Compliance is Easier Than You Think:

Challenges and Solutions for Hedge Fund Managers Considering the Global Investment Performance Standards (GIPS®)

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EXECUTIVE SUMMARY

- The Global Investment Performance Standards ("GIPS" or the "Standards") are a voluntary set of best practices, developed and promulgated by the CFA Institute (CFAI), for investment management firms to use when calculating and presenting their investment performance to prospective clients. Due to increased demand for additional guidance in the marketplace for hedge fund managers ("HFM"s), the intention of this paper is to provide solutions for those HFMs that are attempting to increase their own transparency by adhering to the GIPS.
- Increased transparency, demand from institutional investors, the promulgation of private client accounts for HFMs, and industry best practice are just a few reasons why HFMs are choosing to claim compliance with the GIPS.
- Transparency, it seems, has become nearly as important as performance for prospective investors in the alternative space.
- One of the basic tenets of the GIPS is that the entire firm (i.e., the management company) must claim compliance with the GIPS. Compliance is at the firm-wide level and not the product/strategy level. Assets under management for GIPS purposes should be reflective of all assets within the defined firm.
- Firms that comply with the GIPS must make every reasonable effort to provide a fully compliant GIPS presentation to all prospective investors. The "fully compliant" presentation often does not differ substantially from a firm's current product fact sheets or what is contained in a pitch-book and only minor modifications and additional disclosures need to be added.
- Complying with the GIPS Input Data Requirements is often very simple for HFMs. The GIPS require monthly return calculations, and nearly all funds strike a NAV monthly. Furthermore, the use of third party administrator data for purposes of GIPS compliance is permissible, provided that the data and calculations meet all applicable requirements. In cases where funds have, at minimum, monthly liquidity, intra-month cash flows are not present, and therefore the calculation of monthly performance is a simple exercise using NAVs.
- Composite construction, often the most challenging aspect of GIPS for traditional asset managers, is often a non-event for HFMs. Since most HFMs have different funds based on differing investment strategies, there is often a one-to-one relationship between funds and composites.
- For single-fund composites, there are a number of acceptable options for calculating performance: tracking the original, full fee paying investor in the fund, taking the gross of fees return of the total fund and netting it down by the maximum fee, or calculating performance on the total pool of assets in the fund which includes all series and share classes.
- Sidepockets are a sticky issue, but they can be dealt with in the GIPS compliant framework. Determining whether to include or exclude sidepockets when representing strategy performance to prospective investors is often based on circumstances unique to the firm and why the sidepocket was created.
- Backtested and/or simulated results can be shown to prospects as supplemental information, provided that it accompanies a fully compliant presentation and that these results are not linked to the actual fund/composite performance.

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INTRODUCTION

The Global Investment Performance Standards ("GIPS" or the "Standards") are a voluntary set of best practices, developed and promulgated by the CFA Institute (CFAI), for investment management firms to use when calculating and presenting their investment performance to prospective clients. Historically, the GIPS have been tailored more toward the institutional, long-only asset manager. However, as more assets have been allocated to alternative investments, and as regulatory scrutiny has dramatically increased, hedge fund managers (HFMs) and other alternative managers are increasingly embracing the GIPS. While this move toward acceptance of the GIPS in the alternative industry is a noteworthy trend, it is not without challenge.

The GIPS, as they are currently written, do not address many of the unique features and characteristics that are inherent in the structure of alternative investment vehicles. While there is currently no guidance within the GIPS on many of the typical questions that HFMs must address, the CFAI realizes the need for additional direction in this area. On this point, Jonathan Boersma, CFA, Executive Director of the GIPS, stated

> *While the Standards can currently be applied to hedge funds, there are issues and structures that are unique to this segment of the market that warrant further guidance. Master-feeder structures, for example, pose a challenge to managers when presenting performance and firms must determine which level is the most representative of the returns investors experienced. Side pockets are also an area that merit guidance. Should a firm include the side pockets when presenting historical performance? Should they be presented separately? Additional guidance will be issued to address these and other issues specific to hedge funds.*[1]

The GIPS Executive Committee has formed the Alternative Investment Strategy Working Group, which has been developing guidance for alternative strategies. The intent of the GIPS is to provide a sufficiently broad framework such that all types of asset managers can claim compliance with the GIPS. Indeed, "the goals in developing and evolving the Global Investment Performance Standards are to establish them as the recognized standard for calculating and presenting investment performance around the world and for the GIPS standards to become a firm's 'passport' to market investment management services globally.[2]" The objective of the future guidance to be issued by the CFAI is to provide clarity on a variety of options as to how HFMs may achieve compliance. During the Q&A section of the Executive Committee conference call on January 29th, 2010, when the newest edition of the GIPS, known as the GIPS 2010 Edition, was made official, members of the Executive Committee confirmed that providing additional guidance for alternative managers is a priority for the Executive Committee. As a result, we anticipate that this draft of additional guidance will become public at some point in 2010.

The goal of this paper is to suggest solutions for HFMs that are attempting to increase transparency by adhering to the GIPS. In the absence of formal guidance from the CFAI, this paper sets forth our current understanding of how the GIPS should be applied to HFMs. The comments and suggestions in this paper are not intended to replace or supersede any current or future formal or informal guidance issued by the CFAI, which may differ from the views and opinions expressed herein. Nothing in this paper should be relied upon as advice for any particular set of facts, nor as a substitute for the guidance of GIPS professionals.

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1 – Boersma, Jonathan. "GIPS Compliance: Improving confidence in traditional and alternative strategies." *The Hedge Fund Journal*. Mar. 2009. 10 Mar. 2010. Link to article >

2 – CFA Institute. *Global Investment Performance Standards 2010*. Charlottesville: CFA Institute, 2010. (p.iv)

We have organized this white paper into two parts. Part I explores the trend toward GIPS compliance for HFMs and the corresponding benefits. Part II analyzes many of the core elements of the GIPS as they apply to HFMs.

We would like to extend a special thanks to Stone House Consulting for its input and advice on the contents of this paper.

PART I: THE CASE FOR THE GIPS

A. Background of the GIPS

Before discussing the specifics of how the GIPS can be applied to HFMs, it is important first to have a general understanding of the fundamentals of GIPS compliance. The GIPS, in their original incarnation, were devised and first released by the Financial Analyst Federation (a predecessor group to the CFAI), as the AIMR-PPS in 1987. There have been multiple revisions to the Standards since this initial version; however, throughout the entire history of the GIPS, the Standards have been designed for the benefits of the prospective client, with the end goal to provide an apples-to-apples comparison of investment managers' performance across the globe. Firms claiming compliance with the GIPS adhere to the same requirements governing the fundamentals of compliance, input data, calculation methodology, composite construction, and disclosure and presentation. As a consequence, the prospective client considering two firms that each claim compliance with the GIPS is assured that the performance for both firms has been calculated under the same compliant methodologies, that the same required statistics will be presented by both firms, and that important performance-related disclosures are being made. This uniformity also provides the prospect a greater sense of comfort that it has complete information when making allocation decisions. Until recently the comfort provided by the GIPS generally has been available only to investors looking to invest with long-only managers, despite the apparent advantages to achieving uniformity in reported HFM performance.

B. GIPS: Responding to the Demand for Hedge Fund Transparency

As HFMs compete for the increasing amount of assets being placed in the alternative space, they are finding many reasons why claiming compliance with the GIPS would be an attractive initiative. Many institutional investors such as endowments, foundations and pension plans, over the last decade, have been increasing their target allocations to include alternative assets as a larger component of a well diversified portfolio. This increase in endowments alone has been so significant that, as one source noted, "in 2008, endowments invested roughly 46 percent of their money in alternatives, up from 42 percent in 2007 and 27 percent in 2000," and "[l]arge endowments with over $1 billion in assets have [in 2008] as much as 52 percent invested, up from 47 percent invested in 2007.[3]" Because of this influx of institutional assets, it follows that HFMs are becoming subject to enhanced due diligence, as well as a heightened demand for comparability among HFMs. Not surprisingly, many of these managers have been turning to the GIPS as a way to effectively achieve the transparency being demanded by the marketplace.

3 – Hill, Gary, and Svea Herbst-Bayliss. "Education endowments put more with hedge funds." *Reuters News* Thomson Reuters, 27 Jan. 2009. 10 Mar. 2010. Link to article >

In addition to the increase in institutional assets being placed with HFMs, the recent frauds that have coursed through Wall Street have only heightened the need for increased transparency in the alternative space. Carl Bacon, a well-known professional in the performance measurement industry, noted that

> *The days of rushed, ill-prepared due diligence and acceptance of unjustifiable performance fees are over. In the future, investors will demand transparency, an understanding of the underlying risks of the fund - and, possibly, GIPS compliance and independent verification.*[4]

Anecdotally, transparency has become nearly as important as performance for prospective investors in the alternative space. As HFMs compete for assets, the "GIPS can really be a way to differentiate yourself from your competition because it allows you to go to institutional investors and other sophisticated investors and give them that assurance that the figures are reliable because they are GIPS compliant.[5]" The GIPS go a long way in satisfying the increased demand for transparency that is a constant topic of discussion in the investment management industry post-Madoff.[6]

It is important to note that the GIPS' fundamental principles are those of fair representation and full disclosure. These principles are always to be followed, particularly when firms encounter gray areas in the Standards. The Standards' end goal of transparency and uniformity is so needed in the alternative industry that the President's Working Group on Financial Markets' *Principles and Best Practices for Hedge Funds Investors* suggested that "when practical and applicable, investors should require that hedge fund managers report their performance according to GIPS reporting standards.[7]" Furthermore, a recent survey of over 75 asset management firms, representing over $7 trillion in assets under management, found that "two-thirds of respondents project that hedge funds, when pitching a firm's performance track record, will need to be compliant with the GIPS.[8]

The GIPS are comprised of six core sections as well as two additional sections devoted to real estate and private equity. HFMs, like any other asset manager, must follow all applicable requirements of the GIPS in order to claim compliance. The remainder of this discussion will consist of a step-by-step examination of each section of the GIPS. While each individual standard will not be specifically addressed, the discussion will focus on the specific requirements that often present unique challenges to HFMs. In the course of the discussion, we will also present industry best practices regarding the most common solutions for each of these challenges.

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4 – Bacon, Carl. "News feature - Hedge funds urged to adopt global standard." *Hedge Funds Review* Incisive Media Ltd., 22 Apr. 2009. 10 Mar. 2010. Link to article >

5 – Banzaca, Jennifer. "Global Investment Performance Standards Facilitate Reliable, Apples-to-Apples Comparisons by Hedge Fund Investors, and Offer Marketing Opportunities for Hedge Fund Managers" *The Hedge Fund Law Report* 3.9 (2010) 04 Mar. 2010. 10 Mar. 2010 Link to article >

6 – While the GIPS were not designed specifically to detect fraud, the scrutiny to which a firm is subject during a typical verification (via the minimum verification procedures) would likely raise certain red flags that might cause the verifier to ask the difficult questions that could ultimately point towards fraudulent activity.

7 – "Principles and Best Practices For Hedge Fund Investors." *The Investors' Committee to the President's Working Group on Financial Markets*. 15 Apr. 2008. 10 Mar. 2010. Link to article >

8 – Miller, Holly. "The Glass Hammer / Stone House Consulting Survey of Buy-Side Industry Trends." *The Glass Hammer*. 3 Nov. 2009. 10 Mar. 2010. Link to article >

PART II: SOLVING GIPS COMPLIANCE ISSUES

A. Fundamentals of Compliance

This first section of the GIPS focuses on the more qualitative issues of compliance, such as defining the firm, ensuring that the firm's policies and procedures are established and documented, and providing a "fully compliant presentation" to all prospective investors.

1. Definition of the Firm

A common misconception that HFMs have is that the claim of compliance can be made on a single product or fund (i.e., "we want to claim compliance on our Global Macro Fund"). However, one of the basic tenets of the GIPS is that the entire firm (i.e., the management company) must claim compliance with the GIPS; a firm's flagship fund cannot claim compliance. From the GIPS perspective, the "firm" can be defined as how it holds itself out to the public. For example, if a firm has five funds of approximately $200 million each, then the GIPS compliant firm will most likely consist of the five funds representing $1 billion in assets under management. All discretionary, fee paying accounts must be placed into composites. An HFM cannot choose what vehicles are included in composites; however, they can still choose which composites it wants to market actively.

In some instances, an investment adviser might be so large that it incorporates several different subsidiaries, such as a retail arm, an institutional arm, and an alternative fund management arm. In these cases, it is not required (and not always appropriate) for the parent company to make the claim of compliance. Rather, the GIPS-defined firm could be one of the subsidiaries, assuming that the subsidiary holds itself out to the public as a distinct business entity. For the purposes of this discussion, we will assume that the HFM is the GIPS-defined firm, whether it is a subsidiary of a larger institution or whether it is a standalone business. In this case, all of the funds and any private client accounts managed by the HFM would be included in the firm's claim of compliance.

2. Policies and Procedures

Standard 0.A.6 of the GIPS states that all firms claiming compliance with the GIPS are required to "document, in writing, their policies and procedures used in establishing and maintaining compliance with all applicable requirements of the GIPS.[9]" For many HFMs, this often can be an instructive exercise. A comprehensive policies and procedures document will address all aspects of a firm's claim of compliance, including the definition of the firm, discretion, composites, calculation methodologies, and the creation and distribution of marketing materials. To have this information in a written document also serves as an effective internal control, helping to ensure consistency in a firm's operations particularly when the HFM experiences employee turnover.

For firms that have already adopted an operational policies and procedures document, a section on GIPS compliance and performance measurement can simply be included. Otherwise, a new document can be created, specifically devoted to the policies and procedures that the firm follows to establish and maintain its GIPS compliance. The construction of a policies document should not be an overly laborious task. However this is an area where firms often gain value from working with a third-party service provider.

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9 – CFA Institute. *Global Investment Performance Standards (GIPS) Handbook*. Second Edition, 2006. 2 ed. Charlottesville: CFA Institute, 2006. (p.21)

3. Firm Assets

The GIPS require that total reported firm assets be the sum of all discretionary, non-discretionary, fee-paying, and non-fee paying accounts within the defined firm. For HFMs, calculation of this number can be made more challenging when determining whether to present assets gross or net of leverage. The GIPS do not specifically address the calculation of assets gross or net of leverage, but in a response to this exact question, the GIPS Helpdesk has stated that "it would be best to report *both* gross and net assets if leverage is a significant factor for the firm.[10]" Furthermore, the HFM should provide any additional disclosures that would help an investor understand how the HFM's assets have been calculated. Since the NAV of a fund consists of net assets (assets less liabilities), it seems appropriate in most cases to present assets net of leverage (with the option also to show gross assets) and we recommend doing so.

4. Providing a Compliant Presentation

Standard 0.A.11 of the GIPS requires firms "to make every reasonable effort to provide a compliant presentation to all prospective clients.[11]" This compliant presentation must include performance that has been calculated utilizing approved calculation methodologies and include specific statistics and disclosures in addition to what most HFMs typically present in their existing one-page "fact sheets." Some of the required statistics include gross or net-of-fees performance on an annual basis, composite assets, firm assets, and number of accounts in each composite. Required disclosures include, but are not limited to, the definition of the firm, description of the composite/investment strategy, the availability of a complete list and description of the firm's composites, and the composite's fee schedule. Depending upon the specifics of the particular HFM, additional disclosures are likely to be necessary.

Because of these requirements, the GIPS compliant presentation will likely be different from legacy presentations of the HFM's performance. However, it is this document that facilitates the apples-to-apples comparison. While at first this might seem like an onerous task, creating a compliant presentation for a composite generally is not a time-consuming ordeal. Ordinarily, the required statistics are readily available and the disclosures are not overly complex. It is also helpful to remember that creating a compliant presentation does not mean that HFMs need to completely rework their existing marketing material. Typically, the existing marketing materials can continue to be used, and the compliant presentation is simply an addition to the information that a prospective client will receive. HFMs do need to ensure that performance is consistent across all marketing materials and this performance needs to agree with performance being presented on the compliant presentation. To ensure all prospective investors have received a compliant presentation, many HFMs will include the presentation as an appendix to their pitchbooks.

B. Input Data

1. Portfolio Valuation

Firms claiming compliance are required to capture all data and information necessary to support and calculate performance. This generally includes external cash flows and current market values for holdings (cost basis or book value is not permitted). Obtaining accurate current market values can be a challenge for HFMs, and in this vein, the upcoming GIPS 2010 Edition (effective 01/01/11) will require that all portfolios utilize fair value. This change from market value to fair value will increase the accuracy and transparency of many illiquid, difficult-to-value investments, as well as

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10 – GIPS HelpDesk Reply. 29 Nov. 2007 (Available upon request)

11 – CFA Institute. *Global Investment Performance Standards (GIPS) Handbook*. Second Edition, 2006. 2 ed. Charlottesville: CFA Institute, 2006. (p.22)

create consistency with the financial reporting standards set forth by the International Accounting Standards Board® (IASB) and the Financial Accounting Standards Board (FASB). The GIPS 2010 Edition includes the GIPS Valuation Principles, an appendix to the GIPS that addresses in detail a firm's valuation requirements. The GIPS Valuation Principles also provide an instructive valuation hierarchy that is to be incorporated into a firm's policies and procedures. The hierarchy begins with market value at the top as the most accurate valuation determinant and proceeds down a list of successively less observable valuation methods, culminating with the use of subjective, unobservable inputs. It is, of course, important that an HFM thoroughly document its policies for valuing portfolios. These policies may differ from one HFM to the next and may already be delineated in a fund's offering memorandum. Private client accounts may have different valuation procedures. If so, these should be captured within the firm's policies and procedures.

2. Valuation Frequency

Currently, holdings must be valued at market value, on the date of any large, external cash flow, and prior to January 1, 2010, on a monthly basis. Beginning January 1, 2011, firms will be required to value all assets using Fair Value methodology, while still being valued on the date of any large, external cash flow. Most HFMs subscribe and redeem investors in their funds on a quarterly or monthly basis, and as a consequence, do not have intra-month external cash flows. As a result, the appropriate valuation frequency will most likely be monthly, and HFMs that strike a NAV at month-end are often able to use this NAV to satisfy the GIPS monthly valuation requirement. It is worth mentioning that most HFMs utilize a third-party fund administrator for calculating their funds' NAVs. This use of a third-party is a common practice and permissible under the GIPS. It is incumbent upon the HFM to ensure that the administrator is valuing all funds in accordance with GIPS requirements. It is also important for HFMs to understand that if a fund experiences a large, external cash flow intra-month, then it would be necessary to revalue the fund on the date of the cash flow (the magnitude of the cash flow triggering the revaluation should be pre-set in the HFM's policies), and geometrically link the two sub-periods to arrive at a monthly return. As HFMs accept private client accounts, the likelihood of intra-month cash flows rises and revaluation of accounts will become more commonplace within the organization.

A mid-month or even monthly valuation can be slightly more challenging for funds that contain illiquid assets or funds that include private equity investments as part of the larger fund. In these circumstances, it might not be possible to observe a current market valuation for these types of assets with such frequency. However, this does not automatically mean that an HFM with hard-to-value investments cannot be compliant. Rather, in this case the HFM would need to rely on its valuation policies, which should make reference to or contain the valuation hierarchy found in the GIPS Valuation Principles. When a market value is not observable, a firm would need to work down its valuation hierarchy. As discussed above, beginning 01/01/11 firms will be required to use Fair Valuation. For liquid assets, firms must use "the objective, observable, unadjusted quoted market price;[12]" however, for illiquid investments, a firm must follow its valuation hierarchy. Again, it is important to note that the GIPS definition of Fair Value and the GIPS Valuation Hierarchy are consistent with the Fair Valuation definitions used by IASB and FASB. A possible step down a firm's valuation hierarchy might include using internally generated estimates or values of illiquid assets. In any case, it is important that the firm consistently adheres to its portfolio valuation policies when contemplating the valuation of a fund holding illiquid assets.

12 – CFA Institute. *Global Investment Performance Standards 2010.* Charlottesville: CFA Institute, 2010. (p.25)

C. Calculation Methodology

1. The GIPS Require Time-Weighted Rate of Return

One of the central tenets of the GIPS is that performance be calculated using a time-weighted rate of return (TWRR). A TWRR removes the impact of external cash flows, which are typically client-driven, and calculates a return that most accurately reflects the portfolio manager's ability. Removing the impact of a cash flow is done either by revaluing the account on the date of the cash flow or by weighting the flow according to the day of the month on which the flow occurred. Because cash flows are not usually coming in or out of a fund during the middle of a month, HFMs are typically able to satisfy this TWRR requirement by calculating a simple return based on the fund's monthly NAVs. However, as HFMs bring on private client accounts, it will be necessary to ensure the firm has the ability to revalue or weight the cash flow, if it occurs during the middle of the month.

Private Equity funds are not bound by the TWRR methodology, but rather must calculate and present a since-inception internal rate of return (SI-IRR). The logic here is that because private equity managers typically control the cash flows (capital calls and proceed distributions), then a calculation methodology, such as a dollar-weighted rate of return, that incorporates the timing and amount of the cash flows needs to be used.

2. Performance Streams

One of the more challenging aspects of the GIPS that HFMs attempting to claim compliance wrestle with concerns what performance stream should be shown. Specifically, how should net-of-fees performance be calculated and presented? Inherent in alternative funds are complexities such as multiple share classes and series, differing fee structures, and master-feeder structures with on-shore and off-shore return streams. However, there are various options for addressing these matters.

Method A.

Tracking the original, full fee-paying investor or share class of a fund is one of the most common ways in which a fund will present performance. Here a firm will "present [a] return for [the] initial series of [the] highest paying share class, which reflects the net return of [an] investor in the fund since inception, assuming no subscriptions or redemptions.[13]" When a fund has a master-feeder structure, it could be appropriate to identify and use the most representative, full fee-paying share class in a feeder for performance. For example, a fund might show the return stream of its full-fee paying onshore feeder if it feels this stream is the most representative from the prospective investor's perspective. Clearly, the advantage of this method is that the most representative performance stream is utilized. However, the disadvantage with using a representative investor or share class is that it clearly does not reflect every investor's return. When market volatility is high, omitting the shorter performance history of more recent investors can lead to material differences between the performance record and the performance of the overall fund. When determining a proxy investor or share class to use, HFMs need to consider what return would be most representative from a prospective investor's point of view.

While this method of showing performance might seem counterintuitive from a composite construction perspective (simply because not all assets in the fund are included in the calculations), this method is typically the most common way a fund will present performance. Because each of the underlying investors holds a percentage of the Limited Partnership (LP), the gross of fees returns for all investors in a given share class would be equal, and the differences in returns among investors is the result of the different fees and timing of entry into the fund. As a result, it is a

13 – Lamanna, Valerie. "Applying the GIPS Standards to Hedge Fund and Other Alternative Strategies." *2007 GIPS Standards Annual Conference.* Session VI. Slide 17

reasonable practice to select a most representative share class, series, or investor to use when presenting performance. In effect, by utilizing the net return stream of the initial, full fee-paying investor, a firm would be reporting a net return very similar to that which would be calculated had the firm netted down the gross composite return by the maximum fee. However, it should be noted that this method of utilizing a representative share class for composite performance is only applicable when the fund is the only account in the composite. When private client accounts are included in a composite along with the fund, it would not be appropriate to utilize a representative return stream from the fund; an aggregation of all of the returns of the private client accounts and fund returns would be required.

Method B

An alternative methodology to Method A involves netting down the fund's (or a certain share class's) gross return by a model fee. Funds that do this will take their highest stated management fee as well as performance fee and apply these to the gross of fees performance to arrive at a net return. This method effectively achieves the same result as the first method discussed. Utilizing a model fee instead of an actual fee makes it easier to calculate net performance when a firm has made changes to its fee structure over time. Another advantage with using model fees to calculate net returns is the ease of calculation, which can typically be performed in a spreadsheet. One downside, however, is that the net return is not an actual net return, but rather a simulated return using assumptions regarding the fees. In addition, if the model fees used for the calculation are substantially higher than the actual fees that investors are typically charged, using a model fee could understate net performance.

Method C

A third method of GIPS reporting that addresses the limitations of using the original investor or share class method is the "aggregate approach." Using this methodology, all investors' net returns are weighted to arrive at an asset-weighted net return for the fund. This return reflects the performance of all underlying investors regardless of when they came into, or when they exited the fund. While the advantage of this approach is that it reflects all underlying assets of the fund, the significant disadvantage is that the return presented is one that no individual investor has ever actually achieved. When a prospective investor reviews the performance stream, such investor could never conclude that "this is the return I would have achieved had I invested at the inception of the strategy." What further complicates this methodology is that different investors can often have differing management fees, performance fees, and high-water marks based on when they subscribed to the fund. By netting down the gross performance of all investors, the net return becomes an amalgamation of multiple, different incentive fees, which may not be particularly useful. While we believe this method is permissible, our opinion is that this method is less favorable due to the underlying investors' high-water marks that, in our experience, seem to obfuscate the net of fees performance year over year. This method works best, and is essentially required, when there are multiple accounts (funds and private client accounts) included in the composite.

Although there are many approaches to determining net performance, the overriding principle is clear: HFMs need to consider what performance is most representative from the prospective investor's point of view. It is the responsibility of the HFM to determine whether the most reflective return is best generated using an actual investor, a modeled fee, or an aggregation of all investors.

3. What Fees to Use?

Some HFMs have questioned whether or not performance fees should be included in the net return. When calculating net returns, all fees, including the performance fee, should be included. This is consistent with the GIPS definition of an investment management fee, which is "asset-based (percentage of assets), performance-based (based on performance relative to a benchmark), or a combination of the two.[14]" If a firm did not include the performance fee, the net return would not be reflective of the performance that the actual investors achieved.

Because the terms "gross" and "net" in the hedge fund world are not always consistent with the GIPS terminology, it is important to discuss briefly their terminology. The GIPS define gross-of-fees returns as "the return on assets reduced by any trading expenses incurred during the period,[15]" while net-of-fees returns as "the gross-of-fees return reduced by the investment management fee.[16]" As mentioned, the GIPS include both asset-based fees as well as performance-based fees in the investment management fee. Some HFMs consider gross returns as net of both trading expenses and the asset-based fee, but gross of the performance-based fee, and consider net returns as net of the trading expenses, asset-based fee, and performance-based fee. The GIPS do not prohibit such treatment, but this is somewhat atypical, as the gross performance simply needs to be net of trading expenses and not management fees. Please see the following table.

Return	10.00%
– Trading Expense	.08%
GIPS Gross Return	**9.92%**
– Investment Management Fee	1.00%
Net Return*	**8.82%**
– Performance Based Fee	.88%
GIPS Net Return**	**7.94%**

*Also called "Gross" return by some HFMs
** Sometimes referred to as net-net

D. Composite Construction

Composite construction, or the aggregation of individual accounts representing a similar strategy, is an area of the GIPS that can present challenges to long-only managers. For example, significant time and consideration must be devoted by these managers to aggregating hundreds or even thousands of accounts into strategy-specific composites. Determining accurate definitions of composites and dealing with accounts that might have unique objectives or restraints can make this a daunting task.

For HFMs, composite construction has historically been quite simple. In most instances, the fund itself represents the only account managed within a particular strategy, though this is changing because of the increased prevalence of private client accounts. When the fund is the only account managed to a given strategy, the composite will be entirely comprised of a single account, the hedge fund. When funds have master-feeder and/or on-shore and off-shore structures, given that these different components are managed to the same strategy and are managed and traded at the master level, they should generally all be included in the same composite. As noted above, there is flexibility when determining what performance stream to use for presentation purposes, but the underlying assets of all components of the fund should be represented in the calculation of composite assets. This will be an aggregation of all of the fund assets, including the assets of all on-shore and off-shore feeders and all share classes and series. As HFMs add more private client accounts, composites are evolving to include both the fund itself as well as any private client that is managed to the same strategy. For example, an HFM could maintain a convertible arbitrage composite comprised of

14 – CFA Institute. *Global Investment Performance Standards (GIPS) Handbook*. Second Edition, 2006. 2 ed. Charlottesville: CFA Institute, 2006. (p.60)

15 – Ibid., p. 59

16 – Ibid., p. 61

the one hedge fund and three separate accounts that are all managed to the convertible arbitrage strategy. The overriding idea is that all like-managed accounts (separate accounts, funds, pooled vehicles, etc) should be included in the same composite.

1. Side Pockets

The composite construction process can become a little bit more complicated for funds that have established side pockets. Side pockets are often created to allow new investors to come into the fund without having exposure to legacy illiquid investments, and they preserve the fund's liquidity profile by not allowing redeeming investors to disproportionally deflate the liquid portion of the fund. Side pockets segregate certain investments from the rest of the fund, and only certain investors are entitled to a portion of the eventual proceeds of the securities. There are two options for presenting performance of funds with side pockets.

Option 1

The first option includes presenting two different performance streams, one for the original investors exposed to the side pocket, and another stream that does not reflect the performance of the side pocket. This option would be most appropriate if the inclusion of the side pocket investments would have a material impact on performance of the overall fund. However, showing the performance stream of the side pocket can often be a difficult challenge, as valuations for the side pocket can be hard to make.

Option 2

The other option is to present a single performance stream. If electing to utilize this option, the firm will want to present the performance stream that is most representative from the prospective investor's point of view. If the side pocket was only offered to a preferred share class, then it is likely that the performance being presented for GIPS purposes should *not* include the effect of the side pocket, as it is not representative of the performance that a typical investor would have experienced. Under this scenario, it would be important to disclose *what* performance is being presented and to make a note that other return streams are available upon request.

If an HFM chooses not to show the performance of the side pocket, it is critical that the HFM discloses that a side pocket exists, the estimated value of the side pocket, and any other relevant information. It bears mentioning that it is never permitted to remove the effects of side pocket performance on a retroactive basis if the exclusion is simply to facilitate better performance. The inclusion or exclusion of the side pocket performance must be based upon what would be most representative from the prospective client's perspective. Of course, regardless of which approach a firm chooses to take with side pockets, full disclosure is of the highest importance.

E. Disclosures / Presentation and Reporting

For the purposes of this discussion, our coverage of these two elements of the GIPS will be combined because they both relate to an HFM's responsibility to create fully compliant presentations for its composites. The fully compliant presentation is the document that allows for the prospective investor to make an apples-to-apples comparison between similar strategies of different managers. The compliant presentation consists of two required elements: the composite statistics and the required disclosures that accompany the statistics. Examples of required statistics include the gross or net performance, composite assets, and total firm assets, while examples of required disclosures include the definition of the firm, the definition of the composite, and the currency in which performance is expressed. On the following page is an example of a GIPS compliant presentation for a composite that contains a hedge fund.

XYZ INVESTMENT MANAGEMENT

January 1, 2005 through December 31, 2009

ABC Composite - Net Returns

Year	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD	S&P 500
2005	-5.71%	9.98%	5.48%	0.46%	0.63%	0.06%	7.08%	-1.49%	0.82%	1.62%	3.19%	-4.38%	17.99%	4.90%
2006	2.34%	0.8%	0.84%	0.89%	6.38%	0.31%	-0.62%	-0.26%	0.92%	5.39%	1.71%	0.96%	21.24%	15.77%
2007	1.96%	-6.81	-0.21%	0.56%	-0.59%	-1.17%	-5.37%	2.19%	-1.32%	3.02%	0.54%	0.11%	-7.31%	5.48%
2008	5.42%	6.48%	-6.91%	-6.37%	0.19%	-0.96%	-4.13%	-0.84%	-3.95%	4.68%	-1.68%	-2.62%	-11.15%	-37.03%
2009	-3.73%	-0.34%	4.70%	1.23%	0.93%	-0.66%	-0.06%	2.90%	-1.66%	4.91%	0.98%	-0.56%	8.63%	26.5%

	2005	2006	2007	2008	2009
Composite Assets ($ Millions)	$884.9	$1,072.86	$994.44	$883.51	$959.67
Total Firm Assets ($ Millions	$1,327.35	$1,609.29	$1,491.65	$1,325.27	$1,439.51

XYZ Investment Management has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

Firm and Composite Information

XYZ Investment Management is an independent management firm that manages alternative investment strategies for high net worth individuals and institutions.

The ABC Composite invests in equities, fixed income securities, commodities, and derivatives to produce an absolute return. The ABC Composite was created on January 1, 2005. A complete list and description of firm composites is available upon request. Additional information regarding the firm's policies and procedures for calculating and reporting performance results in available upon request.

The fund utilizes leverage and derivative transactions, including futures and swap transactions. The returns from these transactions are material to the performance of the composite. Further information about the use of derivatives and leverage is available upon request.

Benchmark

The volatility of the index shown may be materially different from the individual performance attained by a specific investor. The index has not been selected to represent an appropriate benchmark to compare an investor's performance, but rather is disclosed to allow for comparison of the investor's performance to that of a certain well-known and widely recognized index.

Performance Calculations

Valuations and returns are computed and stated in U.S. Dollars. Results reflect the reinvestment of dividends and other earnings.

Gross-of-fees returns are presented before management and custodial fees, but after all trading expenses and withholding taxes. The calculation of the net-of-fees return is the aggregate performance of all un-affiliated onshore investors and is based on the gross of fees return, less expenses, administration fee, management fee and performance fee. We believe this return is indicative of the return expected by a full fee paying investor.

Fees include a 1.0% per annum investment management fee, and a 20% performance fee that is accrued monthly.

For the entire period presented above, the composite consisted of a sole account. As the composite has consisted of one account for all periods, dispersion is not applicable.

Verification

XYZ has received a firm-wide verification from ACA Beacon Verification Services for the period 01/01/05 – 12/31/09. The ABC Composite has received a Performance Examination for the same time period. A copy of the verification report is available upon request.

Past performance does not guarantee future results.

In addition to the specified disclosures required of all firms, it is particularly important for HFMs to include additional disclosures regarding assumptions made in the presented performance. If a fund is including the oldest, highest-fee paying share class as a representative return stream in the composite, this assumption would need to be disclosed. Other unique aspects of the composite, such as treatment of side pockets, performance fees, high-water marks, and the degree to which leverage or derivatives are utilized should also be disclosed. Because the Standards do not currently provide guidance on many of these issues that HFMs encounter, industry best practice would encourage disclosing any information that the HFM believes would be useful to the prospective investor in evaluating the performance results of the composite.

The idea of creating a compliant presentation may be new to many HFMs who are used to showing only the return stream, with minimal disclosures regarding the assumptions and methodology of the performance. Again, the creation of these presentations is typically not a massive, time consuming effort, but rather consists of modifications of the HFM's existing materials. When advertising, once a claim of compliance is made, all performance used in any marketing pieces (i.e., pitch books) must be the same performance found in the GIPS compliant presentation.

F. Other Considerations

1. Supplemental Information

HFMs will often maintain results from a model or back-tested strategy. Because the GIPS require performance to be only that of actual management of a strategy (refered to as "live performance"), these model or back-tested results are typically shown as supplemental information. Supplemental information is defined as "any performance-related information included as part of a compliant performance presentation that supplements or enhances the required…disclosure and presentation provisions of the GIPS.[17]" This information must be clearly disclosed as such; however, it still may be presented as long as it accompanies a GIPS compliant presentation. A common practice for firms that wish to report back-tested results is to include this supplemental track record in a table on a separate page following the GIPS compliant presentation. The supplemental performance table must contain a disclosure that the performance is supplemental because it was created using back-tested results or a model and that it is not live performance.

Another important consideration is that the GIPS prohibit the linking of supplemental information with actual performance. As a result, any annualized numbers for the GIPS compliant performance may not include any periods of time that contain performance created using back-testing or a model. It also is important to note that the SEC staff is particularly sensitive to the presentation of back-tested and model performance, so careful consideration of all regulatory requirements and not only the GIPS is imperative.

2. Portability

For portfolio managers who leave one HFM to join another and want to bring along the track record of the hedge fund they previously managed, portability comes into play. When the following three requirements of the GIPS are met, a track record from a prior firm must be ported.

> i. *Substantially all the investment decision makers are employed by the new firm (i.e., research department, portfolio managers, and other relevant staff);*

17 – Ibid., p. 242

ii. The staff and decision-making process must remain intact and independent within the new firm; and

iii. The new firm has records that document and support the reported performance.[18]

Disclosure of the ported track record is also required. When the underlying records cannot be substantiated, or any of the other criteria above cannot be met, portability cannot be achieved and the HFM must not link the performance achieved at the prior firm to that of the new firm. However, the HFM could show the performance from the prior firm as supplemental information, provided that the supplemental information is clearly disclosed and it is not linked to the track record of the new firm.

3. Funds of Funds

When calculating monthly performance, a fund of funds typically arrives at a monthly NAV by aggregating the market values of all underlying fund investments, less liabilities, fees, and expenses attributable to the fund of funds itself. When the majority of the underlying funds are liquid and able to provide the fund of funds with end of month values, NAV calculation, and thus GIPS compliant performance, are easily created. However, when the fund of funds contains underlying funds that are illiquid and/or infrequently report their performance (i.e., private-equity funds), calculation of the GIPS compliant performance is significantly more challenging.

As previously discussed, the GIPS require accounts to be valued at least monthly. When market values are not available, the firm would need to rely on its valuation policies and specifically the valuation hierarchy to which the firm adheres. A possible step down the valuation hierarchy could lead the firm to generate an internal estimate or value of an illiquid investment using information available from other similar investment types or benchmarks. Of course, in a valuation hierarchy, the internal estimate is the least preferred and most susceptible to manipulation, but the GIPS do specifically state that "in the case of thinly traded securities, the firm may use a reasonable method for valuation as long as the method is consistently applied.[19]"

4. Benchmarks for Hedge Funds

The GIPS require that all composites present a benchmark in the composite's GIPS compliant presentation. However, there is leeway in that the HFM does not have to present a benchmark if it has not identified a benchmark applicable to the given strategy. If no benchmark is presented, the firm must identify the reason why in the disclosures. While benchmarks for hedge funds exist (i.e., an applicable HFRI index, MSCI World for a global manager), it is not uncommon for HFMs not to provide a benchmark. That said, a good practice would be to present an index such as the S&P 500 or the Barclays Capital U.S. Aggregate Bond Index as the benchmark. In such an instance, the HFM would disclose that the inputs to the benchmark are materially different from those of the strategy and that they are presented solely for comparison purposes. This practice would also be consistent with SEC staff guidance stating that an HFM should disclose the effects of material market or economic conditions on the results portrayed.

18 – Ibid., p. 20

19 – Ibid., p. 78

CONCLUDING THOUGHTS

In closing, it is important to reiterate how quickly GIPS compliance is being embraced in the alternative asset management space. As discussed, this rush to compliance is the natural effect of more assets being placed in alternative strategies as well as the increased flight to transparency and regulatory scrutiny that the financial industry has been subject to in the last several years.

As more HFMs have moved to claim compliance, it has become readily apparent that the GIPS are not a perfect match for HFMs and that there are many considerations for HFMs on which the GIPS simply do not provide guidance. However, the GIPS are flexible enough to allow HFMs to achieve compliance. Furthermore, attaining compliance for HFMs is more readily achievable than is commonly perceived. It is anticipated that the GIPS will eventually publish the guidance on which the Alternative Investment Strategy Working Group has been working. With this additional guidance, many of the unique issues discussed above will be more easily resolved. Until further guidance is published, HFMs who claim compliance need to remember and abide by the fundamental principles of the GIPS: fair representation and full disclosure.

It has been the intention of this discussion to serve as a general roadmap, in the absence of any formal guidance, for HFMs interested in achieving GIPS compliance. We strongly urge HFMs to consult with a GIPS expert as they work through the nuances of claiming GIPS compliance.

APPENDIX

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