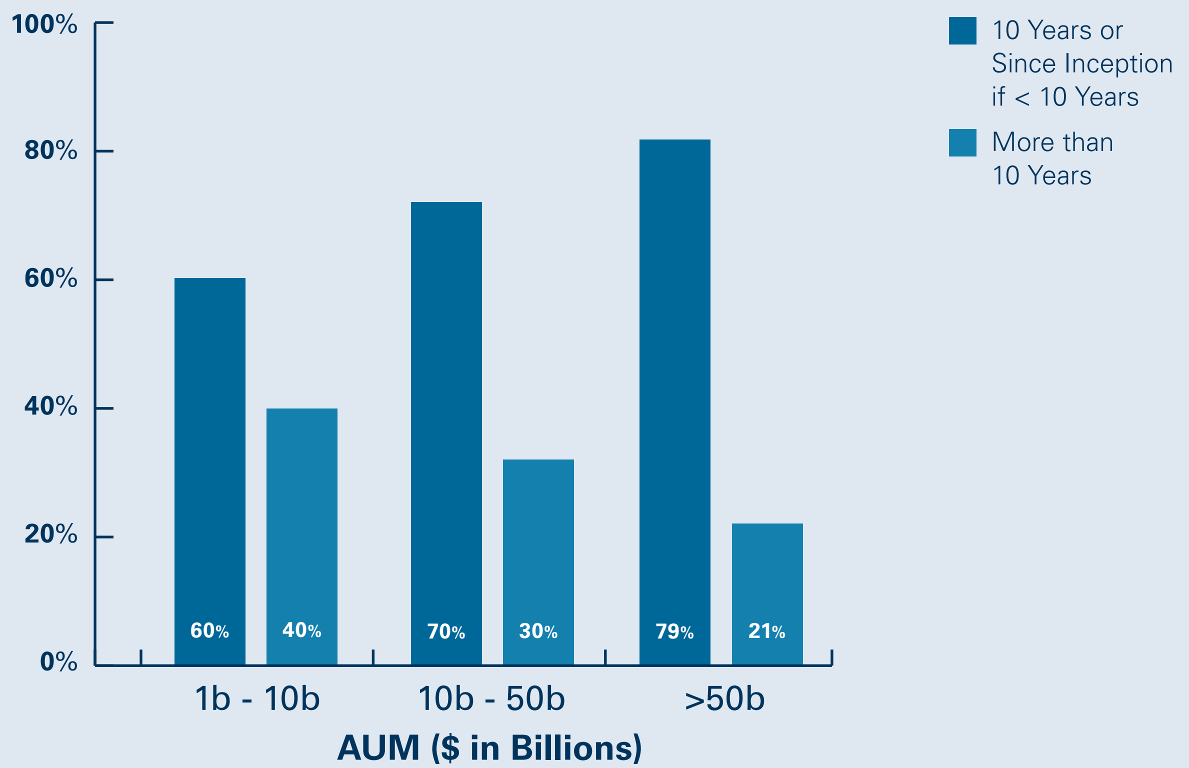
Larger firms are more likely to update compliant presentations only annually. Looking at only those firms that manage at least $10 billion, 81% update compliant presentations annually. Only 9% of firms that manage over $50 billion update compliant presentations more frequently than annually. Larger firms will typically have more composites and updating compliant presentations more frequently than annually can put a strain on resources due to the time it takes to create and review compliant presentations.

Periods Presented in Compliant Presentations

A firm must be able to prepare a compliant presentation for every composite on the firm's list of composite descriptions; this includes marketed composites as well as non-marketed composites. When initially claiming compliance, a firm must present a compliant track record of at least five years (or since inception, if the composite has been in existence for less than five years) in compliant presentations.

After the firm initially claims compliance, it must add an additional year of information until it has a 10-year compliant track record. Subsequently, a firm may choose to present more than the required 10 years of data, or may choose to present data for only the most recent 10-year period. Some reasons to only include the minimum required period are to limit the risk of errors that may trigger error correction, decrease the size of the compliant presentations, and reduce the time it takes to create and maintain the compliant presentations. Many firms choose to present annualized returns in marketing materials outside the compliant presentation that captures performance for periods prior to the required minimum 10-year period.

WHICH PERIODS DO FIRMS PRESENT IN COMPLIANT PRESENTATIONS?



Larger firms are more likely to present only the minimum required track record. Looking at only those firms that manage more than $10 billion, only 19% present data for more than 10 years in compliant presentations.

WRAP FEE AND DUAL CONTRACT ACCOUNTS

Wrap fee/separately managed account (SMA) portfolios, which we refer to as wrap accounts, have some unique challenges for calculating and reporting performance. The GIPS standards define wrap fees as a type of bundled fee that is specific to a particular investment product. The wrap fee is an asset-based fee charged by a wrap fee sponsor that may include a combination of investment management fees, trading expenses, custody fees, and/or administrative fees.

Wrap accounts are generally offered by a broker-dealer (the "sponsor"), whereby clients of the sponsor have access to institutional investment managers that they typically would not otherwise be able to hire. The sponsor acts as the intermediary between the individual wrap client and the investment manager. Essentially the sponsor sub-contracts with investment managers to provide investment advisory services on behalf of the sponsor's clients. Thirty-four percent of our clients manage wrap accounts.

A dual contract account is an account where the client has a contract with two entities: a financial adviser/ sponsor and the investment manager. The client pays the sponsor an asset-based fee for financial advisory services and this fee may also include trading and custodian expenses. The client also pays an investment management fee directly to the manager. Approximately 20% of our clients manage dual contract accounts.

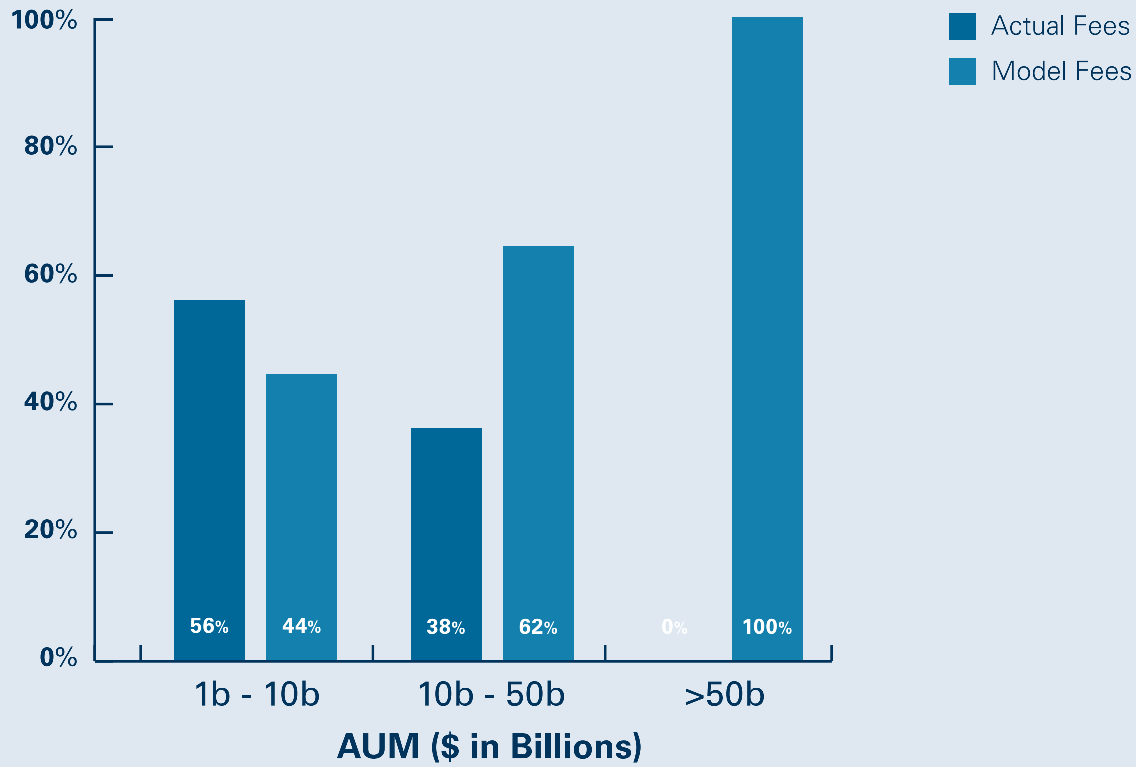
Calculating Performance for Wrap Accounts

The primary issue with wrap accounts is the inability to calculate a GIPS-compliant return that reflects the deduction of trading expenses because they typically do not pay explicit trading expenses. Since trading expenses are part of the total wrap fee paid to the sponsor, and generally cannot be segregated, there is no way for a firm to calculate returns net of trading expenses.

Most firms we work with calculate and present a "pure" gross return for wrap composites. A "pure" gross return is a return that does not reflect the deduction of trading expenses and is considered supplemental information under the GIPS standards.

When presenting performance to a prospective wrap client, composite returns must be presented net of the total wrap fee. Just like non-wrap composites, wrap composite net returns may be calculated using actual fees or model fees. Determining the sponsor's actual total wrap fee can be difficult, if not impossible. Wrap sponsors generally are not willing to share this information with investment managers. As a result, many firms choose to calculate wrap composite net returns using an industry standard 3% model wrap fee. A firm may use a model fee that is different from 3%, but the firm must be able to prove that the fee that is used is the highest wrap fee for a particular composite or sponsor. Over half of our clients that manage wrap accounts use a model fee to calculate wrap composite net returns, and 65% of these firms use a model fee of 3%.

WHICH METHODOLOGY IS USED TO CALCULATE WRAP COMPOSITE NET RETURNS?



More than 70% of firms over $10 billion use model fees to calculate wrap composite net returns. This is likely because larger firms tend to have multiple sponsors for each strategy and identifying actual fees paid for thousands of wrap accounts on multiple platforms is difficult, if not impossible.

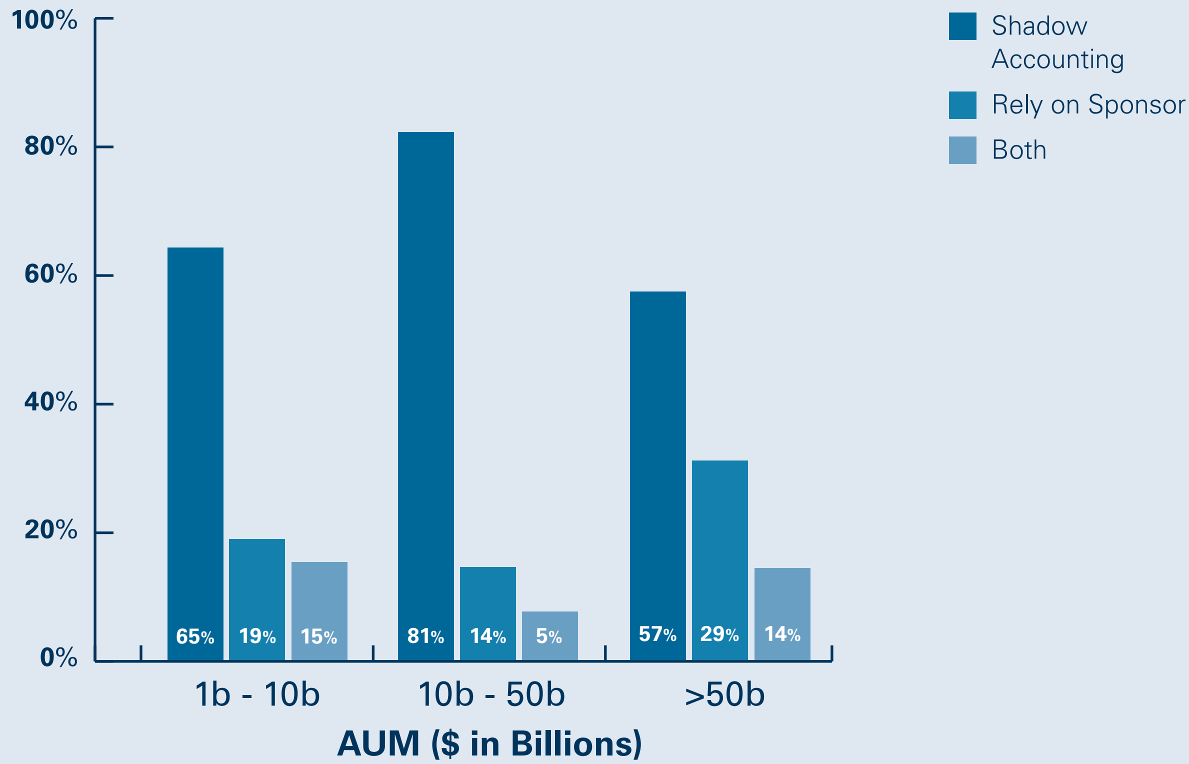
Books and Records for Wrap Accounts

Another challenge with wrap accounts is maintaining books and records to support performance. Because the sponsor acts as an intermediary between the investment manager and the individual wrap client, the firm must determine how it will obtain appropriate records to support performance. Under the GIPS wrap provisions, firms have options for satisfying the GIPS requirement to capture and maintain all data and information to support all items included in a compliant presentation.

One option is for the firm to use shadow accounting. Shadow accounting involves calculating performance on the firm's in-house performance system. With shadow accounting, the firm is essentially replicating the account returns of the sponsor and is in control of composite assignment. While shadow accounting can require additional resources, it is the most transparent way to calculate performance for wrap accounts and allows firms to ensure they have the records necessary to support performance. Approximately 70% of our clients that manage wrap accounts use shadow accounting.

Instead of shadow accounting, a firm may choose to place reliance on the sponsor's records. Placing reliance on the sponsor can be beneficial for smaller firms that have staffing or system constraints that would not allow the firm to effectively process a large volume of accounts. However, placing reliance on the sponsor does not alleviate the firm's responsibility to ensure accounts are properly included in composites and performance is calculated correctly. A firm should periodically perform testing to ensure that it can continue to place reliance on data from the sponsor.

HOW DO FIRMS CAPTURE AND MAINTAIN WRAP DATA?



Firms that manage wrap accounts may choose to include accounts in wrap composites at the individual account level or use an omnibus account. An omnibus account is an aggregation of all of the sponsor's accounts that are managed in that strategy. Instead of looking through to the sponsor's underlying accounts, the sponsor is treated as one big account for composite purposes.

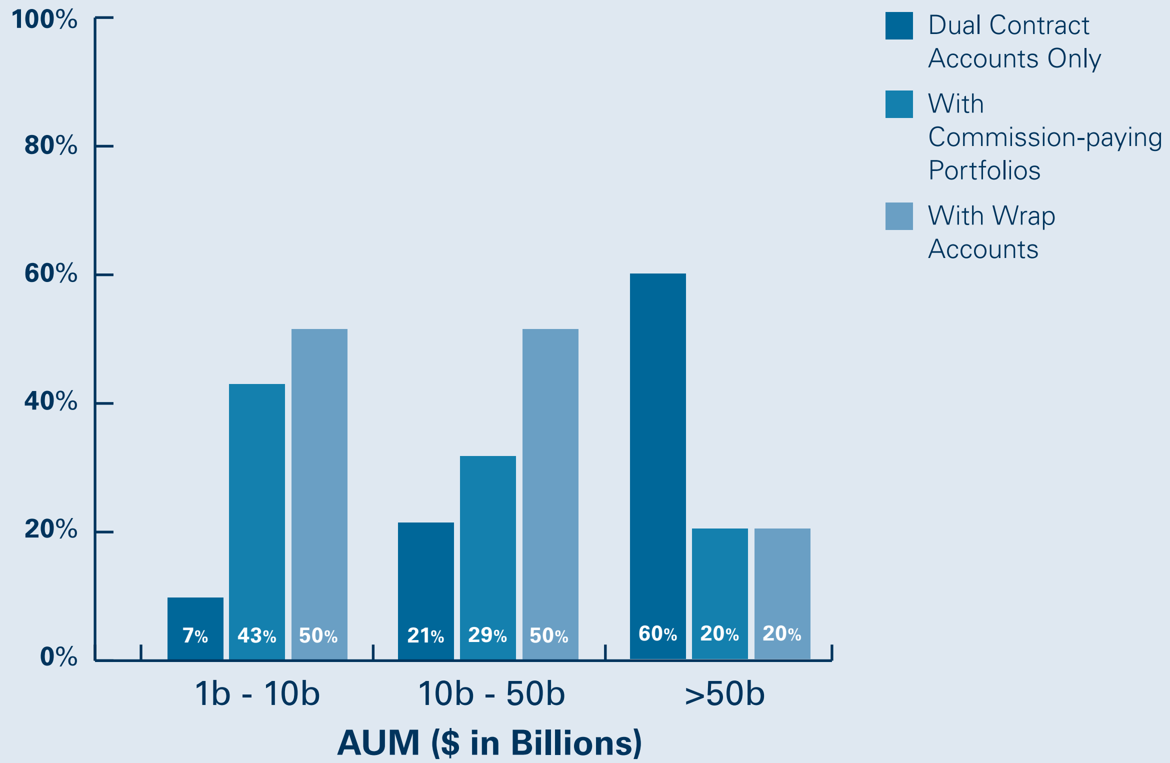
Of our clients that manage wrap accounts, 17% use an omnibus account for at least some of the wrap accounts they manage. Firms over $50 billion have the highest percentage — 43% of these firms use omnibus accounts.

Composite Assignment for Dual Contract Accounts

Dual contract accounts are unique because they have characteristics of both wrap accounts and non-wrap accounts. Like non-wrap accounts, the investment manager has a relationship with the client and is paid a separate investment management fee. Dual contract accounts are similar to wrap accounts in that the fee paid to the sponsor often includes trading expenses that cannot be separately identified so dual contract accounts have the same return calculation challenges as wrap accounts. Due to the hybrid nature of dual contract accounts, a firm has options for how to treat these accounts for composite assignment purposes. A firm may choose to include these accounts in a dual contract accounts only composite, in a wrap composite, or in a composite with other commission-paying portfolios.

The key factors in deciding where to house these accounts are whether the accounts pay a per-transaction fee (commission) and how the accounts are traded. Because dual contract programs come in a variety of shapes and sizes, firms take a variety of approaches to assigning dual contract accounts to composites.

HOW DO FIRMS ASSIGN DUAL CONTRACT ACCOUNTS TO COMPOSITES?



Looking at firms over $10 billion, only 26% include dual contract accounts in composites with commission-paying portfolios. We attribute this to the fact that dual contract accounts are generally smaller in size than institutional portfolios and larger firms manage them more like wrap accounts.

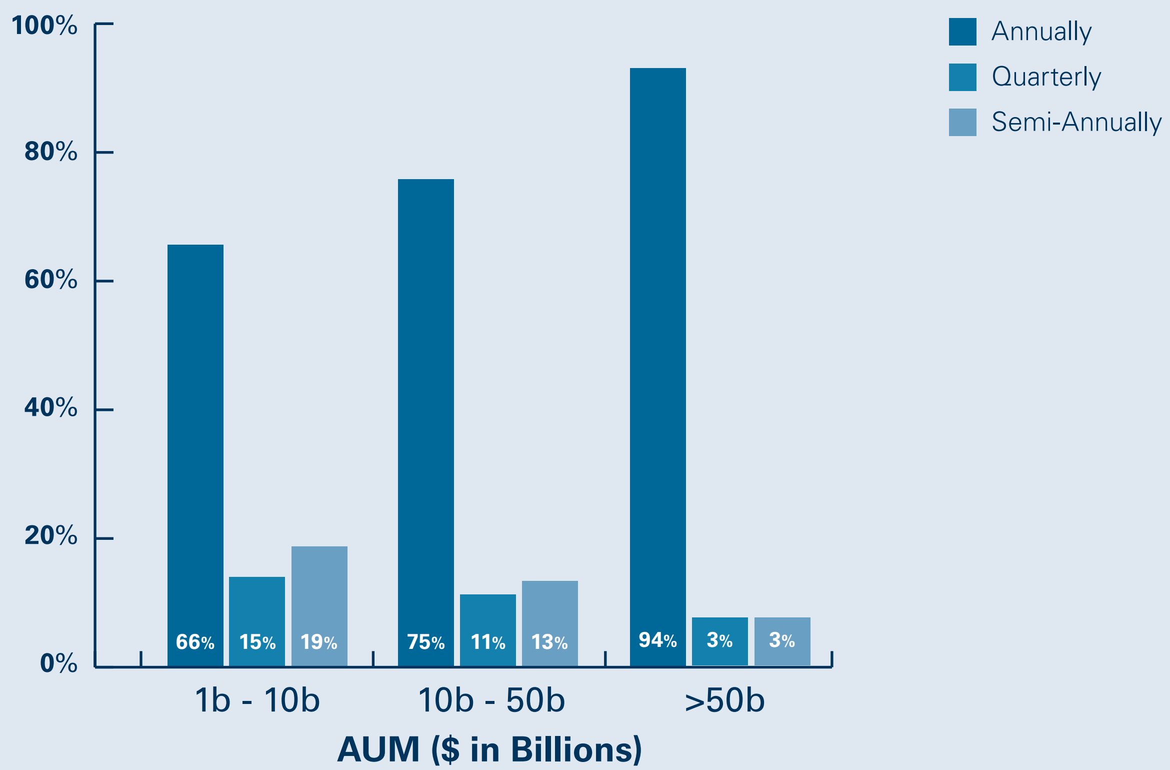
VERIFICATION AND PERFORMANCE EXAMINATIONS

To add credibility to its claim of compliance with the GIPS standards, a firm may choose to have a firm-wide verification performed by an independent third party. Verification tests the construction of the firm's composites as well as the firm's policies and procedures as they relate to the GIPS standards. A firm-wide verification report attests, for a specified period, whether the firm (1) complied with all of the composite construction requirements of the GIPS standards on a firm-wide basis, and (2) has policies and procedures designed to calculate and present performance in compliance with the GIPS standards.

Verification Frequency

Most of the firms we verify choose to have their firm verified on an annual basis. Often, the verification process is started shortly after the firm has finalized all year-end composite data. Over the past few years, we have seen a decline in the number of firms that choose to have their firm verified more frequently than annually. Because a verification can add a fair amount of hours to a firm's workload, reducing the firm's verification frequency can have a positive impact on the firm. If the firm has good controls in place to calculate and present performance, we believe that annual verification is sufficient.

HOW OFTEN ARE FIRMS VERIFIED?



The frequency of verification decreases as firm size increases. Of those firms that manage more than $10 billion, 82% are verified annually, 10% are verified semi-annually, and 8% are verified quarterly.

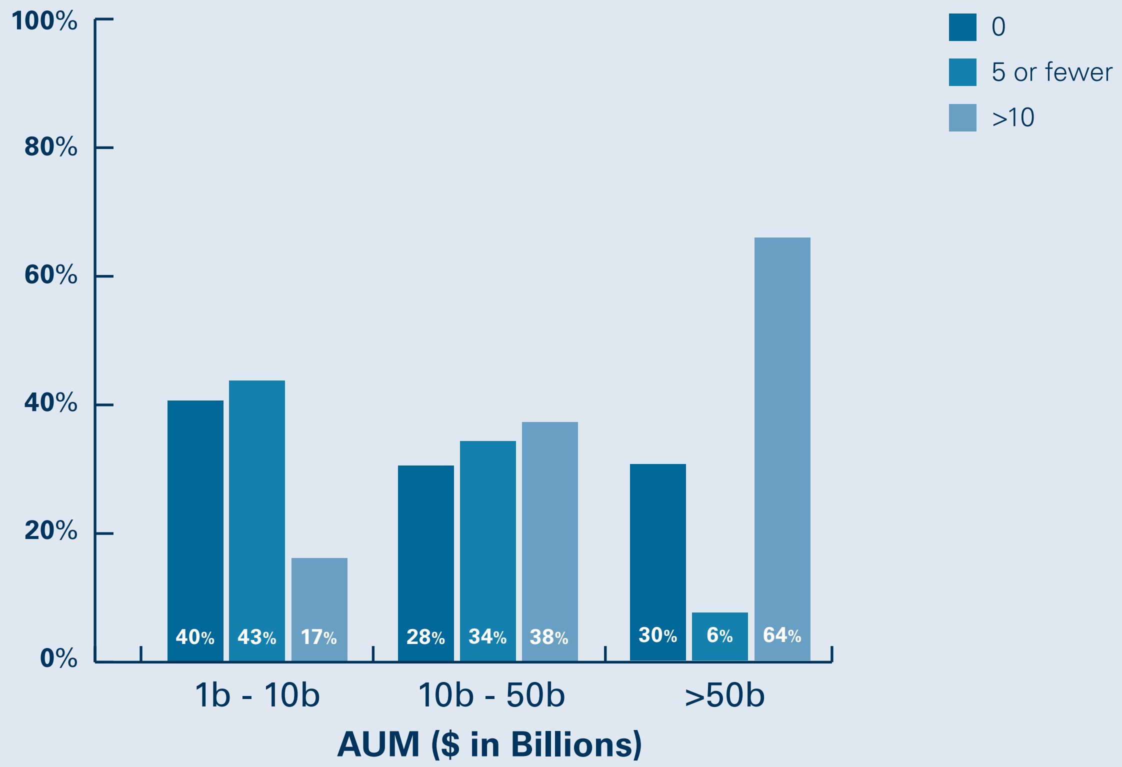
Performance Examinations

A firm-wide verification does not provide assurance on the accuracy of any specific composite. If a firm wants to have the results of a specific composite tested, this can only be done by having a performance examination of that composite.

A performance examination report attests, for a specified period, that the specific composite has been constructed and its performance has been calculated in compliance with the GIPS standards, and that the firm has prepared and presented the composite's compliant presentation in compliance with the GIPS standards. A performance examination takes a deeper dive into the specific composite to ensure that the composite is constructed and calculated consistent with the firm's policies and the GIPS standards. It also includes a detailed review of the composite's compliant presentation, to ensure all the information presented in the compliant presentation is proper and that all required disclosures are included.

Note that a performance examination may not be performed without a firm-wide verification. Firms that choose to get performance examinations generally get them for their key marketed composites. Sixty-five percent of our clients have at least one composite examined.

HOW MANY COMPOSITES RECEIVE A PERFORMANCE EXAMINATION?



Larger firms are more likely than smaller firms to get performance examinations and have more composites examined. For firms over $10 billion, 71% have at least one composite examined in addition to the firm-wide verification. The average number of examined composites for these firms is 16, while firms under $10 billion have an average of five examined composites.

One reason larger firms are more likely to get performance examinations is that many RFPs ask if a composite has been examined. In fact, we've heard from clients recently that many RFPs are requiring that composites have a minimum 3-year examined track record in order to be considered. Firms also choose to have performance examinations because they want to have assurance on the results of marketed composites in order to mitigate risk.

CONCLUSION

We hope you found it helpful to learn what GIPS-compliant firms do. Although each firm is unique, this information provides a framework for considering new policies or evaluating existing policies. Please contact us if you would like more information about any of the facts presented or if we can help you evaluate other policies or practices.

GIPS® is a registered trademark owned by CFA Institute.

Crista DesRochers, CIPM
ACA Performance Services | Managing Director

2014 NE Broadway Street
Portland, OR 97232

503-288-2704, ext. 103
cdesrochers@acacompliancegroup.com
www.acacompliancegroup.com

ACA
COMPLIANCE GROUP
PERFORMANCE SERVICES

acacompliancegroup.com/gips

About ACA Performance Services

ACA Performance Services, a division of ACA Compliance Group, offers GIPS verification and related services to investment managers across the globe. ACA Performance Services was formed in 2013 with the combination of ACA Beacon Verification Services and Vincent Performance Services. Globally, ACA Performance Services is the largest team of professionals solely dedicated to GIPS verification and related services.

For more information regarding ACA Performance Services, please visit us at www.acacompliancegroup.com/gips.

Follow us on Twitter @ACACompliance or LinkedIn.