Global Investment Performance Standards (GIPS®) for Asset Owners

Explanation of the Provisions in Section 23

September 2020

CFA Institute®
Global Investment
Performance Standards

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INTRODUCTION

The Explanation of the Provisions in Section 23 provides interpretation of each provision included in Section 23—Total Fund and Composite Maintenance. Asset owners that choose to comply with the Global Investment Performance Standards (GIPS®) must comply with all applicable requirements of the GIPS standards, including any Guidance Statements, interpretations, and Questions and Answers (Q&As) published by CFA Institute and the GIPS standards governing bodies.

A total fund is a pool of assets managed by an asset owner according to a specific investment mandate, which is typically composed of multiple asset classes. The total fund is typically composed of underlying portfolios, each representing one of the strategies used to achieve the asset owner's investment mandate. The asset owner is required to create a total fund and present total fund information to the oversight body.

A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The composite return is the asset-weighted average of the performance of all portfolios in the composite. Asset owners are not required to present composites in compliance with the GIPS standards but may choose to do so. If an asset owner chooses to create an additional composite and present it in a GIPS Asset Owner Report, it must present the GIPS Asset Owner Report to the oversight body.

Each provision is included in a grey text box. Within the provisions are words appearing in small capital letters. This indicates defined terms that can be found in the GIPS Standards Glossary. Following each provision is a discussion that provides interpretive guidance to help readers understand the provision.

23. TOTAL FUND AND COMPOSITE MAINTENANCE

23.A. Total Fund and Composite Maintenance—Requirements

Provision 23. A.1

TOTAL FUNDS MUST include all assets managed by the ASSET OWNER as part of the TOTAL FUND's investment mandate, objective, or strategy.

Discussion

A total fund is defined as a pool of assets managed by an asset owner according to a specific investment mandate, which is typically composed of multiple asset classes. The total fund usually consists of underlying portfolios, each representing one of the strategies used to achieve the asset owner's investment mandate. Each total fund must include all assets managed by the asset owner as part of the total fund's investment mandate, objective, or strategy.

Provision 23.A.2

If the ASSET OWNER manages more than one TOTAL FUND according to the same strategy, all TOTAL FUNDS managed according to the same investment strategy MUST be presented either:[23]

a. Separately to the OVERSIGHT BODY, or

b. As a COMPOSITE to the OVERSIGHT BODY.

Discussion

If an asset owner manages more than one total fund according to the same investment strategy, the asset owner has a choice regarding how the total funds are presented to the oversight body. The asset owner may choose to present each total fund separately to the oversight body, creating a separate GIPS Asset Owner Report for each total fund. Alternatively, the asset owner may include all total funds managed according to the same investment strategy in one total fund

[23] REQUIRED for periods beginning on or after 1 January 2015.

composite and create one GIPS Asset Owner Report for the total fund composite to present to the oversight body.

Although asset owners often use the term "composite" to refer to any grouping of accounts or assets, it has a specific meaning in the GIPS standards. In the GIPS standards, a composite is defined as an aggregation of one or more portfolios or total funds that are managed according to a similar investment mandate, objective, or strategy. By definition, therefore, a total fund composite may include only total funds managed according to a similar investment mandate, objective, or strategy.

If an asset owner manages more than two total funds according to the same strategy, the asset owner may include some of the total funds together in a total fund composite and present the remaining total fund(s) separately to the oversight body. There must be a GIPS Asset Owner Report for the total fund composite and for each total fund presented separately to the oversight body. Asset owners may create total fund composites giving consideration to the respective oversight body. As an example, suppose that an asset owner manages three total funds according to the same investment strategy. Two total funds, one managed for the police officers' retirement system and one managed for the firefighters' retirement system, have the same oversight body. The third total fund is managed for the teachers' retirement system and has a separate oversight body. The asset owner may choose to combine the total funds for the police officers' and firefighters' retirement systems into one total fund composite for presentation to the one oversight body, and the asset owner may present the total fund managed for the teachers' retirement system separately to the second oversight body. This approach would be chosen to facilitate the reporting of the total funds to the respective oversight bodies. The asset owner can also choose not to include the total funds for the police officers' and firefighters' retirement systems in a composite and would instead present each total fund separately to the oversight body.

Provision 23.A.3

If the ASSET OWNER manages TOTAL FUNDS according to different strategies, then each TOTAL FUND MUST be presented separately to the OVERSIGHT BODY.

Discussion

Only total funds that are managed according to the same investment strategy may be included together in a total fund composite. If an asset owner manages total funds according to different strategies, each total fund must be presented separately to the respective oversight body, and there must be a separate GIPS Asset Owner Report for each total fund.

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Provision 23.A.4

COMPOSITES MUST be defined according to investment mandate, objective, or strategy. COMPOSITES MUST include all PORTFOLIOS that meet the COMPOSITE DEFINITION. If the ASSET OWNER chooses to create an additional COMPOSITE, then all PORTFOLIOS that meet the COMPOSITE DEFINITION MUST be included in the additional COMPOSITE.

Discussion

Although asset owners often use the term "composite" to refer to any grouping of accounts or assets, it has a specific meaning in the GIPS standards. In the GIPS standards, a composite is defined as an aggregation of one or more portfolios or total funds that are managed according to a similar investment mandate, objective, or strategy.

If an asset owner manages more than one total fund according to the same investment strategy, the asset owner has a choice regarding the use of composites. The asset owner may include all total funds managed according to the same investment strategy in a total fund composite, create a GIPS Asset Owner Report for the total fund composite, and present composite performance to its oversight body. Alternatively, the asset owner may choose to not create a composite and instead present each total fund separately to its oversight body. If an asset owner decides to create one or more total fund composites, these would be considered required composites.

In addition to any required total fund composites, an asset owner may choose to create one or more additional composites. An additional composite is a grouping of portfolios representing a particular strategy or asset class that the asset owner chooses to present in a GIPS Asset Owner Report.

As an example, asset owners often create asset class composites to represent each of the asset classes in the total fund (e.g., equity, fixed income, hedge funds, private equity, real estate). As another example, an asset owner may wish to create an additional composite for its private equity venture capital investments that consists of the venture capital investments held in all private equity portfolios. Although additional composites are not required, asset owners are encouraged to create additional composites when it is meaningful and appropriate and to present them in a GIPS Asset Owner Report. If an asset owner chooses to prepare a GIPS Asset Owner Report for an additional composite, the asset owner must present that composite's GIPS Asset Owner Report to the asset owner's oversight body. Asset owners are not required to create additional composites and present them in a GIPS Asset Owner Report but are recommended to do so.

If an asset owner chooses to create additional composites, all portfolios that meet the composite definition for an additional composite must be included in the composite. If a portfolio meets the composite definition for more than one composite, the portfolio must be included in each of the relevant composites.

Additional composite returns are not required to include cash and cash equivalent returns. Asset owners may, therefore, create additional composites that do not include cash and cash equivalents. For example, an asset owner might decide to create an additional composite that includes all equity investments of the total fund. The asset owner may present this Equity Composite in a GIPS Asset Owner Report even though the Equity Composite returns do not include cash and cash equivalents. Only asset owners that are reporting performance to their oversight body and are not competing for business have the ability to present additional composite returns that do not include cash and cash equivalents as GIPS-compliant information. If the asset owner competes for business, additional composite returns must include cash and cash equivalents. (See Provision 21.A.24 for further information on what to do when the asset owner competes for business.)

Creating meaningful composites is critical to fair presentation, consistency, and comparability of results over time. Asset owners make the ultimate decision as to which portfolios belong in each composite.

To create appropriate composites, it is important to understand what is meant by a composite description and a composite definition.

A <u>composite description</u> is defined as general information regarding the investment mandate, objective, or strategy of the composite. The composite description may be more abbreviated than the composite definition but must include all key features of the composite and must include enough information to allow the oversight body to understand the key characteristics of the composite's investment mandate, objective, or strategy, including:

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

A <u>composite definition</u> is defined as detailed criteria that determine the assignment of portfolios to composites. Criteria may include, but are not limited to, investment mandate, style or strategy, asset class, the use of derivatives, leverage and/or hedging, targeted risk metrics, investment constraints or restrictions, and/or portfolio type (e.g., segregated account or pooled fund).

Composite descriptions are disclosed in GIPS Asset Owner Reports and on the list of total fund descriptions and composite descriptions. (See Provision 21.A.17 for further information on creating the list of total fund descriptions and composite descriptions.) Composite definitions must be documented in the asset owner's policies and procedures.

To differentiate between a composite definition and a composite description, it might be helpful to think of a composite description as focused on a description of the strategy represented by the composite. In contrast, a composite definition includes not only the composite strategy, as represented by the composite description, but also the detailed criteria that determine whether a portfolio is included in a composite (e.g., if a composite includes segregated accounts versus pooled funds). Asset owners must use their judgment when determining what information is appropriate to include in a composite description and composite definition for a specific strategy. Asset owners are encouraged to include more than the required minimum information in a composite description if doing so will help the oversight body understand both the nature of the portfolios included in the composite and the strategy used. In some instances, the composite description and composite definition may be the same or have small differences. This is acceptable as long as the composite description and composite definition are complete and reflect the criteria listed in their glossary definitions.

Additional Considerations

The following are examples of composite descriptions that might be found in a GIPS Asset Owner Report created for an additional composite and the related composite definitions that are documented in policies and procedures.

US Equity Composite

Composite Description

The Domestic Equity Composite (Composite) includes all portfolios from the Total Fund for which the majority of the portfolio is invested in US equities, American depositary receipts (ADRs), REIT shares, and domestic equity derivatives. Composite returns do not include the effect of cash or cash equivalents for internally managed assets.

Composite Definition

The Domestic Equity Composite (Composite) includes all portfolios from the Total Fund for which the majority of the portfolio is invested in US equities, American depositary receipts (ADRs), REIT shares, and domestic equity derivatives. Composite returns do not include the effect of cash or cash equivalents for internally managed assets. The Composite includes internally managed assets, segregated accounts, and pooled funds.

Private Equity Composite

Composite Description

The Private Equity Composite includes all domestic and international investments in leveraged buyout and venture capital funds. These funds tend to have long lock-up periods (seven years or longer) because many of the portfolio investments are not liquid and the leveraged buyout funds use leverage extensively. We make commitments to the funds in various amounts, and capital is called as investment opportunities become available.

Composite Definition

The Private Equity Composite includes all domestic and international investments in leveraged buyout and venture capital funds. These funds tend to have long lock-up periods (seven years or longer) because many of the portfolio investments are not liquid and the leveraged buyout funds use leverage extensively. We make commitments to the funds in various amounts, and capital is called as investment opportunities become available. All portfolios in the composite are pooled funds. All pooled funds with private market investments that have more liquidity are included in the hedge fund composite.

Provision 23.A.5

Any change to a COMPOSITE DEFINITION MUST NOT be applied retroactively.

Discussion

Although investment strategies can change over time, in most cases asset owners should not change the definition of a total fund composite or additional composite. (An additional composite is a grouping of portfolios representing a particular strategy or asset class that the asset owner chooses to present in a GIPS Asset Owner Report.) Generally, changes in strategy result in the creation of a new composite. In some cases, however, it may be appropriate to redefine a composite. If an asset owner determines that it is appropriate to redefine a composite, it must disclose the date and description of the redefinition. Changes to composites must not be applied retroactively.

Note that if an asset owner chooses to create a new composite to reflect a new investment strategy, the asset owner may move portfolios that meet the new composite definition into the new composite. The history of existing portfolios must remain with the original composite.

Provision 23.A.6

TOTAL FUNDS and COMPOSITES MUST include new PORTFOLIOS on a timely and consistent basis as soon as they are funded.

Discussion

A portfolio is defined as an account representing one of the strategies in or components of the asset owner's total fund, including assets managed by external managers for which the asset owner has discretion over the selection of the external manager. For a total fund, any new portfolios within the total fund must be included in the total fund as soon as they are funded. If there is a total fund composite, and if any of the total funds in the composite are being newly established, this requirement also applies.

The same is true for additional composites. (An additional composite is a grouping of portfolios representing a particular strategy or asset class that the asset owner chooses to present in a GIPS Asset Owner Report.) For any additional composite the asset owner chooses to create, any new portfolios (i.e., a portfolio is considered to be an investment) must be included in the relevant composite as soon as they are funded.

Provision 23.A.7

Terminated PORTFOLIOS MUST be included in the historical performance of the TOTAL FUND or COMPOSITE through the final day the assets are managed.

Discussion

A portfolio is defined as an account representing one of the strategies in or components of the asset owner's total fund, including assets managed by external managers for which the asset owner has discretion over the selection of the external manager. The requirement to include terminated portfolios (i.e., a portfolio is considered to be an investment) in the total fund's or composite's historical performance through the final day the assets are managed or held prevents survivorship bias by retaining the performance history of the portfolio for the entire time period for which it was managed to the total fund's or composite's strategy.

The same is true for additional composites. (An additional composite is a grouping of portfolios representing a particular strategy or asset class that the asset owner chooses to present in a GIPS Asset Owner Report.) If all portfolios are removed from an additional composite, for any reason, the performance record of the additional composite comes to an end. If, after a period of time, portfolios are again included in the additional composite, the prior performance history of the additional composite must be presented but must not be linked to the ongoing additional composite performance results. Please see Provision 24.A.6 for more information on presenting performance when there is a break in the total fund or composite track record.

Provision 23.A.8

If the ASSET OWNER chooses to create a COMPOSITE that includes more than one TOTAL FUND, or if the ASSET OWNER creates additional COMPOSITES, TOTAL FUNDS and PORTFOLIOS MUST NOT be moved from one COMPOSITE to another unless either (1) documented ASSET OWNER–directed changes to a TOTAL FUND'S or PORTFOLIO'S investment mandate, objective, or strategy or (2) the redefinition of the COMPOSITE make it appropriate. The historical performance of the TOTAL FUND or PORTFOLIO MUST remain with the original COMPOSITE. TOTAL FUNDS and PORTFOLIOS MUST NOT be moved into or out of COMPOSITES as a result of tactical changes.

Discussion

This provision is applicable if the asset owner chooses to create a composite that includes more than one total fund or if the asset owner creates additional composites. (An additional composite is a grouping of portfolios representing a particular strategy or asset class that the asset owner chooses to present in a GIPS Asset Owner Report.)

Asset owners are permitted to move total funds or portfolios into and out of composites only as a result of documented asset owner–directed changes to a total fund's or portfolio's investment mandate, objective, or strategy or if the redefinition of a composite makes such a move appropriate. Documentation of a change in a total fund's or portfolio's investment mandate, objective, or strategy can include, but is not limited to, letters, e-mails, and internal memorandums documenting the change.

This requirement seeks to preclude or at least minimize the movement of total funds and portfolios into, out of, and between composites. Theoretically, once an asset owner creates composites based on its various investment strategies, total funds and portfolios will be managed to those strategies on a long-term basis. As a result, defining composites is a critical issue when complying with the GIPS standards.

Over time, however, a total fund's investment mandate may be modified, and asset owners may adopt new investment strategies. In those instances, moving a total fund or portfolio from one composite to another may be necessary. Total funds or portfolios must not be moved from one composite to another because of changes in tactical asset allocation. As noted earlier, total funds and portfolios can be moved into different composites only in the case of documented changes to a total fund's or portfolio's investment mandate, objective, or strategy or when the redefinition of a composite makes such a move appropriate.

If the investment strategy for the total fund or portfolio has changed, the transfer of a total fund or portfolio from one composite to another is treated as a termination when it is removed from the former composite and treated as a new total fund or portfolio when moved to the new composite.

The total fund's prior history must remain in the former composite through the last full measurement period the total fund was managed in the former style. A portfolio's prior history must remain in the former additional composite through the day the assets were managed in the former style.

If the asset owner redefines the composite, it must determine if it is appropriate to include the history of the total funds and portfolios in that composite. Asset owners must create a policy, apply it consistently, and not cherry-pick total funds, portfolios, or time periods in order to make performance look better.

Example 1

An asset owner has two total funds managed according to the same investment strategy: Total Fund 1 is managed for the police officers' retirement system, and Total Fund 2 is managed for the firefighters' retirement system. The asset owner has chosen to present the two total funds as one composite to the oversight body. After several years, the investment strategy for Total Fund 1 changes, and the two total funds are no longer managed according to the same investment strategy.

Going forward, the asset owner must remove Total Fund 1 from the Total Fund Composite and present it separately to the oversight body. The asset owner may choose to present no performance history in the GIPS Asset Owner Report for Total Fund 1, because it represents a new strategy. Alternatively, the asset owner may choose to present the performance history for Total Fund 1 only in its GIPS Asset Owner Report. If the asset owner chooses to show performance history for Total Fund 1 related to its former strategy, the change in the investment strategy of Total Fund 1 is considered a significant event and must be disclosed in the GIPS Asset Owner Report. (See Provision 24.C.16.)

The GIPS Asset Owner Report for the Total Fund Composite would include the combined performance of Total Fund 1 and Total Fund 2 until Total Fund 1 was removed from the Total Fund Composite. From that point forward, the GIPS Asset Owner Report would include only the performance of Total Fund 2. Alternatively, the asset owner may choose to terminate the Total Fund Composite and present only the performance of Total Fund 2 in a GIPS Asset Owner Report.

Example 2

An asset owner has two total funds managed according to the same investment strategy. Over the years, the asset owner has presented the total funds separately to its oversight body. The asset owner has now decided to include the total funds in the same composite. It therefore creates a Total Fund Composite that includes both total funds and presents a GIPS Asset Owner Report for the new Total Fund Composite to its oversight body.

Presenting the total funds separately to the oversight body for a period of time, and subsequently choosing to combine the total funds in a composite for presentation to its oversight body, is permitted for asset owners. It is also permissible for an asset owner to have combined the total funds for a period of time and then decide that it is preferable to present the total funds separately to the oversight body. The decision to present the total funds to the oversight body in a new manner must be documented.

Once an asset owner changes the manner in which it presents the total funds to the oversight body, the new manner of presentation should be continued. It is also important to remember that fair representation is one of the fundamental principles on which the GIPS standards are based. Asset owners must not change the manner in which total funds are presented to the oversight body in order to hide poor performance or inappropriately highlight more positive returns.

Example 3

An asset owner has created two additional composites: one representing large-cap domestic equities (Large-Cap Domestic Equity Composite) and one representing small-cap and mid-cap domestic equities (Small-Cap/Mid-Cap Domestic Equity Composite). Together, these two composites include all of the domestic equities in the total fund. The asset owner subsequently decides to create a broader composite to represent all domestic equities, regardless of their market cap.

The asset owner would create a Domestic Equity Composite that includes all of the domestic equity portfolios in the total fund. All portfolios in the Large-Cap Domestic Equity Composite and the Small-Cap/Mid-Cap Domestic Equity Composite would be included in the new Domestic Equity Composite. The asset owner could either: 1) discontinue the Large-Cap Domestic Equity Composite and the Small-Cap/Mid-Cap Domestic Equity Composite; or 2) continue to maintain the Large-Cap Domestic Equity Composite and the Small-Cap/Mid-Cap Domestic Equity Composite, in addition to the broader Domestic Equity Composite.

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