

Global Investment Performance Standards (GIPS®) for Firms

Explanation of the
Provisions in Section 3

January 2020



CFA Institute®
Global Investment
Performance Standards

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INTRODUCTION

The Explanation of the Provisions in Section 3 provides interpretation of each provision included in Section 3—Composite and Pooled Fund Maintenance. Firms 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 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. Creating meaningful composites is essential to the fair presentation, consistency, and comparability of performance over time and among firms. Pooled funds must be included in composites if they meet a composite definition.

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.

3. COMPOSITE AND POOLED FUND MAINTENANCE

3.A. Composite and Pooled Fund Maintenance—Requirements

Provision 3.A.1

The FIRM MUST create COMPOSITES for the FIRM’s strategies that are managed for or offered as a SEGREGATED ACCOUNT.

Discussion

A composite is an aggregation of one or more portfolios (segregated accounts and/or pooled funds) managed according to a similar investment mandate, strategy, or objective. A firm must create a composite for each of the firm’s strategies that is managed for or offered as a segregated account. A segregated account is a portfolio owned by a single client. A portfolio with a pooled fund wrapper (i.e., a single-investor pooled fund), which is unitized but is not available to other investors, is considered a segregated account. If a firm is a sub-advisor for a pooled fund, the firm must treat the sub-advised pooled fund as a segregated account. A composite will contain only one portfolio if the firm has only one portfolio that is managed for or offered as a segregated account for a particular strategy.

For periods beginning on or after 1 January 2020, firms are not required to create or maintain composites that include only one or more pooled funds if the strategy of the pooled fund(s) is not offered as a segregated account.

It is important to remember that the GIPS standards do not differentiate between “marketed” and “non-marketed” composites. The requirement to create composites applies to all strategies that are offered as a segregated account, or managed for a segregated account, whether or not the strategy is marketed by the firm. All composites must be included on the list of composite descriptions (see Provision 1.A.22), and the firm must be able to provide a GIPS Composite Report for any composite that is included on this list (see Provision 1.A.24).

If a firm manages portfolios with overlay strategies, the firm is required to create an overlay composite for an overlay strategy when the overlay strategy is managed separately from the underlying portfolio and the firm offers the overlay strategy as a segregated account. Firms are not required to create an overlay strategy composite when the overlay strategy is implemented as part of a broader strategy but may do so.

Provision 3.A.2

All actual, fee-paying, discretionary SEGREGATED ACCOUNTS MUST be included in at least one COMPOSITE. Non-discretionary PORTFOLIOS MUST NOT be included in COMPOSITES.

Discussion

A segregated account is a portfolio owned by a single client. As noted in Provision 3.A.1, a segregated account with a pooled fund wrapper (i.e., a single-investor pooled fund), which is unitized but not available to other investors, is treated as a segregated account. In addition, a firm that is a sub-advisor for one or more pooled funds must treat the sub-advised pooled funds as segregated accounts.

An actual segregated account is a portfolio that is invested in real, tangible assets and is differentiated from a hypothetical, simulated, or backtested track record for a portfolio or an advisory-only (model) portfolio.

A fee-paying segregated account incurs investment management fees, which are fees paid to the firm, either directly or indirectly, for the management of the segregated account. If a segregated account pays no investment management fees, it is considered a non-fee-paying segregated account.

If a firm temporarily waives the investment management fee for a segregated account that is normally charged a fee, the segregated account is still considered a fee-paying segregated account (with a fee of zero for that period) and must be included in the appropriate composite. Some firms may manage segregated accounts that have a minimal investment management fee that is meant to cover operating or transaction costs. This arrangement is common for segregated accounts that are owned by friends and employees of the firm. If a segregated account has a very small investment management fee that is not representative of the investment management fee that a segregated account would typically pay, the firm must consider such a segregated account as a fee-paying account for purposes of composite inclusion. However, because the segregated account has only a minimal investment management fee that is not representative of the firm's investment management fee for that strategy, the segregated account should be included in the percentage of composite assets that is non-fee paying. The percentage of composite assets that is non-fee paying is a required disclosure in GIPS Composite Reports when net-of-fees composite returns are presented and are calculated using actual investment management fees.

A firm is not required to include non-fee-paying segregated accounts in a composite but may choose to do so. Examples of non-fee-paying segregated accounts are portfolios consisting of the firm's own pension plan assets or portfolios managed for friends or employees of the firm that are not charged investment management fees. If the firm chooses to include non-fee-paying discretionary segregated accounts in one or more of its composites, the firm is not required to include

all non-fee-paying discretionary segregated accounts in composites. If a firm chooses to include non-fee-paying discretionary segregated accounts in a specific composite, however, all non-fee-paying segregated accounts meeting the definition of that composite must be included.

If the firm includes non-fee-paying discretionary segregated accounts in its composites, they are subject to the same rules as fee-paying segregated accounts (e.g., the firm must not move non-fee-paying segregated accounts into and out of a composite unless documented changes in client guidelines or the redefinition of the composite makes it appropriate).

A discretionary segregated account is one for which the firm has the ability to implement its intended strategy. If documented client-imposed restrictions significantly hinder the firm from fully implementing its intended strategy, the firm may determine that the segregated account is non-discretionary. There are degrees of discretion, and not all client-imposed restrictions will necessarily cause a segregated account to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with implementing the intended strategy to the extent that the segregated account is no longer representative of the strategy. Firms are responsible for determining whether account restrictions render a segregated account non-discretionary. Discretion may be defined at the segregated account, pooled fund, composite, asset class, or firm level. Once the definition of discretion has been determined, it must be documented in the firm's policies and procedures and applied consistently. Firms must also document the reasons for classifying each non-discretionary segregated account as non-discretionary.

Firms should, where possible and appropriate, consider classifying segregated accounts with defined restrictions as discretionary and grouping them with any other portfolios that have similar restrictions and are managed in the same strategy in a composite.

Non-discretionary segregated accounts must not be included in a firm's composites. Some firms, however, may group together some or all of the firm's non-discretionary segregated accounts in order to simplify account administration. For purposes of complying with the GIPS standards, such a group is not a composite and must not be included on the firm's list of composite descriptions.

Because the intent of the GIPS standards is to accurately and fairly represent firm performance, all actual, fee-paying, discretionary segregated accounts must be included in at least one of the firm's composites. This requirement helps ensure that a firm presents a complete performance record. Without this requirement, firms could potentially exclude poorly performing segregated accounts from composites.

Each composite must contain all segregated accounts that meet the composite's definition. (See Provision 3.A.5 for guidance on the creation of composite definitions.) Therefore, firms must include a segregated account in more than one composite if it satisfies the definition of more than one composite. If the firm includes portfolios in more than one composite, care must be taken to ensure that assets are not double counted when calculating total firm assets. A segregated account must be counted only once, even if it is included in more than one composite. (See Provision 2.A.3.)

In addition to segregated accounts, firms may have created carve-outs managed with their own cash balance, or carve-outs with allocated cash. A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. If a firm has included carve-outs with their own cash balance in a composite, all carve-outs with their own cash balance that have been created and that meet the composite definition for that strategy must be included in that composite. If a firm has included carve-outs with allocated cash in a composite, it must create carve-outs from all similar portfolios within the firm, and all carve-outs with allocated cash that meet the composite definition must be included in that composite.

Multi-Strategy or Multi-Asset-Class Portfolios

Some firms offer a multi-strategy or multi-asset-class segregated account, with each of the underlying strategies or asset classes included in the segregated account represented by “building blocks” for the strategy, which may be portfolios or carve-outs. A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. For example, a multi-strategy fixed-income segregated account might include portfolios or carve-outs that represent different fixed-income strategies, such as long- and short-duration strategies or high-yield and high-quality strategies. A multi-asset class portfolio might include portfolios or carve-outs that represent equity and fixed-income strategies.

All actual, fee-paying discretionary segregated accounts must be included in at least one composite. This can be accomplished either by including total multi-strategy and multi-asset-class segregated accounts in composites or by including each of the underlying portfolios or carve-outs of total segregated accounts in composites. With the issuance of the 2020 edition of the GIPS standards, a multi-strategy or multi-asset-class segregated account is no longer required to be included in a composite if each of the segregated account’s underlying portfolios or carve-outs are included in appropriate composites. This guidance replaces guidance included in a Q&A issued in November 2012 stating that a discretionary multi-strategy portfolio was required to be included in a multi-strategy composite, even if all of the underlying portfolio segments were included in composites. This change applies to all periods for which the firm claims compliance.

A firm may also choose to include both multi-strategy or multi-asset-class segregated accounts and the underlying portfolio or carve-out segments in a composite. The firm may then present the multi-strategy or multi-asset-class composites or the segment composites to prospective clients, or it may choose to present both. If the firm chooses to present segment composites and not present multi-strategy or multi-asset-class composites to prospective clients of a multi-asset-class or multi-strategy composite, it must present all segment composites of the multi-strategy or multi-asset-class strategy.

When the firm chooses to maintain both multi-strategy or multi-asset-class composites and the segment composites, it must be careful not to double count when calculating total firm assets.

It is the firm's responsibility to ensure that all of its actual, fee-paying, discretionary segregated accounts are included in any composite for which they meet the composite definition. Accordingly, firms must have policies and procedures to identify changes to a segregated account (both discretionary and non-discretionary) that would require a segregated account to be reclassified for composite assignment purposes. If a segregated account changes from discretionary to non-discretionary status because of a new restriction and must be removed from a composite, the segregated account must be removed from the composite on a prospective basis only.

Provision 3.A.3

All actual, fee-paying, discretionary POOLED FUNDS MUST be included in at least one COMPOSITE if they meet a COMPOSITE DEFINITION. The FIRM is not REQUIRED to create a COMPOSITE that only includes one or more POOLED FUNDS unless the FIRM offers the strategy as a SEGREGATED ACCOUNT. The FIRM may terminate any COMPOSITE that was created solely to include one or more POOLED FUNDS if the COMPOSITE is not representative of the FIRM's strategy offered as a SEGREGATED ACCOUNT.

Discussion

A pooled fund is a fund whose ownership interests may be held by more than one investor and is managed to a defined strategy on behalf of fund investors. A portfolio with a pooled fund wrapper (i.e., a single-investor pooled fund), which is unitized but not available to other investors, is treated as a segregated account and not a pooled fund. If a firm is the sub-advisor for a pooled fund, the firm must treat the pooled fund as a segregated account and not a pooled fund.

An actual pooled fund is a pooled fund invested in real, tangible assets and is differentiated from a hypothetical, simulated, or backtested track record for a pooled fund.

A fee-paying pooled fund incurs investment management fees, which are fees paid to the firm, either directly or indirectly, for the management of the pooled fund. If a pooled fund pays no investment management fees, it is considered a non-fee-paying pooled fund.

A firm is not required to include non-fee-paying pooled funds in a composite but may choose to do so. Examples of non-fee-paying pooled funds are pooled funds that include assets of only friends or employees of the firm that are not charged investment management fees, or a feeder fund in a master/feeder fund structure where all fees are charged at the master fund level. If the firm chooses to include non-fee-paying discretionary pooled funds in one or more of its composites, the firm is not required to include all non-fee-paying discretionary pooled funds

in composites. If a firm chooses to include non-fee-paying discretionary portfolios in a specific composite, however, all non-fee-paying pooled funds meeting the definition of that composite must be included.

If the firm includes non-fee-paying discretionary pooled funds in its composites, they are subject to the same rules as fee-paying pooled funds (e.g., the firm must not move non-fee-paying pooled funds into and out of a composite unless documented changes in pooled fund guidelines or the redefinition of the composite makes it appropriate).

A discretionary pooled fund is one for which the firm has the ability to implement its intended strategy. Firms make the ultimate decision as to whether or not pooled fund restrictions render a pooled fund non-discretionary. Discretion may be defined at the segregated account, pooled fund, composite, asset class, or firm level. Once the definition of discretion has been determined, it must be documented in a firm's GIPS standards policies and procedures and applied consistently. Firms should, where possible and appropriate, consider classifying pooled funds with defined restrictions as discretionary and grouping them with any other portfolios that have similar restrictions and are managed in the same strategy in a composite.

Non-discretionary pooled funds must not be included in a firm's composites. Some firms, however, may group together some or all of the firm's non-discretionary pooled funds in order to simplify account administration. For purposes of complying with the GIPS standards, such a group is not a composite and must not be included on the firm's list of composite descriptions.

Because the intent of the GIPS standards is to accurately and fairly represent firm performance, all actual, fee-paying, discretionary pooled funds must be included in at least one composite if they meet a composite definition. A firm must include a pooled fund in more than one composite if it satisfies the definition of more than one composite. This requirement ensures that a firm presents a complete picture of its performance record. Without this requirement, there is a potential for firms to exclude poorly performing pooled funds from composites. If the firm includes portfolios in more than one composite, care must be taken to ensure that assets are not double counted when calculating total firm assets. A pooled fund must be counted only once, even if it is included in more than one composite. (See Provision 2.A.3.) Prior to 1 January 2020, firms were allowed to differentiate between segregated accounts and pooled funds when defining composites. For example, a firm could choose to create one composite for segregated accounts managed in the firm's large-cap equity strategy and another composite for pooled funds managed in the same strategy. As of 1 January 2020, firms may no longer take this approach. On a prospective basis, pooled funds that are managed in a strategy that is managed for or offered as a segregated account must be included in the same composite as any segregated accounts managed or offered in that strategy. Under prior editions of the GIPS standards, a firm was required to include all portfolios, including pooled funds, in at least one composite. Under the 2020 edition of the GIPS standards, a firm is not required to create or maintain a composite that includes only one or more pooled funds if the firm does not offer the pooled fund strategy as a segregated account strategy.

Firms that complied with prior editions of the GIPS standards may terminate any composite that includes only one or more pooled funds if that composite is not representative of a strategy offered as a segregated account. A firm may choose to create a composite that includes only one or more pooled funds, however, even if the pooled fund strategy is not offered as a segregated account strategy.

There may be situations in which a firm offers a certain strategy only as a pooled fund but at a later date decides to offer the strategy as a segregated account as well. Once the firm begins to offer the strategy as a segregated account, it must then create a composite that will include only the pooled fund until it begins to manage segregated accounts in the strategy. The initial track record for the composite will be based on the pooled fund's track record. It is also possible that the firm might begin to manage a segregated account in the strategy at the request of a client, even though the firm did not offer the strategy as a segregated account. Once the firm begins to manage a segregated account in the strategy, it must create a composite that includes both the pooled fund and the segregated account. The track record would be based on the track record of the pooled fund initially, because it is the first portfolio in the composite, and would subsequently include any segregated accounts managed in the strategy.

A pooled fund must be assigned to a composite if it meets a composite definition. A composite definition includes not only the composite strategy but also the criteria that determine whether and when a portfolio managed in the strategy represented by the composite is included in the composite. For a more complete explanation of a composite definition, please see Provision 3.A.5.

Pooled funds with different base currencies may be included in the same composite, but their assets and returns must be expressed in the same currency as that of the composite. If pooled funds managed in a specific strategy have different base currencies, firms should consider whether the effect of any hedging justifies creating multiple composites defined by both the mandate and hedging. If a pooled fund has multiple share classes, each of which is invested similarly but has a different base currency and there is no currency hedging, each share class may be included in the composite, but the firm must convert the returns and assets for all of the share classes to the same currency for inclusion in the composite. Alternatively, the firm may include in the composite one share class as a proxy for the total fund, if the converted returns for all share classes are the same or very similar. The firm would include the fair value of the assets of the total fund instead of the proxy share class.

It is the firm's responsibility to ensure that all of its actual, fee-paying, discretionary pooled funds are included in any composite for which they meet the composite definition. Accordingly, firms must have policies and procedures to identify changes to a pooled fund (both discretionary and non-discretionary) that would require a pooled fund to be reclassified for composite assignment purposes. If a pooled fund changes from discretionary to non-discretionary status because of a new restriction and must be removed from a composite, the pooled fund must be removed from the composite on a prospective basis only.

Provision 3.A.4

Non-fee-paying discretionary PORTFOLIOS may be included in a COMPOSITE. If the FIRM includes non-fee-paying discretionary PORTFOLIOS in a COMPOSITE, those PORTFOLIOS MUST be subject to the same policies and procedures as fee-paying PORTFOLIOS.

Discussion

If a portfolio (a segregated account or pooled fund) pays no investment management fee, it is considered a non-fee-paying portfolio. Examples of non-fee-paying portfolios are portfolios consisting of the firm's own pension plan assets, a portfolio for a new strategy that currently consists only of a firm's seed capital, or portfolios managed for friends or employees that are not charged investment management fees.

If a firm temporarily waives the investment management fee for a portfolio that is normally charged a fee, the portfolio is still considered a fee-paying portfolio (with a fee of zero for that period) and must be included in the appropriate composite. Some firms may manage portfolios that have a minimal investment management fee that is meant to cover operating or transaction costs. This arrangement is common for portfolios that are owned by friends and employees of the firm. If a portfolio has a very small investment management fee that is not representative of the investment management fee that a segregated account would typically pay, the firm must consider such a portfolio as fee-paying for purposes of composite inclusion. However, because the portfolio has only a minimal investment management fee that is not representative of the firm's investment management fee for that strategy, the segregated account must be included in the percentage of composite assets that is non-fee paying. The percentage of composite assets that is non-fee paying is a required disclosure in GIPS Composite Reports when net-of-fees composite returns are presented and are calculated using actual investment management fees.

A firm is not required to include non-fee-paying discretionary portfolios in a composite but may choose to do so. Examples of non-fee-paying portfolios are portfolios consisting of the firm's own pension plan assets or portfolios managed for friends or employees of the firm that are not charged investment management fees. If the firm chooses to include non-fee-paying discretionary portfolios in one or more of its composites, the firm is not required to include all non-fee-paying discretionary portfolios in composites. All non-fee-paying discretionary pooled funds meeting the definition of that composite must be included.

If the firm includes non-fee-paying discretionary portfolios in one or more of its composites, they are subject to the same policies and procedures as fee-paying portfolios (e.g., the firm must not move the non-fee-paying portfolio into and out of a composite without documented changes in client or pooled fund guidelines or unless the redefinition of the composite makes it appropriate).

Provision 3.A.5

COMPOSITES MUST be defined according to investment mandate, objective, or strategy. COMPOSITES MUST include all PORTFOLIOS, including SEGREGATED ACCOUNTS and POOLED FUNDS, that meet the COMPOSITE DEFINITION. The FIRM MUST NOT exclude PORTFOLIOS from COMPOSITES based solely on legal structure differences.

Discussion

A composite is an aggregation of one or more portfolios (segregated accounts or pooled funds) managed according to a similar investment mandate, objective, or strategy. Creating meaningful composites is critical to fair presentation, consistency, and comparability of results over time and among firms. Firms make the ultimate decision as to which portfolios belong in each composite. Pooled funds are required to be included in a composite only if they are managed according to a strategy that is managed for or offered as a segregated account and they meet the composite definition.

To create appropriate composites, it is important to understand what is meant by a composite description and a composite definition. For many of the provisions of the GIPS standards, it is important to understand the difference between a composite description and a composite definition.

A *composite description* 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 a prospective client 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.
- if illiquid investments are a material part of the strategy.

A *composite definition* 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; taxable versus tax exempt).

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 and

when a portfolio is included in a composite. These additional criteria include such factors as the new portfolio inclusion policy, as well as any policies regarding significant cash flows or minimum asset size that are applicable to the composite. Firms must use their judgment when determining what information is appropriate to include in a composite description and composite definition for a specific strategy. Firms are encouraged to include more than the required minimum information in a composite description or composite definition if doing so will help a prospective client or prospective investor understand both the nature of the portfolios included in the composite and the strategy used.

Composite descriptions are disclosed in GIPS Composite Reports and on the List of Composite Descriptions. Composite definitions must be documented in the firm's policies and procedures.

The following table shows some examples of the items typically included in a composite description and a composite definition. An actual composite description and composite definition will be specific to the composite and may include items not on this list and may not include some items on this list.

Item	Included in Composite Description	Included in Composite Definition
<i>Description of Strategy</i>		
Investment mandate, objective, or strategy	X	X
Portfolio type	X	X
Asset class	X	X
Investments used	X	X
Client type (institutional, retail)	X	X
Investment constraints/restrictions	X	X
Material risks of strategy	X	X
How leverage, derivatives, and short positions may be used, if a material part of strategy	X	X
If illiquid investments are a material part of strategy	X	X
Benchmark	*	X
<i>Composite Inclusion/Exclusion Policies (if applicable)</i>		
Timing of inclusion of new portfolios		X
Timing of exclusion of closed portfolios		X
Minimum size policy		X
Significant cash flow policy		X
Tax status	**	X
Targeted risk metrics		X

* Often included in composite descriptions but required in composite description if the benchmark is one of the criteria for assigning portfolios to a composite—that is, portfolios must be managed against a particular index to be included in the composite.

** If portfolios are assigned to the composite based on tax status, the composite description must include the tax status. If tax status is simply information about the type of portfolios included in the composite, it can be included in the composite definition only.

The following are examples of composite descriptions and composite definitions.

Intermediate-Maturity Fixed-Income Composite

Composite Description

The Intermediate-Maturity Fixed-Income Composite includes all institutional portfolios that invest in intermediate-maturity government and corporate bonds. All bonds have a credit rating of BBB or higher. Key risks include the risk of default of corporate bonds and the negative effect of rising interest rates on bond prices.

Composite Definition

The Intermediate-Maturity Fixed-Income Composite includes all institutional portfolios that invest in intermediate-maturity government and corporate bonds. All bonds have a credit rating of BBB or higher. Key risks include the risk of default of corporate bonds and the negative effect of rising interest rates on bond prices. New portfolios are added to the composite when they are fully invested, as indicated by a cash position of 5% or less. The minimum size for inclusion of new portfolios in the composite is \$5 million. Before a new portfolio is added to a composite, it must be at or above the minimum size for the composite as of the prior month end. Tolerance for violation of the minimum size is established at 10%. If a portfolio falls below 10% of the minimum size at the end of one month, it is removed from the composite the following month. When the portfolio has returned to the minimum size by month end, it is returned to the composite in the following month. If a portfolio experiences a 15% cash inflow during a calendar month, it is automatically removed from the composite for that month. Following the policy for inclusion of new portfolios in the composite, if the cash level is 5% or less at month end, the portfolio will be returned to the composite in the following month. A cash outflow of 15% during a calendar month will trigger an automatic removal of a portfolio from the composite. The portfolio will be returned to the composite in the month following the outflow if it continues to meet other composite criteria, such as size. A portfolio may be removed from a composite prior to the month of the actual cash flow if there is a significant buildup of cash to prepare for the outflow.

US Large-Cap Growth Composite

Composite Description

The US Large-Cap Growth Composite includes all tax-exempt, institutional segregated accounts that invest in large-capitalization US stocks considered to have earnings growth prospects that are superior to that of the average company within the benchmark, the XYZ Large-Cap Growth Index. The targeted tracking error is less than 4% per annum.

Composite Definition

The US Large-Cap Growth Composite includes all tax exempt, institutional segregated accounts that invest in large-capitalization US stocks considered to have earnings growth prospects that

are superior to that of the average company within the benchmark, the XYZ Large-Cap Growth Index. The targeted tracking error is less than 4% per annum.

The US Large-Cap Growth Composite includes only discretionary institutional tax-exempt portfolios. A portfolio is defined as discretionary if it is free of any unique client needs or restrictions that will materially affect performance. The minimum size for inclusion in the composite is \$1 million. When a new large-cap growth portfolio is fully invested (a cash level of 10% or less) at month end, it will be added to the composite in the following month. Terminated portfolios are included in the composite through the last full month for which the firm has discretion. The termination date is based on the notification date of the loss of the portfolio (i.e., the date on which discretion was lost) rather than the date of the actual closing of the portfolio.

A Significant Cash Flow (SCF) policy was adopted for the Large-Cap Growth Composite starting 1 February 2015. The SCF policy is triggered by a net cash inflow or outflow of 15% or more of portfolio assets during a calendar month. If a portfolio in the composite experiences a 15% or greater cash inflow during a calendar month, it is automatically removed from the composite for that month. If the cash level is 10% or less at month end, the portfolio will be returned to the portfolio in the following month. A cash outflow of 15% or more will trigger an automatic removal of a portfolio from the composite. The portfolio will be returned to the composite in the month following the outflow if it continues to meet other composite criteria, such as size. A portfolio may be removed from the composite prior to the month of the actual cash flow if there is a significant buildup of cash to prepare for the outflow.

The Large-Cap Growth Composite has a composite inception date of 1 July 2012 and a composite creation date of 1 April 2014.

The firm must determine what definition of the composite is most appropriate: either a broad, “inclusive” definition, with a potential for a wide internal dispersion of portfolio returns, or a narrow, “exclusive” definition, with a potential for a smaller internal dispersion of portfolio returns.

The GIPS standards require firms to develop objective criteria for defining composites. The following are guiding principles that firms must consider when defining composites:

- Composites should enable current and prospective clients and investors to compare the performance of one firm with that of another.
- Firms must apply the criteria for defining composites consistently. For example, the firm may not select only certain, specific portfolios that meet the composite definition (i.e., “cherry-picking”) but must include all portfolios that satisfy the criteria for inclusion.
- Firms are not permitted to include portfolios with materially dissimilar investment mandates, objectives, or strategies in the same composite. The performance of such a composite is meaningless. When there are many portfolios that have unique, defining investment characteristics and these portfolios have a strategy that is managed for or offered as a segregated account, it may be necessary for the firm to create numerous single-portfolio composites.

- Portfolios must not be moved from one composite to another unless documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes such a move appropriate. The historical performance of the portfolio must remain with the original composite.

The firm may create broader composites, sometimes referred to as “umbrella” or “parent” composites, that include portfolios from more narrowly defined composites. For example, a firm may create a composite of all fixed-income portfolios with an intermediate-maturity mandate that includes portfolios from different intermediate-maturity-term composites that are based on specific benchmarks. Please see Provision 3.A.19 for additional guidance on this point.

Composite Definition Hierarchy

The following suggested hierarchy may be helpful as firms consider how to define composites. Firms are not required to define their composites according to each level of the hierarchy. When considering this suggested hierarchy for composite definition, it is important to keep in mind that pooled funds are required to be included in a composite if they meet a composite definition.

Investment Mandate, Objective, or Strategy

Composites may be based on the overall investment mandate, objective or strategy, or overall product description.

Examples: Large-cap global equities, long-maturity international bonds, small-cap stocks, global long/short equity, or private equity

Asset Class

Composites based on a broad asset class are the most basic and should be representative of the firm's products. Firms may further define asset classes by country or region.

Examples: Equity, fixed income, balanced, real estate, venture capital, US fixed income, European equities

Style or Sector

Firms may further define a composite based on the style or sector.

Examples: Growth, value, active, indexed, asset class sector (e.g., telecommunications)

Benchmark

Firms may define composites based on the portfolios' benchmark, provided the benchmark reflects the investment mandate, objective, or strategy. This situation is often the case if the benchmark also defines the investment universe.

Examples: Swiss Performance Index, S&P 500 Index, FTSE 100 Index

Risk/Return Characteristics

Portfolios with different risk characteristics (e.g., targeted tracking error, beta, volatility, and information ratio) and return objectives may be grouped together into different composites.

Example: A Japanese equity portfolio with a targeted excess return of 1% and targeted tracking error of 2% would be in a separate composite from a Japanese equity portfolio with a targeted excess return of 3% and targeted tracking error of 6%.

Constraints/Guidelines

Firms may choose to further define their composites based on relevant client constraints or guidelines. The following are examples of constraints or guidelines that could result in materially different strategies and, therefore, justify separate composites.

Extent of the Use of Derivatives, Hedging, Short Positions, and/or Leverage

Portfolios that use derivatives, hedging, short positions, and/or leverage may have a different investment strategy from those portfolios that do not use these techniques or instruments. Accordingly, firms must consider whether portfolios that use derivatives, hedging, short positions, and/or leverage should be included in separate composites from portfolios that are restricted from using, or do not use, such instruments or strategies.

Tax Considerations

The firm should define separate composites for portfolios with specific tax considerations if such considerations hinder the firm's ability to implement a specific investment strategy as compared with similar portfolios without specific tax considerations. The different tax situations of institutional and private clients may require different investment strategies. For example, private clients may have restrictions against selling an investment at a loss and rebuying the same investment within a specific time period, but institutional portfolios typically do not have such restrictions. If tax considerations result in different strategies based on the portfolio's tax status, firms are required to define separate composites appropriate to the different strategies.

Type of Client (e.g., pension fund, private client, endowment)

Client type alone must not be used as the primary criterion for defining a composite. In some cases, however, the client type determines the investment strategy because of characteristics that are unique to the client type. If portfolios of different client types have materially different investment strategies and/or styles that are specific to the type of client, the firm must create separate composites representing each of the different strategies that is managed for or offered as a segregated account.

One example would be a wrap fee client. Wrap fee portfolios involve a bundled fee that is specific to the particular investment product. Although the firm can use the same investment strategy for both wrap fee and non-wrap fee portfolios, it may not always have a direct relationship with the end user of its investment management services, even though these portfolios are often considered discretionary assets of the firm. Instead, multiple parties are involved in this business model, with a wrap fee sponsor serving as the intermediary between the firm and the end user of investment services. These factors are what distinguishes wrap fee portfolios and necessitates additional guidance for creating composites. For information on creating appropriate composites to show to prospective wrap fee clients, both before and after a firm obtains wrap fee portfolios, please see Provision 3.A.14.

Instruments Used

The firm may define separate composites based on the specific instruments used for a strategy. An example would be portfolios managed in a commodity strategy, wherein some portfolios choose to invest in the commodity strategy using futures while other portfolios invest in the commodity strategy using physical commodities.

Portfolio Size

Differences in portfolio size may result in meaningful, material differences in investment strategy and justify the creation of separate composites. For example, smaller segregated accounts managed according to a mid-cap equity strategy may be invested in pooled funds while larger segregated accounts managed in the same strategy are invested in individual securities.

Client Characteristics (e.g., cash flow needs, risk tolerances)

Firms may create composites based on multiple client characteristics. For example, a firm may choose to create a growth equity composite for clients that require a 15% cash balance because they withdraw cash on a regular basis versus clients whose portfolios are fully invested. Cash flow considerations and how they affect the investment strategy are often key factors when firms consider whether to include pooled funds in composites.

Portfolio Types/Legal Structure

A composite must include all portfolios that are managed according to the same strategy. Differences in portfolio types or legal structure alone would not warrant a separate composite definition. If differences in portfolio types, such as limited partnerships and segregated accounts, lead to differences in how the strategy is implemented, then the firm would split limited partnerships and segregated accounts into separate composites. Differences driven by a portfolio's legal structure may also arise in implementing a strategy. For example, some portfolio types may be prohibited from investing in 144(a) securities or new-issue IPOs. If the portfolio type or legal structure does not affect the management of the portfolio, then portfolio type or legal structure must not be used as a criterion for composite definition. If the portfolio type or legal structure affects the management of the portfolio, then the firm must create separate composites based on portfolio type or legal structure.

Prior to 1 January 2020, firms were allowed to differentiate between segregated accounts and pooled funds when defining composites. For example, a firm could choose to create one composite for segregated accounts managed in the firm's large-cap equity strategy and another composite for pooled funds managed in the same strategy. As of 1 January 2020, firms may no longer take this approach. On a prospective basis, pooled funds managed in a strategy that is managed for or offered as a segregated account must be included in the same composite as any segregated accounts managed or offered in that strategy.

Currencies

Reporting currency must not be used as a criterion for composite definition unless it affects the investment strategy. For example, suppose that a firm manages portfolios invested in a S&P 500 Index strategy. Some investors in this strategy require reporting in Swiss francs (CHF), some require reporting in British pounds (GBP), and others require reporting in US dollars (USD). If the difference in reporting currencies does not create a difference in the underlying portfolios, the firm may not create different composites based on the client reporting currencies.

In contrast, differences in portfolio base currencies that have a material effect on strategy implementation must be considered when defining composites. For example, if a client instructs the firm to invest cash balances in a different currency, this cash restriction could be used as a criterion for composite definition. Additionally, if currency hedging is part of the investment strategy, different composites may be required. Although the hedged returns of portfolios denominated in different currencies are intended to be similar if they are managed to the same strategy, there will be a difference in returns (even with perfect hedging) equivalent to the cost (or benefit) of hedging. This cost (or benefit) of hedging caused by the interest rate differential between currencies can be significant over time.

Additional Considerations

Multi-Strategy or Multi-Asset-Class Portfolios

Some firms offer a multi-strategy or multi-asset-class segregated account, with each of the underlying strategies or asset classes included in the segregated account represented by “building blocks” for the strategy, which may be portfolios or carve-outs. A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. For example, a multi-strategy fixed-income segregated account might include portfolios or carve-outs that represent different fixed-income strategies, such as long- and short-duration strategies or high-yield and high-quality strategies. A multi-asset-class portfolio might include portfolios or carve-outs that represent equity and fixed-income strategies.

All actual, fee-paying discretionary segregated accounts must be included in at least one composite. This can be accomplished either by including total multi-strategy and multi-asset-class segregated accounts in composites or by including each of the underlying portfolios or carve-outs of total segregated accounts in composites. With the issuance of the 2020 edition of the GIPS standards, a multi-strategy or multi-asset-class segregated account is no longer required to be included in a composite if each of the segregated account’s underlying portfolios or carve-outs are included in appropriate composites. This guidance replaces guidance included in a Q&A issued in November 2012 stating that a discretionary multi-strategy portfolio was required to be included in a multi-strategy composite, even if all of the underlying portfolio segments were included in composites. This change applies to all periods for which the firm claims compliance.

A firm may also choose to include both multi-strategy or multi-asset-class segregated accounts and the underlying portfolio or carve-out segments in a composite. The firm may then present the multi-strategy or multi-asset-class composites or the segment composites to prospective clients, or it may choose to present both. If the firm chooses to present segment composites and not present multi-strategy or multi-asset-class composites to prospective clients of a multi-asset-class or multi-strategy composite, it must present all segment composites of the multi-strategy or multi-asset-class strategy.

When the firm chooses to maintain both multi-strategy or multi-asset-class composites and segment composites, it must be careful not to double count when calculating total firm assets.

Example 1:

A firm creates balanced portfolios with different weights for equity and fixed income based on a client’s investment needs. The firm may determine that each segregated account is so customized that the composites for total segregated accounts would not be meaningful. The firm decides to include the segments of each segregated account in asset class composites and does not create balanced composites.

Example 2:

A firm might decide to create composites based on ranges that represent various blends of a balanced strategy with an equity component and a fixed-income component. There might be an “aggressive” balanced composite for portfolios whose equity segment represents 70% to 100% of the balanced portfolio, a “moderate” balanced composite for portfolios whose equity portion represents 40% to 69%, and a “conservative” composite for portfolios whose equity segment represents 0% to 39%. The firm may also choose to create both balanced and asset class composites.

It is important to remember that if a firm chooses to include a total multi-strategy or multi-asset-class portfolio in a composite, the composite must be constructed according to strategic ranges of asset mixes provided in the client investment guidelines, not according to the tactical percentage of assets invested in the different asset classes. Firms often have discretion to tactically alter the asset allocation in an effort to add value. Portfolios must not be moved into or out of composites in response to changes in tactical asset allocation. Only in the case of client-documented strategic asset allocation changes can portfolios be moved into different composites. Client-documented strategic asset allocation changes include those situations in which the client has given contractual authority to the portfolio manager to make strategic changes in asset allocation. Please see Provision 3.A.10 for additional guidance on this point.

Inception Date

Because composites represent an investment strategy over time, a composite based solely on the composite’s inception date would, generally, not show representative results of how the strategy performed over time in changing market conditions. Therefore, in general, firms are not permitted to create composites based solely on the composite inception date.

In very specific situations, however, such as for private equity or real estate closed-end fund composites, it may be appropriate to group portfolios into composites according to inception date (i.e., by vintage year) and strategy. Vintage year is typically based on either the year of the investment vehicle’s first drawdown or capital call from its investors or the year when the first committed capital from outside investors is closed and legally binding. For certain investments, the vintage year will drive the investment opportunities in a certain strategy.

Firms with Multiple Offices, Branches, or Investment Divisions

Firms are permitted to define different composites for offices, branches, or investment divisions within the defined firm only if the portfolios are managed according to investment mandates, objectives, or strategies that are unique to each particular office, branch, or division. Thus, it is the investment mandate, objective, or strategy that determines the composite, not the location or group. Composites may, therefore, include portfolios from different offices within the firm that are managed according to the same investment mandate, objective, or strategy. However, composites must include only portfolios within the definition of the firm.

Internal Dispersion of Portfolio Returns within a Composite

Although internal dispersion is one measure to determine how consistently a firm has implemented its strategy across the portfolios in the composite, it can be measured only on an ex post basis and, therefore, must not be used as a criterion to define a composite. An internal dispersion figure may serve as a good indicator of whether the criteria for composite definition are suitable or whether the firm should consider redefining the composite. There is no general rule for a maximum amount of composite internal dispersion. The firm should contemplate the definition of a broad, “inclusive” composite with a wide internal dispersion of portfolio returns versus a narrow, “exclusive” composite with a narrower internal dispersion measure.

Treatment of Fees

Firms must not define a composite based on either the type of fees that are paid or the portfolios’ fee schedule. For example, it would not be appropriate to create two versions of a composite that differ only because some portfolios in the composite have a performance-based investment management fee while others do not. A firm may not exclude a pooled fund from a composite for which the fund meets the composite definition solely because the fund pays higher fees than segregated accounts.

Firms should include non-fee-paying portfolios in composites. The GIPS standards do not, however, require that non-fee-paying portfolios be included in composites.

Portfolio Manager

Composites must not be defined solely based on portfolio manager. For example, if a firm uses five portfolio managers to manage portfolios invested in its Growth Equity strategy, and all portfolio managers follow the same investment strategy, the firm must not create composites based on individual portfolio managers. Composites must be defined by the strategy according to which portfolios are managed and not by the person who manages the portfolios.

Inclusion of Segregated Accounts and Pooled Funds in Composites

Once a firm has established composite definitions, all actual, fee-paying, discretionary segregated accounts must be assigned to at least one appropriate composite, as well as to all composites for which they meet the composite definition. All actual, fee-paying discretionary pooled funds must be assigned to any composite for which they meet a composite definition. If a segregated account or pooled fund meets more than one composite definition, the segregated account or pooled fund must be included in each of the relevant composites.

Provision 3.A.6

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

Discussion

Although investment strategies can change over time, in most cases firms should not change the definition of a composite. 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 a firm 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.

When there are changes related to strategy implementation, the firm must determine if the changes to the composite's investment process or personnel result in a change in the investment strategy of the portfolios in the composite. If the firm determines that the changes result in a new investment strategy offered by the firm, a new composite must be started with a current composite creation date and no composite history. The firm must clearly document its decision and rationale. If the changes in resources, process, and personnel do not result in a change in investment strategy, the firm must not create a new composite but must revise the composite description and composite definition where appropriate.

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

The following are some examples of changes in investment strategy and resulting composite changes.

Example 1: Evolution of a Composite Strategy

A firm has a mid-cap equity composite. It is decided that the composite will begin using futures to fully invest any cash balances. Most client guidelines permit the use of futures, but some do not. The firm does not wish to continue to offer a mid-cap strategy that does not use futures.

The firm is permitted to view this change as an evolution of its existing mid-cap strategy rather than as the creation of a new strategy. It must change its composite description and composite definition to indicate the use of futures and the date on which the use of futures began. The portfolios that allow the use of futures remain in the composite.

Because the firm did not wish to continue to offer a mid-cap strategy that does not use futures, the firm would consider the mid-cap portfolios that do not allow the use of futures to be non-discretionary portfolios and exclude these portfolios from all composites on a prospective basis.

If instead the firm wished to continue to also offer a mid-cap strategy that does not use futures, as a variation of its mid-cap strategy, the firm would create a new composite for mid-cap portfolios that do not use futures. The mid-cap portfolios that do not use futures would be moved to the new composite with a new composite creation date.

Example 2: Combining Composite Strategies

A firm currently has two small-cap equity composites. The investment mandate is the same for both composites, but the permissible market-cap range differs. One composite invests in small-cap stocks with market caps ranging between \$100 million and \$1.0 billion. The second composite invests in stocks ranging from \$500 million to \$1.5 billion. The firm would like to expand, with client acceptance, the market-cap range for all portfolios in each composite so that all of the firm's small-cap portfolios could invest in stocks ranging from \$100 million to \$1.5 billion, eliminating the need for two composites.

If the firm decides to create a new strategy by expanding the permissible size range for all small-cap portfolios, the firm must create a new composite. The new composite will consist of all the small-cap portfolios in the two composites. The two existing small-cap composites will cease to exist. The new small-cap composite will not have historical performance results because the new composite's strategy (the expanded market-cap range) is newly implemented. The firm must include the two terminated small-cap composites on the list of composite descriptions for at least five years after the composites' termination date. The firm must obtain any needed client approval for the change in investment mandate and must appropriately document the creation of the new small-cap composite and the termination of the former small-cap composites.

Example 3: Redefinition of a Composite Based on Historical Tactical Decisions

For the past five years, a firm has offered a global equity composite. The firm defined the strategy to allow investments in equity securities from any geographic area, but the firm tactically did not hold any Japanese equities during that time. The firm has now decided that its global equity strategy will not allow investments in Japanese stocks. It therefore wants to redefine the composite as global equities ex-Japan.

Redefining the composite as a global equities ex-Japan composite is not permitted. Historically, the firm did not actually manage the assets in a global equities ex-Japan style. The original composite had a broad global investment mandate that could have included investments in Japan. The firm made a tactical decision not to own Japanese equity securities. Redefining the composite's strategy more narrowly would not accurately reflect the composite's historical investment strategy and would not provide an accurate history of the mandate. The firm is accountable for the tactical decision not to own any Japanese securities. If the firm wishes to offer a global equities ex-Japan composite, it must create a new composite with an investment mandate that reflects the lack of Japanese investments as a strategic decision and not a tactical one. With clients' permission, the firm may move clients into the new global equities ex-Japan composite. The new

composite would have no historical track record. The firm may continue the existing global equity strategy or terminate the global equity composite and find other investment options for clients who do not wish to move into the global equities ex-Japan composite.

Example 4: Umbrella Composites

A firm manages two composites in a mid-cap equity strategy. One composite is based on fundamental research, and the other is a quantitative strategy. The firm would like to create an “umbrella” composite to illustrate the performance of its mid-cap strategies while continuing to market both of its mid-cap strategies.

An umbrella composite is a broadly defined composite that includes portfolios from more narrowly defined composites. In this case, the umbrella composite represents the firm’s mid-cap equity strategies. The firm will include all of the portfolios from its two mid-cap equity composites in the umbrella composite. The umbrella composite’s track record will therefore be a combination of the track records of both mid-cap equity composites. The two mid-cap equity composites will continue to exist.

Umbrella composites may be created retroactively and would include the track records of the underlying composites. For an additional discussion of umbrella composites, please refer to Provision 3.A.19.

Provision 3.A.7

COMPOSITES MUST include new PORTFOLIOS on a timely and consistent COMPOSITE-specific basis after each PORTFOLIO comes under management.

Discussion

The firm is responsible for setting reasonable guidelines for each composite regarding the inclusion of new portfolios. Firms are encouraged to establish a policy that includes new portfolios in composites as soon as possible, preferably at the start of the next full performance measurement period. The measurement period is the period for which the composite performance is calculated.

Firms may need time to invest the assets of a new portfolio to reflect the firm’s investment strategy, and the GIPS standards allow firms flexibility in determining when to add the new portfolio to the composite. Different strategies may result in different time frames for inclusion based on the liquidity of the assets involved. Although in most situations it is fairly easy to purchase and sell securities, some securities may be more illiquid and, therefore, a longer period of time may initially be required to implement the firm’s strategy. Firms must establish a policy on a composite-specific basis and apply it on a timely and consistent basis.

In the case of specific instructions from the client, firms may delay including a new portfolio in a composite. For example, a client may indicate to the firm that assets will be deposited over an extended period, which may delay the full implementation of the firm's strategy until all assets are received. This scenario can result in an exception to the composite's new portfolio inclusion policy. If a firm determines that the incremental investing does not affect the implementation of the style or strategy, however, the firm must follow its composite-specific policy for including new portfolios in the composite.

Provision 3.A.8

COMPOSITES MUST include only those PORTFOLIOS that are managed for the full performance measurement period for which the COMPOSITE return is calculated. PORTFOLIOS that are not managed for the full performance measurement period MUST NOT be included in the COMPOSITE.

Discussion

When calculating composite time-weighted returns, firms must include in the composite only those portfolios that are managed for the full performance measurement period. This requirement applies to all methodologies for calculating composite performance, including the aggregate method.

When considering a composite for which time-weighted returns are presented, if performance intervals are calculated on a monthly basis, only portfolios that are managed for the full month are included in the composite return calculation. Including portfolios that were not managed for the full month would result in returns that are not truly representative of the strategy for the performance period being calculated. For example, assume the firm calculates composite returns monthly. When calculating the composite return for the month of March, only portfolios that have a full month of performance are included. A portfolio with an inception date of 5 March would not be included, nor would a portfolio that terminated on 23 March. To illustrate why the returns are not truly representative, assume the composite contains three portfolios for the full month of March for which the monthly portfolio returns are 3.4%, 3.5%, and 3.6%. The firm gets a new portfolio that starts 5 March, and because the first few days of March had strong performance that the new portfolio did not experience, the return of that portfolio is 1%. Another portfolio that was originally in the composite terminated on 23 March, and there was negative performance at the end of the month that the portfolio did not experience, so that portfolio's return is 5%. To calculate a monthly composite return for March, it would not make sense to include the partial-period returns for the new and terminating portfolios, 1% and 5%, because those returns are missing part of the month. Additionally, there would be no beginning weight for the portfolio that opened on 5 March.

However, the first portfolio in a composite may be included in the composite when the portfolio is fully invested when it is the only portfolio in the composite for the full performance measurement period. Also, the last portfolio in a composite may be included in the composite until the day on which the firm loses discretion to manage the portfolio. A firm must create policies and procedures regarding the inclusion of new portfolios in a composite and the exclusion of terminated portfolios from a composite, and it must apply those policies and procedures consistently. The policies may be composite specific.

For a composite for which a money-weighted return (MWR) is presented, there is only a single since-inception MWR. If a composite for which a MWR is presented includes more than one portfolio, the MWR can be calculated by combining the cash flows and values of the individual portfolios using the aggregate method. Portfolios must be included in the composite calculation for the full period for which the portfolio is under management.

Provision 3.A.9

Terminated PORTFOLIOS MUST be included in the historical performance of the COMPOSITE up to the last full measurement period that each PORTFOLIO was under management and for which the FIRM has discretion.

Discussion

The requirement to include terminated portfolios in the composite's historical performance up to the last full measurement period during which each portfolio was under management and for which the firm has discretion prevents survivorship bias by retaining the performance history of the portfolio while it was managed to the composite's strategy. Once a client notifies the firm of the termination, the firm generally loses its discretion over the portfolio because the firm is restricted in its management of the portfolio. If this is the case, the firm must include the portfolio in the composite through the last full measurement period for which the firm has discretion and exclude it from the composite for subsequent periods. As an example, suppose that a firm was notified on 25 May of the termination of a portfolio and was instructed to immediately commence liquidating the portfolio. Assuming monthly performance measurement periods, because the firm lost discretion to manage the portfolio effective 25 May, the portfolio must be included in the composite return calculation for April and excluded from the composite return calculation for May. A firm must create policies and procedures regarding the handling of the termination of portfolios in a composite, and it must apply those policies and procedures consistently. The policies may be composite specific.

A change in the legal status of a portfolio alone would not be a valid reason to remove the portfolio from the composite. As an example, suppose that a firm managed a portfolio for an individual

and, when the client passed away, the portfolio had to be closed and reopened as part of a trust rather than in the individual's name. From the firm's perspective, the portfolio was not terminated because the portfolio did not leave the firm and the firm never lost discretion over the portfolio. The change in the legal status of the portfolio alone is not a valid reason to remove the portfolio from the composite if the assets never left the portfolio, the firm was never restricted in its management of the portfolio, and the portfolio strategy remained unchanged. If the firm had to suspend trading for an extended period to allow for the change in legal status, however, it would be appropriate for the firm to temporarily remove the portfolio from the composite and re-include it when the transition to the trust was complete.

If all of the portfolios are removed from a composite, for any reason, the composite's performance record comes to an end. If, after some period of time, portfolios are again included in the composite, the prior performance history of the composite must be presented. If time-weighted returns are being presented and the break in performance occurred more than 10 years ago, or before the firm claimed compliance with the GIPS standards, the performance prior to the break is not required to be presented. The composite's prior performance history must not be linked to the ongoing composite performance results. If money-weighted returns (MWR) are being presented, MWRs may not be calculated across the break in performance. The firm must present a MWR for the period from inception to the break in performance. If portfolios in the composite have committed capital, the firm must present the information required by Provision 5.A.4 (e.g., committed capital and ratios) as of the end date of this return calculation. When portfolios are once again included in the composite, the firm must begin to calculate a MWR for the period after the break in performance through the most recent annual period end. If the break in performance occurred more than 10 years ago or before the firm claimed compliance with the GIPS standards, the MWR and the information required by Provision 5.A.4 (e.g., committed capital and ratios) prior to the break in performance are not required to be presented.

Provision 3.A.10

PORTFOLIOS MUST NOT be moved from one COMPOSITE to another unless documented client-directed changes to a PORTFOLIO's investment mandate, objective, or strategy or the redefinition of the COMPOSITE make it appropriate. The historical performance of the PORTFOLIO MUST remain with the original COMPOSITE. PORTFOLIOS MUST NOT be moved into or out of COMPOSITES as a result of the FIRM's tactical changes.

Discussion

Firms are permitted to move portfolios (segregated accounts and pooled funds) into and out of composites only because of documented changes to a portfolio's investment mandate,

objective, or strategy or in the case where the redefinition of a composite makes it appropriate. Documentation of the client-directed change can include, but is not limited to, letters, e-mails, and internal memorandums documenting conversations with clients.

This requirement seeks to preclude or at least minimize the movement of portfolios into, out of, and between composites. Theoretically, once a firm creates composites based on its various investment strategies, 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 client's investment objective may change, a pooled fund's investment mandate may be modified, and firms may adopt new investment strategies. In those instances, moving a portfolio from one composite to another may be necessary. In the case of segregated accounts, wherein the client selects the strategy, the move must be based on a change in the segregated account's strategy that is directed by the client and is clearly identified and documented. In the case of a pooled fund, there must be a documented change in the pooled fund's investment strategy. Portfolios must not be moved from one composite to another because of changes in tactical asset allocation. Portfolios can be moved into different composites only in the case of client-documented strategic asset allocation changes for segregated accounts or changes in the investment mandate for pooled funds, or when the redefinition of a composite makes such a move appropriate.

If the firm suggests a change in strategy that would result in a client's portfolio moving to a new composite, the firm must make every reasonable effort to provide the client with a GIPS Composite Report for the new composite. If the client requests a change that would result in the firm moving the client's portfolio to a new composite, the firm should provide the client with a GIPS Composite Report for the new composite but is not required to do so.

There are situations in which a client has contractually given the firm authority over the allocation of a multi-strategy or multi-asset-class portfolio. In such cases, the documentation of an allocation change should be considered "client-directed" documentation for the change when combined with a client contract that assigns the firm authority over asset allocation within a portfolio. The documentation of the change must include the timing of and reason for the change and must be recorded. A memo to the client file or a record in the client management system would suffice.

The transfer of a portfolio from one composite to another is treated like a portfolio termination when it is removed from the former composite and treated like a new portfolio when moved to the new composite. The portfolio's prior history must remain in the former composite through the last full measurement period during which the portfolio was managed in the former style.

Provision 3.A.11

If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM:

- a. MUST NOT include PORTFOLIOS below the COMPOSITE-specific minimum asset level in that COMPOSITE.
- b. MUST NOT apply retroactively any changes to that COMPOSITE-specific minimum asset level.

Discussion

When a firm establishes a minimum asset level for including portfolios in a composite, the firm has determined that portfolios below that level are too small to be representative of the strategy. Once this level has been established, the firm must not include portfolios below the composite-specific minimum asset level in the composite.

Although firms may not retroactively change a composite-specific minimum asset level, firms attaining compliance may apply a composite minimum asset level retroactively. If a firm is initially coming into compliance with the GIPS standards and is building a compliant track record, it may establish a minimum asset level for a composite and apply that minimum asset level as it constructs the composite's history. Firms must document and disclose any subsequent changes to the composite's minimum asset level and must not retroactively apply the new limit.

Portfolios may fall below the minimum asset level as a result of client withdrawals or depreciation (decrease in asset value). A firm's policies regarding minimum asset levels must define, for each composite with a minimum asset level, whether the composite minimum asset level policy is applied only when a portfolio is first invested in the composite or if it is applied for all periods. There are different approaches to establishing policies and procedures for minimum asset levels.

- Some firms see the composite minimum asset level as a limitation only when initially investing the portfolio and believe that portfolios that subsequently fall below the minimum asset level continue to reflect the composite strategy. These firms establish a composite minimum asset level that applies only to the portfolio's initial size.
- Some firms have policies that apply to the portfolio's initial size and also to subsequent decreases in market value that result from external cash flows and not to market activity. Firms that leave portfolios in the composite when they fall below the minimum asset level as a result of market activity must have policies that address the appropriate action when a portfolio that is below the minimum asset level has a withdrawal and the portfolio cannot be rebalanced to the composite strategy.

- Some firms believe that assigning a composite minimum asset level means that the firm must have a certain amount of assets to manage the portfolio on an ongoing basis as well as to initially invest the portfolio. Such firms view a portfolio falling below the minimum asset level for any reason, including external cash flows or market activity, as non-discretionary.

If a firm's policies regarding minimum asset levels require that a portfolio be removed from a composite solely as a result of market activity, and the firm calculates composite returns monthly, the portfolio should remain in the composite during the first month it drops below the composite minimum because of market fluctuations. A decrease in value resulting from market fluctuations reflects the portfolio manager's performance and, therefore, should be captured in the composite return. When firms test the composite minimum using the end-of-month value, this has the unintended consequence of creating an upward bias for the composite return because the firm is removing portfolios with negative performance from the composite. The test for minimum assets should therefore be done using beginning-of-month values, not ending values.

Each of these approaches is consistent with the requirements regarding minimum asset levels. It is critical that if a firm establishes a minimum asset level for a composite, it must document its policies regarding how portfolios will be treated if they fall below the minimum and must apply these policies consistently.

When establishing policies and procedures regarding a minimum asset level, firms may consider establishing a threshold for applying both the minimum asset level and a minimum time period in order to minimize portfolio movement into or out of a composite. For example, a firm's policies might establish a threshold of 10% below the minimum asset level when determining if a portfolio should be removed from the composite. The firm's policies might also indicate that a portfolio must remain below/above the minimum for at least two periods prior to removal/addition.

If a portfolio is removed from a composite because it falls below the composite-specific minimum asset level, the portfolio's prior history must remain in the composite. Like all policies, once the firm establishes a policy regarding the minimum asset level, it must be applied consistently. Once a portfolio is removed, the firm must determine if the portfolio meets any other composite definition and, if so, must include it in the appropriate composite(s) in a timely and consistent manner. For example, a firm might determine it needs a minimum of \$5 million to implement its Broad Large-Cap strategy. Portfolios below the \$5 million minimum are invested in a concentrated variation of this strategy and are included in the Concentrated Broad Large-Cap Composite. In this case, although the investment mandate may be the same, the strategy is implemented differently based on the portfolio's size.

Firms should bear in mind that if all the portfolios in a composite fall below the minimum asset level and, according to the firm's policies, are removed from the composite, the composite's performance record would come to an end. If, after some period of time, portfolios move above the minimum asset level or new portfolios are added to the composite, the composite's prior performance history must be shown but not linked to the ongoing composite performance results.

Note that a composite's historical performance does not change if a firm establishes a new minimum asset level for the composite. If a firm chooses to implement a new minimum asset level or change the minimum asset level for an existing composite, the firm must document and disclose the new minimum or change to the minimum and apply the new minimum consistently going forward. The firm must not go back and restate historical performance to include or exclude portfolios using the new minimum asset level. Prospectively, the firm will include in the composite only those portfolios that meet the new minimum asset level for the composite. As pointed out earlier, however, if a firm is initially coming into compliance with the GIPS standards and is building a compliant track record, the firm may establish a minimum asset level for a composite and apply that minimum asset level as it constructs a composite's history.

It is important to be aware of the difference between a composite minimum and a product minimum. A composite minimum represents the size below which a portfolio is considered too small to be managed to a specific strategy because the strategy cannot be fully implemented. A composite minimum determines whether a portfolio is included in a composite. A product minimum is used for marketing purposes as a guideline for accepting new segregated accounts. A firm may accept new clients that have less than the stated product minimum. A firm may have a product minimum and no composite minimum, a composite minimum and no product minimum, or different amounts for a product minimum and a composite minimum. As Provision 3.B.1 points out, if a firm has one or more composite minimums, it should not present a GIPS Composite Report to a prospective client for any composite for which the prospective client is known not to meet the composite's minimum asset level.

Provision 3.A.12

A FIRM that removes PORTFOLIOS from COMPOSITES because of SIGNIFICANT CASH FLOWS MUST define "significant" on an EX ANTE, COMPOSITE-specific basis and MUST consistently follow the COMPOSITE-specific policy.

Discussion

For the purposes of the GIPS standards, an external cash flow is defined as capital (cash or investments) that enters or exits a portfolio. A significant cash flow is defined as the level at which the firm determines that a client-directed external cash flow may temporarily prevent the firm from implementing the composite strategy. The firm may define a significant cash flow as a single flow or an aggregate of a number of flows within a stated period of time. Transfers of assets between asset classes within a portfolio or firm-initiated cash flows must not be considered significant cash flows and must not be used to move portfolios out of composites on a temporary basis.

Firms that wish to remove portfolios from composites in cases of significant cash flows must define “significant” on an ex ante, composite-specific basis and must consistently follow the composite-specific policy. Note that a significant cash flow policy is not appropriate for a composite that presents money-weighted returns (MWRs) and is intended only for composites that present time-weighted returns. This is because, in the case of MWRs, the timing of cash flows is under the firm’s control. The concept of a significant cash flow also does not apply to a pooled fund presented in a GIPS Pooled Fund Report.

Once a significant cash flow policy is established for a composite, the firm must remove from the composite all portfolios that experience a significant cash flow. Firms must establish policies for the timing of excluding portfolios that experience significant cash flows from composites, as well as policies for the timing of re-including those portfolios in composites. These policies must be established on a composite-specific basis. A significant cash flow definition or policy may be changed, as long as it is done prospectively and the change is documented in the firm’s policies and procedures. Changes to a significant cash flow definition or policy must not be applied retroactively. If a firm is initially coming into compliance with the GIPS standards and is building a compliant track record, however, the firm may establish a significant cash flow policy for a composite and apply that significant cash flow policy as it constructs a composite’s history. If a significant cash flow policy is being constructed historically for a newly created composite, a significant cash flow level must not be established with the intent of increasing composite performance.

The significant cash flow definition for a composite may be influenced by the characteristics of the asset class(es) within the strategy, such as market liquidity, and/or by the firm’s trading capabilities. For instance, a significant cash flow may be considered 10% of a portfolio’s value for an emerging market fixed-income composite but may be in excess of 50% of a portfolio’s value for a more liquid composite, such as European equities. In theory, the determination of significance should be based primarily on the liquidity of the asset class and the investment strategy employed. Because of the dynamic nature of global markets and the inherent subjectivity involved, it is impractical to establish absolute levels of significance for each asset class.

The measure of significance must be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of portfolio assets (based on the most recent valuation). No other criteria, such as the impact or lack of impact of the significant cash flow on the respective portfolio’s performance, may be considered.

If a firm has a single portfolio in a composite and that portfolio is temporarily removed from the composite because of the firm’s significant cash flow policy, the composite’s track record is broken and its continuous performance history ends. Once the portfolio is added back to the composite and the composite performance is restarted, the performance history must be presented for periods both before and after the break and cannot be linked across the break. If the break in performance occurred more than 10 years ago or before the firm claimed compliance with the GIPS standards, the performance prior to the break does not need to be presented. In all other cases, the firm must present the performance both prior to and after the performance break.

It is important to be aware of the difference between a large cash flow and a significant cash flow. Large cash flows apply only when daily returns are not calculated. A large cash flow is the level at which the firm determines that an external cash flow may distort the return if the portfolio is not valued and a sub-period return is not calculated. Portfolios that experience a large cash flow remain in the composite. A significant cash flow is the level at which the firm determines that one or more client-directed external cash flows may temporarily prevent the firm from implementing the composite strategy. Portfolios that experience a significant cash flow are temporarily removed from the composite.

As an example, suppose that a firm is establishing policies and procedures for a newly established long-maturity bond strategy. The firm currently values portfolios monthly. As part of determining the valuation policies for this strategy, the performance team asks the following question: Is there a level at which an external cash flow could distort a portfolio's monthly return if the portfolio is not valued and a sub-period return is not calculated? When discussing this issue with the fixed-income team, the performance team determines that an external cash flow of 5% or more could distort a portfolio's return. The firm, therefore, establishes a large cash flow policy for the composite that states that any portfolio managed in the strategy would be revalued in the event of an external cash flow of 5% or greater. The next question is whether there is a level at which an external cash flow would be so significant that it would actually prevent the firm from implementing the composite strategy for the portfolio. A cash flow of 5% would require valuation at the time of the cash flow, but the portfolio would still be considered to be representative of the strategy. It would therefore have to be a bigger external cash flow to cause the portfolio to be no longer representative of the composite strategy. Discussion with the fixed-income team determines that total external cash flows of 15% or more during a calendar month would be significant enough to prevent a portfolio from being representative of the style. The firm therefore establishes a large cash flow policy of 5% and a significant cash flow policy of 15% for its long-maturity bond strategy.

As the example illustrates, the levels used to define large cash flows and significant cash flows will not be the same. The significant cash flow level for a composite must be higher than the large cash flow level. This is because a large cash flow is the level that would require a portfolio to be valued (where daily returns are not calculated) but the portfolio is still considered to be discretionary and remains in the composite. In contrast, a significant cash flow is the level at which the portfolio is no longer representative of the composite strategy and is removed from the composite because the external cash flow disrupts implementation of the investment strategy.

A firm must not adopt a significant cash flow policy solely for the purpose of reducing or eliminating the number of instances when portfolios must be valued because of large cash flows. The significant cash flow level chosen by the firm for a specific composite must represent the firm's estimate of the level of cash flows that would potentially disrupt the investment strategy's implementation. Significant cash flow levels and large cash flow levels must be established independently.

As an alternative to a significant cash flow policy, when a portfolio is removed from the composite, it is recommended that a firm use a temporary new account. (See Provision 3.B.2.) This approach allows a firm to create a new portfolio into which a client's contributions and withdrawals are directed. Provision 3.A.13 provides a further discussion of the use of temporary new accounts to remove the effects of significant cash flows.

Firms may establish a significant cash flow policy that exempts certain types of external cash flows. For example, a client may use a transition manager to move a cash inflow to the firm in the form of assets that the firm has directed to be purchased. The inflow does not prevent the firm from implementing the composite's strategy, so the significant cash flow policy for this composite would not apply in this instance.

Provision 3.A.13

A FIRM that uses TEMPORARY NEW ACCOUNTS to remove the effect of a SIGNIFICANT CASH FLOW MUST establish policies on an EX ANTE, COMPOSITE-specific basis. TEMPORARY NEW ACCOUNTS MUST NOT be included in COMPOSITE performance.

Discussion

As discussed in Provision 3.A.12, a firm may establish a significant cash flow policy that allows the firm to remove a portfolio from a composite if it experiences a client-directed external cash flow that may temporarily prevent the firm from implementing the composite strategy. An alternative method for removing the effect of a significant cash flow is to use temporary new accounts.

If a portfolio experiences a significant cash inflow, the firm would create a temporary new account for the inflow of assets. The funds would remain in the temporary new account until they are invested and reflect the portfolio's investment mandate. The performance of the assets in the temporary new account would not be reflected in the main portfolio's performance until these assets are transferred into the main portfolio. The temporary new account must not be included in composite performance. The assets of the temporary new account would be reflected in total firm assets if the temporary new account is in existence at the end of a reporting period, but they would not be included in composite assets.

If the portfolio experiences a cash outflow that qualifies as a significant cash flow, the firm may create a temporary new account for the outflow of assets. The temporary new account would be funded with the assets the firm will distribute to the client or will liquidate to meet the cash flow needs of the client. The portfolio with the remaining assets would continue in the composite and would reflect the outflow in the performance calculation at the date of transfer to the temporary new account. The temporary new account must not be included in composite performance.

The assets of the temporary new account would be reflected in total firm assets if it is in existence at the end of a reporting period but would not be included in composite assets.

A firm that uses temporary new accounts to remove the effect of a significant cash flow must establish policies on an ex ante composite-specific basis. A temporary new account may also be used for pooled funds to deal with cash flows from subscriptions and redemptions. For example, assume a pooled fund has quarterly openings. Fund investors contribute cash prior to the quarterly subscription date, and the firm puts the cash into a temporary new account. On the first day of the quarter, the firm transfers the cash to the fund. The temporary new account used to hold the contributions is not included in any composite or reflected in the pooled fund's performance.

Wrap Fee

Provision 3.A.14

The FIRM MUST include the performance record of actual WRAP FEE PORTFOLIOS in appropriate COMPOSITES in accordance with the FIRM'S established PORTFOLIO inclusion policies. Once established, these COMPOSITES (containing actual WRAP FEE PORTFOLIOS) MUST be used when presenting GIPS COMPOSITE REPORTS to WRAP FEE PROSPECTIVE CLIENTS.

Discussion

A wrap fee is a type of bundled fee specific to a particular investment product. The wrap fee is charged by a wrap fee sponsor for investment management services and typically includes associated transaction costs that cannot be separately identified. Wrap fees can be all-inclusive, asset-based fees and may include a combination of investment management fees, transaction costs, custody fees, and/or administrative fees. A wrap fee portfolio is sometimes referred to as a "separately managed account" or "managed account."

Although the firm can use the same investment strategy for both wrap fee and non-wrap fee portfolios, it may not always have a direct relationship with the end user of its investment management services, even though these portfolios are often considered discretionary assets of the firm. Instead, multiple parties are involved in this business model, with a wrap fee sponsor serving as the intermediary between the firm and the end user of investment services. These factors are what distinguishes wrap fee portfolios and necessitates additional guidance for creating and maintaining composites that include wrap fee portfolios.

Prior to Managing Wrap Fee Portfolios

A firm may wish to present performance to wrap fee prospective clients for a specific strategy for which the firm does not yet manage wrap fee portfolios. In such a case, the firm must not present the GIPS Composite Report created for non-wrap fee clients. Instead, the firm must calculate a wrap fee performance history for that specific strategy by using that strategy's gross-of-fees non-wrap fee composite history reduced by the highest total wrap fee charged to the client (end user) by the wrap fee sponsor for the strategy (product). The result is net-of-fees wrap fee performance. Note that this approach is permissible only if the firm has no wrap fee portfolios under management for the strategy during the time periods for which the firm compiles the wrap fee performance using only non-wrap fee portfolios. As stated in Provision 4.A.16, when presenting performance to a wrap fee prospective client, the firm must present the percentage of composite assets represented by wrap fee portfolios as of each annual period end. If there are no wrap fee portfolios in the composite as of the annual period end, then the percentage of composite assets represented by wrap fee portfolios for that year end would be 0%. For an example of a GIPS Composite Report prepared for a wrap fee prospective client prior to the firm's managing actual wrap fee portfolios, please refer to Appendix A.

Once a Firm Acquires One or More Wrap Fee Portfolios

Once a firm acquires one or more wrap fee portfolios for management, the firm must include the performance of the actual wrap fee portfolio(s) in a composite that reflects the specific strategy of the wrap fee portfolios in accordance with the firm's established portfolio inclusion policies. The firm must determine if it will combine wrap fee portfolios in a composite with non-wrap fee portfolios with the same strategy or if it will have a separate composite for non-wrap fee portfolios.

The firm has three options to consider:

1. Retain the calculated history that had been shown to clients prior to the acquisition of a wrap fee portfolio (i.e., the strategy's gross-of-fees non-wrap fee composite history reduced by the total model wrap fee), redefine the composite to include only actual wrap fee portfolios going forward, and include relevant disclosures related to the redefinition;
2. Continue to include the ongoing performance of the non-wrap fee portfolios and combine it with performance of actual wrap fee portfolios; or
3. Create a new composite that includes only wrap fee portfolios. The new composite will have no history prior to the date that wrap fee portfolios are first managed.

When presenting wrap fee performance to wrap fee prospective clients, the firm must choose one of these three options.

Firms must not redefine a composite on a retroactive basis. If a firm has chosen Option 2 and combines the ongoing performance of non-wrap fee portfolios with the performance of wrap fee portfolios, it may not retroactively strip those portfolios out of the composite at a later date in

order to create a “wrap fee” composite history. At any point in time, however, the firm may choose to create a new composite that includes only wrap fee portfolios on a prospective basis. This composite would have no history prior to the composite creation date. The firm could then terminate the composite that includes both non-wrap fee portfolios and wrap fee portfolios if it wishes to do so.

The 2010 edition of the GIPS standards included the concept of a sponsor-specific wrap fee composite for the internal use of a wrap fee sponsor only. A sponsor-specific wrap fee composite included only the wrap fee portfolios that were managed for the particular wrap fee sponsor. The concept of sponsor-specific wrap fee composites is considered to be client reporting to a specific wrap fee sponsor and has been eliminated in the 2020 edition of the GIPS standards. A wrap fee composite must include all wrap fee portfolios managed in a specific investment strategy and must not be limited solely to the wrap fee portfolios managed for a specific wrap fee sponsor. Prospective clients for a specific wrap fee strategy must receive information about all portfolios managed in that strategy. Firms that previously maintained sponsor-specific composites would terminate any sponsor-specific wrap fee composites. Firms may remove these composites from the list of composite descriptions and are not required to include them on this list as terminated composites.

Carve-Outs

Provision 3.A.15

Any CARVE-OUT included in a COMPOSITE MUST include cash and any related income. Cash may be:

- a. Accounted for separately, or
- b. Allocated synthetically to the CARVE-OUT on a timely and consistent basis.

Discussion

A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. A carve-out is sometimes managed with its own cash. In other cases, cash is synthetically allocated to a carve-out. For periods beginning on or after 1 January 2010, firms were prohibited from including carve-outs with allocated cash in composites. To be included in a composite, a carve-out had to be managed with its own cash. When complying with the 2020 edition of the GIPS standards, firms are once again allowed to include carve-outs with allocated cash in composites and may do so for all periods, both retrospectively

and prospectively. A carve-out included in a composite must include cash and any related income, with the cash either accounted for separately or allocated synthetically. If firms choose to synthetically allocate cash to a carve-out, they must do so on a timely and consistent basis and must create carve-outs with allocated cash from all portfolios and portfolio segments within the firm managed to that strategy.

Note that carve-outs managed with their own cash balance are not subject to the requirements that apply to carve-outs with allocated cash. However, if a firm includes a carve-out that is managed with its own cash balance in a composite, all similar carve-outs that have been created and have their own cash balance must also be included in that composite.

The following are some acceptable methods that may be used to allocate cash synthetically to a carve-out:

- *Beginning-of-Period Cash Allocation.* Cash is allocated based on the beginning value of the carve-out as a percentage of the beginning value of the total portfolio excluding cash.
- *Beginning-of-Period Plus Weighted Cash Flow Allocation.* Cash is allocated based on the beginning value plus weighted cash flows of the carve-out as a percentage of the beginning value plus weighted cash flows of the total portfolio, excluding cash.
- *Strategic Asset Cash Allocation (true up actual).* The cash allocation is based directly on the target strategic asset allocation. For example, if the portfolio is targeted to have 40% in equities and 60% in bonds, then the allocation of cash will be the difference between the targeted allocation and the actual allocation. If the portfolio had a target allocation of 40% but at the beginning of the period held only 35% in equities, then the cash allocation would constitute the difference (5%).
- *Strategic Asset Cash Allocation (target weights).* An alternative method for strategic asset cash allocation is to allocate cash solely on the basis of target strategic asset allocation and not on the actual beginning-of-period allocation. In this case, 40% of the cash would be allocated to equities and 60% of the cash to bonds, regardless of the actual beginning-of-period allocation to equities and bonds.

Firms must determine which method to use for each composite, document it in their policies and procedures, and apply the method consistently. In all cases, the cash return must be the portfolio's actual cash return. A cash return proxy must not be used.

It is important for firms to be aware that when calculating returns for carve-outs, cash flows that are considered to be internal cash flows for the total portfolio may need to be treated as external cash flows at the carve-out level. For example, the sale of an equity position would be considered an internal cash flow at the total portfolio level, but it must be treated like an external cash flow when calculating performance at the equity carve-out level (the sold assets transfer out of the equity segment and the cash proceeds are an inflow to the cash segment). Firms must establish policies for carve-outs that address valuation frequency, calculation methods, large cash flows, and significant cash flows.

Provision 3.A.16

Any CARVE-OUT included in a COMPOSITE MUST be representative of a standalone PORTFOLIO managed or intended to be managed according to that strategy.

Discussion

A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. A composite is an aggregation of one or more portfolios that are managed according to a similar investment mandate, objective, or strategy. If a firm includes a carve-out in a composite, the firm must believe that the carve-out is representative of a standalone portfolio that is managed or is intended to be managed according to that composite's strategy. (A standalone portfolio is a portfolio that is not a portion of a larger portfolio.) If the carve-out is not representative of the composite's investment strategy, it would be misleading to include the carve-out in the composite.

For example, suppose that a firm manages a global equity strategy. A typical portfolio managed in that strategy holds 100 stocks. The firm decides that it would like to offer a strategy that includes only Japanese equities. Portfolios managed in the global equity strategy currently include holdings of only four Japanese stocks. The firm may not create a carve-out of these four Japanese stocks to represent a Japanese equity strategy. A carve-out representing only four positions in a portfolio of 100 stocks is not representative of a standalone portfolio managed according to a Japanese equity strategy.

In contrast, suppose that the firm manages an Asian equity strategy. A typical portfolio managed in the Asian equity strategy includes 50 stocks, with 30 holdings representing Japanese companies. In this case, a carve-out of the 30 positions representing Japanese companies would likely be representative of a Japanese equity strategy the firm might offer. The number of positions, however, is only one indicator of whether the carve-out would be a representative carve-out. The firm would have to determine that the carve-out is truly representative of the Japanese equity strategy it is planning to offer.

Provision 3.A.17

When the FIRM creates a CARVE-OUT of a particular strategy, allocates cash to the CARVE-OUT, and includes the CARVE-OUT in a COMPOSITE, the FIRM MUST create CARVE-OUTS with allocated cash from all PORTFOLIOS and PORTFOLIO segments within the FIRM managed to that strategy and MUST include those CARVE-OUTS with allocated cash in the COMPOSITE.

Discussion

A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. The GIPS standards are based on the principles of fair representation and full disclosure. It would not be in keeping with these principles to “cherry pick” which carve-outs managed to a particular strategy are included in a composite. When a firm creates a carve-out of a particular strategy, allocates cash to the carve-out, and includes the carve-out in a composite, the firm must create carve-outs with allocated cash from all portfolios and portfolio segments within the firm that are managed to that strategy and include all such carve-outs in the relevant composite. This must be done for all periods for which the carve-out is included in the composite.

When creating a composite that includes carve-outs with allocated cash, firms are encouraged to go as far back into the history of the carve-out strategy as possible. The longer the performance history provided for a composite that includes carve-outs with allocated cash, the more representative of the strategy the composite will be. A firm must not select the periods to include in GIPS Reports by cherry-picking periods that present the firm in a better light.

Provision 3.A.18

When the FIRM has or obtains standalone PORTFOLIOS managed in the same strategy as the CARVE-OUTS with allocated cash, the FIRM MUST create a separate COMPOSITE for the standalone PORTFOLIOS.

Discussion

A carve-out is a portion of a portfolio that is by itself representative of a distinct investment strategy. It may be used to create a track record for a narrower mandate from a multi-strategy or multi-asset-class portfolio managed to a broader mandate. At some point, a firm may obtain standalone portfolios managed in the same strategy as the carve-outs with allocated cash. (A standalone portfolio is a portfolio that is not a portion of a larger portfolio.) The firm must then create a separate composite that contains only the standalone portfolios. The returns and composite assets of the composite that includes only standalone portfolios must be presented in the GIPS Composite Report for the composite that includes carve-outs with allocated cash. This presentation will allow a prospective client to compare the returns of the composite that includes carve-outs with allocated cash to the returns of the composite that contains only standalone portfolios. If the two composites have a significant performance difference, the prospective client has a chance to ask questions about the difference in returns. This provision applies only to situations in which the firm has created a composite that includes carve-outs with synthetically allocated cash.

It does not apply to composites in which the carve-outs included are carve-outs with their own cash balance.

Once a firm has obtained one or more standalone portfolios managed in the same style as the carve-outs with allocated cash, the firm has the following options for the maintenance of the composite that includes carve-outs with allocated cash. It can:

- continue to include only carve-outs with allocated cash in the composite;
- include both carve-outs with allocated cash and standalone portfolios in the composite;
- terminate the composite that includes carve-outs with allocated cash and maintain the composite that includes only standalone portfolios managed in the strategy; or
- redefine the composite to exclude carve-outs with allocated cash going forward.

Firms that wish to continue including carve-outs with allocated cash in the composite should also include standalone portfolios in the composite once standalone portfolios are obtained. Although firms are permitted to continue to include only carve-outs with allocated cash in the composite after they have obtained one or more standalone portfolios managed in the same strategy as the carve-outs with allocated cash, it is not encouraged or expected that many firms will do so.

Firms are reminded that, for all cases in which the firm has a composite that includes carve-outs with allocated cash, as well as standalone portfolios managed in the same strategy, the returns and composite assets of the composite that includes only standalone portfolios must be presented in the GIPS Composite Report for the composite that includes carve-outs with allocated cash.

If a carve-out with allocated cash is included in a composite for any period, the words “carve-out” must be indicated in the name of the composite. (See Provisions 4.C.28.a and 5.C.27.a.)

Carve-outs with allocated cash were permitted in composites prior to 1 January 2010 and prohibited from 1 January 2010 through 31 December 2019. Carve-outs with allocated cash are permitted for all periods, both prospectively and retrospectively, for firms that comply with the 2020 edition of the GIPS standards. The following examples provide guidance on what is required regarding the use of carve-outs with allocated cash that were created and used for periods prior to 1 January 2010.

Example 1

A firm used carve-outs with allocated cash for one of its composites from 1 January 2007 through 31 December 2009. Starting 1 January 2010, when carve-outs with allocated cash were no longer permitted in composites, the firm created and used carve-outs with their own cash balance for that strategy. Even though the firm is permitted to use carve-outs with allocated cash once it complies with the 2020 edition of the GIPS standards, the firm will continue to use carve-outs with their own cash balance. The firm will continue to use the track record from carve-outs with allocated cash it had created and used for the periods prior to 1 January 2010. The firm asks whether it has to create a composite of standalone portfolios, as required by Provision 3.A.18,

for the period prior to 1 January 2010 when carve-outs with allocated cash are included in the composite.

The firm may use the carve-outs it had created and used for the strategy prior to 1 January 2010 without adhering to Provision 3.A.18 regarding the creation of a separate composite for the strategy containing only standalone portfolios. In addition, the firm is not required to apply Provision 4.C.28.a and 4.C.28.d for GIPS Composite Reports that present time-weighted returns or 5.C.27.a and 5.C.28.d for GIPS Composite Reports that present money-weighted returns. These provisions require the indication of “carve-out” in the name of the composite and a disclosure that a GIPS Composite Report for a composite of standalone portfolios is available upon request. It is important to note that this exception applies only to carve-outs with allocated cash that were previously created and used prior to 1 January 2010. If the firm decides to create and use carve-outs with allocated cash for any periods after 1 January 2010, the requirements regarding the creation and presentation of a composite with standalone portfolios would apply, as would the disclosure requirements.

Example 2

A firm notes that, in the 2020 edition of the GIPS standards, the use of carve-outs with allocated cash is permitted for all time periods. The firm had been using carve-outs with their own cash balances for one of their strategies from 1 January 2010 forward but now decides that it would like to extend its track record for that strategy by creating carve-outs with allocated cash for periods prior to 1 January 2010. It is unable to create carve-outs with their own cash balances for periods prior to that date.

If the firm retroactively creates carve-outs with allocated cash for any period, it must adhere to Provision 3.A.18. If the firm manages standalone portfolios in this strategy, it must create a composite for the standalone portfolios managed in the same strategy as the carve-outs with allocated cash and present the returns and composite assets of the composite that includes only standalone portfolios in the GIPS Composite Report for the carve-outs with allocated cash. The firm must also adhere to the disclosure requirements contained in 4.C.28.a and 4.C.28.d for GIPS Composite Reports that present time-weighted returns, as well as to the disclosure requirements in 5.C.27.a and 5.C.27.d for GIPS Composite Reports that present money-weighted returns.

Provision 3.A.19

The FIRM MUST NOT combine different COMPOSITES, POOLED FUNDS, OR CARVE-OUTS to create a simulated strategy and present it as a COMPOSITE.

Discussion

All composite assets must include only actual assets managed by the firm in the respective strategy. (See Provision 2.A.2.) Therefore, a firm must not combine different composites, pooled funds, or carve-outs to create a simulated strategy and present it as a composite. For example, if the performance of actual portfolios in an equity composite is combined with the performance of actual portfolios in a fixed-income composite to show what the results might have been had the equity strategy and fixed-income strategy been combined, the results would be considered a simulated strategy. Even though the returns for the equity and fixed-income composites are based on actual assets managed by the firm, the arbitrary method of combining them historically is subject to manipulation and does not represent real-time, actual asset allocation decisions. The performance results of this simulated strategy would, therefore, be considered hypothetical performance. This would also be true for combinations of different composites, pooled funds, or carve-outs to create a simulated strategy.

A hypothetical blend based on the performance of actual component composites may be included in a GIPS Report as supplemental information only if all the component composites, and the associated GIPS Reports on which the hypothetical blend is based, are included in the GIPS Report. In addition, the hypothetical blend must relate to all composites represented in the GIPS Report. For example, when combining a fixed-income composite and an equity composite to create a balanced portfolio, the blend may be shown as supplemental information in a GIPS Report if it includes the GIPS Report for both the fixed-income composite and the equity composite.

The prohibition against combining different composites, pooled funds, or carve-outs to create a simulated strategy does not prohibit the creation and presentation of composites that are often referred to as “umbrella” or “parent” composites. An umbrella composite is a broadly defined composite that includes portfolios from more narrowly defined composites. Umbrella composites are commonly used for fixed-income composites, in which the umbrella composite is based on the investment mandate and the more narrowly defined subset or “child” composites are based on specific benchmarks. As an example, a firm might have an Intermediate-Maturity Fixed-Income Composite as an umbrella composite that includes all fixed-income portfolios with an intermediate-maturity mandate. A subset composite might include the Intermediate-Maturity ABC Index Composite (all intermediate-maturity fixed-income portfolios with the ABC US Intermediate Aggregate Index as the benchmark) and the Intermediate-Maturity XYZ Index Composite (all intermediate-maturity fixed-income portfolios with the XYZ Intermediate Aggregate Index as the benchmark).

Another example of an umbrella or parent composite would be a Large-Cap Composite that includes all of the firm’s large-cap portfolios. Subsets of this composite might include a Large-Cap Growth Composite (all of the firm’s large-cap growth portfolios) and a Large-Cap Value Composite (all of the firm’s large-cap value portfolios).

3.B. Composite and Pooled Fund Maintenance—Recommendations

Provision 3.B.1

If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM SHOULD NOT present a GIPS COMPOSITE REPORT to a PROSPECTIVE CLIENT known not to meet the COMPOSITE's minimum asset level.

Discussion

When a firm establishes a minimum asset level for including portfolios in a composite, the firm is indicating that portfolios below that level are too small to be representative of that strategy. In the spirit of fair representation, it would not be in the prospective client's best interest to be shown a GIPS Composite Report for a composite with a strategy that is not available to the prospective client. (See Provision 3.A.11 for a discussion of a composite minimum asset level.)

Provision 3.B.2

To remove the effect of a SIGNIFICANT CASH FLOW, the FIRM SHOULD use a TEMPORARY NEW ACCOUNT.

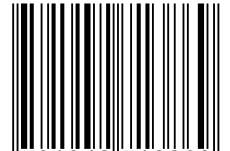
Discussion

In some situations, a client-directed external cash flow may temporarily prevent a firm from implementing the composite strategy. Firms may choose to keep portfolios that experience such cash flows in the composite. Instead, as discussed in Provision 3.A.12, a firm may establish a significant cash flow policy that allows the firm to remove a portfolio from a composite if it experiences a client-directed external cash flow that may temporarily prevent the firm from implementing the composite strategy. Another method for removing the effect of a significant cash flow, as discussed in Provision 3.A.13, is to use temporary new accounts. If a portfolio experiences a cash inflow that qualifies as a significant cash flow, the firm can create a temporary new account for the inflow of assets. The funds remain in the temporary new account until they are invested and reflect the portfolio's investment mandate. If the portfolio experiences a cash outflow that qualifies as a significant cash flow, the firm can create a temporary new account funded with the assets that the firm will distribute to the client or will liquidate to meet the client's cash flow needs. Significant cash flows are not applicable to composites that present performance using money-weighted returns.

It is recommended that a firm use a temporary new account to remove the effect of a significant cash flow rather than removing the portfolio from the composite. The use of temporary new accounts is the most direct method of dealing with significant cash flows and reduces the movement of portfolios into and out of a composite. Please refer to Provisions 3.A.12 and 3.A.13 for a more detailed discussion of a significant cash flow policy and the creation of temporary new accounts.

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