



EAGLE WHITE PAPER

GIPS® 2010 - READY OR NOT, HERE IT COMES

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INTRODUCTION

Executive Summary

Changes to the Global Investment Performance Standards (GIPS®) are fast approaching and have significant system and operations implications for investment management firms. The objective of this paper is to provide an overview of GIPS changes, clarify effective dates for various provisions and discuss related business implications.

Background Information

The Global Investment Performance Standards (GIPS) is a set of standardized, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients. The foundation for GIPS was first established in 1987, with the creation of the AIMR Performance Presentation Standards (AIMR-PPS®). AIMR-PPS were voluntary performance guidelines accepted by the North American investment management industry. AIMR-PPS were intended to address the needs of investors who were challenged to obtain meaningful comparisons of investment performance results. The industry also recognized a need for a single standard to consolidate country-specific performance guidelines. Using AIMR-PPS and country standards as a basis, GIPS was created in the late 1990s. Since that time, a revised version of GIPS was introduced in 2005 to provide a consolidated, global standard. Although not mandated by any regulatory body, according to industry surveys, there is a high adherence to the standards, with roughly 70-90% of investment managers worldwide in compliance or planning to achieve compliance. Russia recently became the 30th country to adopt GIPS.

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GIPS UPDATE, 2010 vs. 2011 PROVISIONS

The effective date for various items from the GIPS 2005 update was postponed until 1 January 2010. Major provisions include valuation at the time of large cash flows, elimination of composite carve outs, and use of uniform month-end valuation dates. From a business operations perspective, the GIPS 2005 provisions that are effective 1 January 2010 are more challenging than the GIPS 2010 provisions. The comment period for these provisions has ended.

GIPS 2010 represents the latest evolution of these global performance standards and includes provisions for new items such as the treatment of “managed” vs. “unmanaged” assets, “fee-paying” vs. “non-fee-paying,” etc. After public comment, the final version will be published at the beginning of 2010 with an effective date of 1 January 2011. All performance presentations must be made according to the revised standards beginning 1 January 2011.



In light of both the GIPS 2005 and 2010 changes, below is what Eagle considers to be the areas where firms should focus in terms of composite management and performance calculations:

2005 CHANGES, EFFECTIVE 1 JANUARY 2010

Portfolio Valuations on the Date of all Large External Cash Flows

The use of portfolio daily valuations or a valuation as of the day of the large external cash flow are required to mitigate the potential distortion of the return calculation.

Portfolio Month-end Valuations

It will be required to value portfolios as of the last calendar day or last business day of the month.

Composite Carve-outs

The definition of carve-outs will change in future guidance to differentiate carve-outs from “sub-portfolios.” If a sub-portfolio is managed as a distinct strategy, it can be included in the appropriate composite as determined by the composite definition. Firms would be prohibited from creating a hypothetical sub-portfolio from a multi-strategy or broader strategy account (e.g., Swiss equities from an EAFE strategy), unless the sub-portfolio is actually managed as its own strategy and representative of a standalone portfolio managed to that strategy. Cash allocation will no longer be allowed after 1 January 2010.

Mandatory Verification

Mandatory verification will not be required. This requirement will also not be required under GIPS 2010. There is a recommendation to include an explicit disclosure of whether or not the firm has been verified.

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PROPOSED 2010 CHANGES, EFFECTIVE 1 JANUARY 2011

Please note that the following are preliminary views by the GIPS Executive Committee on what may be proposed in the upcoming draft of the revised GIPS and are subject to change. The industry will have the opportunity to comment on proposed GIPS 2010 changes when the draft is released for public comment in 2009. There are many more provisions than listed below, and we've highlighted the ones most important to our clients. Firms should review the GIPS 2010 draft to identify areas that may be pertinent to their business and provide feedback during the comment period.

Treatment of "Managed" vs. "Unmanaged"

Moving forward, GIPS will require that managed and unmanaged assets be evaluated as distinct asset categories. Previously, Guaranteed Investment Contracts, works of art, etc., did not need to be included among the assets to be included as compliant assets under the GIPS standards. If the assets are managed, meaning that the manager invests in them as part of an investment strategy, they should be included in firm assets and composites.

"Fee-Paying" vs. "Non-Fee-Paying"

The distinction between fee-paying and non-fee-paying portfolios should be removed when considering composite construction and total firm assets. If a portfolio is managed in a particular strategy, is discretionary, and is included as part of the firm, it must be included in at least one composite. Additional guidance will be forthcoming to address how non-fee-paying portfolios should be treated when presenting net-of-fee returns.

Ex Post Standard Deviation

Firms must disclose the annualized ex post standard deviation of the composite and its benchmark for the most recent three-year period presented in the compliant presentation. Ex post standard deviation reviews the variability of the historical return time series for the composite and the benchmark. In contrast, asset weighted standard deviation, another frequently reported composite measure, looks at the dispersion of accounts within a composite.

Correction of Material Error

Firms will be required to disclose, for a minimum of 12 months, any changes to a compliant presentation due to a correction of a material error.

ERROR CORRECTION GUIDANCE STATEMENT

GIPS released a draft of an Error Correction Guidance Statement in June 2008 for public comment. The purpose of this statement is to provide guidance for how an error is defined and how a firm should handle errors or restatements of performance for GIPS-compliant presentations and other directly-related material. A firm is required to establish policies for how errors of all magnitudes are handled. Key elements of policy include clarity, clear escalation process, and consistency. This statement will become effective 1 January 2010 and retroactive application is not required.

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BUSINESS IMPLICATIONS

Going forward, systems, business operations flexibility and experienced professionals will be paramount to maintaining compliance with GIPS changes. Questions to ask span the spectrum, including internal business practice, data management and software flexibility. Some specific areas to consider include:

Can existing valuation/accounting processes provide accurate daily valuations?

Portfolio daily valuations or a valuation as of the day of the large external cash flow are required to mitigate the potential distortion of the return calculation. A daily valuation approach requires “clean” daily valuations from the official book of record system. A second approach can be implemented by building the valuation on an ad hoc basis for only accounts impacted by a large cash flow. Sub-period valuations for prior day and end of day of the external large cash flow are required as calculation inputs. Ideally, the performance systems and not spreadsheets can support detection of the external cash flows based on product determined percentages, i.e. 5% for fixed income accounts, sub-period valuations to calculate and store sub-period returns and provide respective audit trail.

How can I streamline new reconciliation challenges between an investment manager and performance methodology used by the client’s custodian?

Traditionally, many institutional clients, i.e. corporate pension plans, endowments, etc., relied on a custodian or investment consultant as the official valuation and book of record for all accounts within a plan. Reporting requirements typically only dictate a return based on a monthly valuation. Reconciliation challenges could drastically increase. Software that has the flexibility to replicate different performance methodologies at the account level is instrumental to reducing manual intervention. Proper reconciliation should also help eliminate “reporting noise” for a client when they produce a board report or conduct a manager evaluation.

Can my current core performance calculation and GIPS Composite maintenance process support exception processing to identify and temporarily remove accounts with large cash flows?

Tight integration between the calculation process and the GIPS Composite management system is required to efficiently manage exception-based GIPS Composite maintenance that is accounting data specific and beyond traditional GIPS Portfolio to Composite assignment based on account attributes.

How much business risk and overhead cost is embedded in managing composite membership construction, verifier support and dissemination of marketing materials on the backbone of manual processes, internal single owner system, or spreadsheet? How do I make sure that I am adhering to GIPS documented policies and procedures? How can I continue to meet the ever-evolving GIPS standards and reduce the costs and risk of supporting manual processes or limitations of my current vendor?

Vendor systems can help firms focus on their specific GIPS policies and mitigate time spent on managing IT professionals and keeping proprietary systems up to date on the ever-evolving GIPS standards. A significant amount of time can be spent resolving error corrections and manually intervening to recalculate and distribute reports for a subset of client accounts and marketing materials. Constrained resources can be reallocated to higher value-added functions, such as monitoring and reviewing the investment product approach represented by the GIPS composite.

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EVOLUTION CONTINUES

The GIPS standards will continue to evolve and address the ever-changing market requirements. As such, the complete contents of GIPS will be reviewed every five years and specific areas updated on an ongoing basis. Based on recent trends, specifically around those products designed to achieve more alpha (e.g. 130/30 funds), and investment instruments (derivatives, structured products, private equity, etc.) the complexity of the industry can only be expected to increase. This complexity will further challenge traditional portfolio valuation and investment performance calculation infrastructures and drive the evolution of the standards. Ongoing GIPS subcommittee activities in the areas of fees, taxes, etc. will require firms to monitor and adapt to these changes. Investment firm consolidation through merger and acquisition activity and marketing/distribution efforts to expand across new geographic markets will add additional complexities to account/product composite management. The GIPS executive committee recognizes that change is the only constant in the investment industry and will continue to evolve to meet industry requirements. Investment management firms and performance vendors need to continue to monitor, provide feedback, and plan to accommodate this evolution.

EAGLE INVESTMENT SYSTEMS

Eagle Investment Systems LLC is a global provider of financial services technology, serving the world's leading financial institutions. Eagle is committed to providing enterprise-wide, leading-edge technology and professional services for data management, investment accounting, and performance measurement and attribution. Eagle's performance measurement solution is a fully integrated suite, which provides multiple solutions, including portfolio performance, retail fund performance, GIPS® composite management, equity and fixed income performance attribution, analysis and reporting. Rules-based composite membership maintenance, standard verification reports, flexible disclosure management, and standard presentation reports provide end-to-end GIPS composite management. Exception-based workflow management provides tight integration of accounting, performance and GIPS composite presentation reporting. Eagle's Web-based systems support the complex requirements of firms of any size including institutional investment managers, mutual funds, hedge funds, brokers, public funds, plan sponsors, and insurance companies. Eagle's products are offered as an installed application or can be hosted via Eagle ACCESS, Eagle's application service provider. By deploying Eagle's world-class solutions over the internet, Eagle ACCESS can help firms minimize the risk and expense associated with maintaining hardware and software internally. Eagle Investment Systems LLC is a subsidiary of The Bank of New York Mellon Corporation.