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The Top 5 Things You Need to Know About GIPS 2020

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On June 30, 2019, the CFA Institute released the 2020 version of GIPS. This version represents a comprehensive overhaul of the standards that was designed to improve upon the 2010 version and to expand applicability for

- Firms that manage pooled investment vehicles,
- Firms that manage alternative asset classes, and
- Asset owners.

Below are five important takeaways from GIPS 2020.

1. Reorganization of the Standards

One of the first things you'll notice when you read the 2020 standards is that they are organized differently than the 2010 version. The 2010 version was initially written for firms, not asset owners. GIPS was expanded for asset owners via a Guidance Statement issued in 2014. Asset owners are different than firms and, as such, need standards that are specifically tailored to their unique needs. Thus, the 2020 standards have a section dedicated to asset owners.

The 2020 version of the standards is divided into three chapters, which are separate documents on the CFA Institute's website:

1. GIPS Standards for Firms – Includes core standards that only apply to firms, a section for firm advertising guidelines, and a glossary. The glossary only contains terms located in this chapter.
2. GIPS Standards for Asset Owners – Includes core standards that only apply to asset owners, a section for asset owner advertising guidelines, and a glossary for asset owners.
3. GIPS Standards for Verifiers – Provides the guidance that verifiers must follow when performing verification and performance examination services. It consolidates and replaces the guidance in the 2010 standards as well as the guidance statements.

The core GIPS standards that apply to firms have been reorganized as well. The following table shows the 2010 layout compared to the GIPS Standards for Firms in GIPS 2020.

2010 Version	2020 Version
0 – Fundamentals of compliance	1 – Fundamentals of compliance
1 – Input data	2 – Input data and calculation methodology
2 – Calculation methodology	3 – Composite and pooled fund maintenance
3 – Composite construction	4 – Composite time-weighted return report
4 – Disclosure	5 – Composite money-weighted return report
5 – Presentation and reporting	6 – Pooled fund time-weighted return report
6 – Real estate	7 – Pooled fund money-weighted return report
7 – Private equity	
8 – Wrap fee / SMA	

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2. Treatment of Funds

Many firms that focused on managing funds were not well served by the 2010 version of GIPS. GIPS 2010 and prior versions were designed from a composite centric view, which works well for firms managing separate accounts. For funds, whether private (limited distribution pooled funds such as hedge funds) or public (broadly distributed pooled funds such as mutual funds), the standards treated funds the same as separate accounts. This meant that all limited distribution pooled funds (LDPFs) and broadly distributed pooled funds (BDPFs) were required to be lumped into composites the same way that separate accounts were. For firms that managed a large number of BDPFs, this meant that they would have to create many single account composites in order to comply with the GIPS standards.

GIPS 2020 changes this significantly. Given that BDPFs are typically marketed and presented to the general public under regulatory frameworks, requiring firms to create many single fund composites was deemed not useful. In GIPS 2020, firms do not have to prepare GIPS reports for BDPFs. This would eliminate the creation of single account composites for firms that manage BDPFs. However, BDPFs must be included in a composite if the fund meets the composite definition. This might occur if a manager offered the same strategy for a BDPF and for separate accounts. In addition, a firm could chose, at its discretion, to create a GIPS pooled fund report for a BDPF. We don't expect many firms to do this, but it is an option.

GIPS 2010 had one type of performance presentation called a "compliant presentation." This covered everything, including separate accounts and pooled funds. GIPS 2020 has an additional category for reporting. "Compliant presentations" have been replaced with "GIPS composite reports." These reports are used for presenting the performance of composites. A new category of reports has been created called "GIPS pooled fund reports," which we address below. "GIPS report" is a broad term meaning either a GIPS composite report or a GIPS pooled fund report.

Like broadly distributed funds, limited distribution funds were previously required to be included in composites under GIPS 2010. For GIPS 2020, these can be included in separate GIPS pooled fund reports. However, an LDPF must be included in a composite if the fund meets the composite definition.

It is also interesting to note that GIPS 2020 allows firms to use gross or net returns for GIPS pooled fund reports. This was done to facilitate various regulatory requirements in different countries. Some countries require gross. In the U.S., net is generally required.

3. Expanded Use of Money-Weighted Returns

In GIPS 2010, firms were required to use money-weighted returns (MWR) when calculating returns for private equity funds. Time-weighted returns (TWR) and MWR were required for closed-end real estate funds. These were the only scenarios in which firms were able to use MWR. All other calculations were required to be TWR.

The key difference between TWR and MWR is that TWR removes the impact of external cash flows in return calculations. This is useful for evaluating an investment firm where the firm does not control external cash flows; rather, the clients do. MWRs calculate returns differently so that the timing of external cash flows impacts the return calculation. The most common MWR calculation methodology is the Since Inception Internal Rate of Return (SI-IRR). MWRs are useful in evaluating a firm's performance where the firm controls the external cash flows.

Part of what GIPS 2020 sought to accomplish was to reduce asset class specific guidance. In GIPS 2020, firms may present MWR if they have control over the external cash flows of the composite portfolios or pooled fund, and the composite portfolios or pooled fund has at least one of the following characteristics:

- Closed-end
- Fixed life
- Fixed commitment
- Illiquid investments are a significant part of the investment strategy.

This is welcome news for firms that manage asset classes where MWR would be more relevant. With the changes to GIPS 2020, any asset class is able to use MWR if the criteria are met.

It is also interesting to note that the 2010 version of GIPS required SI-IRRs through each annual period end. The 2020 version of GIPS only requires one SI-IRR through the most current annual period end. In addition, the 2020 version of GIPS allows for more than one type of MWR. Although SI-IRR is commonly used, firms may use other methods such as the Modified Dietz calculation methodology. In GIPS 2010, only SI-IRR was permitted when presenting MWRs.

4. Carve-Outs

Before GIPS 2010, firms were allowed to include carve-outs with allocated cash in composites. A carve-out with allocated cash is where a firm pulls out a segment of a portfolio along with a portion of the cash account. A typical scenario where this would be done would be a balanced account that contains fixed income and equity segments, yet has one cash account. Under the pre-2010 standards, firms could pull the equity segment out along with an allocated piece of the cash account. Cash was often allocated pro rata based on beginning of period segment values.

Many people raised concerns regarding carve-outs, arguing that firms could cherry-pick the accounts subjected to carve-outs. Many also argued that allocating a cash account doesn't fully reflect the reality of managing a portfolio with its own separate cash account.

Many heated debates led to the ban of carve-outs with allocated cash in the 2010 edition of the standards. In GIPS 2010, the only way firms were allowed to pull out segments of a portfolio was if separate cash accounts were maintained for each segment. This is time consuming and costly, so many firms stopped using carve-outs.

GIPS 2020 reintroduces carve-outs with allocated cash, but puts many restrictions in place to address previous concerns. One of the reasons for bringing carve-outs back is to address the needs of private wealth managers. These firms often have clients which utilize investment "building blocks" offered by the firm and then customize them. Customizations might include the requirement to hold low tax basis stock, to pay out all dividend and income to the investor, or other restrictions. Customizations might also include allocation decisions relating to how much fixed income versus equity investments to hold. This high degree of customization has frustrated private wealth managers from a GIPS perspective and has led to challenges in creating composites. Many of these composites had a high degree of dispersion of returns between accounts. With GIPS 2020, private wealth managers could consider the use of carve-outs to address their building blocks. These building blocks could be equity, fixed income, etc.

As previously noted, carve-outs come with several restrictions. These restrictions include the following:

1. Carve-outs must be representative of a stand-alone portfolio managed or intended to be managed to that strategy.
2. If a firm has a stand-alone portfolio that is the same strategy of the carve-out with allocated cash, the firm is required to create an additional separate composite that only contains the stand-alone portfolios. This restriction is designed to address concerns that carve-outs with allocated cash may differ from actual separate accounts managed to the same strategy.
3. If a firm carves out a segment of an account to include it in a composite, it must pull that strategy segment out of every account in the firm that contains it. This is designed to address cherry picking which accounts have their segments carved out.
4. Firms are not allowed to combine different composites, funds, or carve-outs to create a simulated strategy.

5. GIPS Report Updates

In GIPS 2010, firms did not have any deadlines for updating compliant presentations. The GIPS 2020 exposure draft proposed a six month deadline. Many comment letters indicated that this was too short a timeframe, especially for large firms with hundreds of composites or for firms managing alternatives that need to wait for external valuations.

Taking the comment letter feedback into consideration, GIPS 2020 requires that firms update GIPS reports within 12 months. This means that when a firm provides a GIPS report to a prospective investor, the GIPS report must include information through the most recent annual period end within 12 months of that annual period end.

While firms are not required to so, the 2020 version of the standards recommends that firms update GIPS reports on a quarterly basis. Interestingly, the adopting release of the GIPS Standards for Firms notes that it would not be necessary for a firm to update all required numerical information for such updates. The adopting release further notes that additional guidance on this point will be provided in the GIPS Handbook.

In Conclusion

GIPS 2020 has introduced numerous changes to improve the standards, ease the burden of compliance, and make the process more relevant for many firms in the Investment industry. These changes are significant. If you currently claim compliance or are thinking about becoming compliant, you will be impacted by the new standards.

While we have offered this overview of the most significant changes coming out of GIPS 2020, it is important to understand how the new standards will specifically impact your organization. For more guidance about GIPS 2020 and to schedule a conversation about next steps, please **contact us.**

And, if you already claim compliance with GIPS, consider taking advantage of Kreischer Miller's free GIPS initial assessment which will:

- Identify potential issues and areas for improvement, and
- Provide meaningful feedback about your current process.

Contact us for your free GIPS initial assessment.

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About Kreischer Miller

Kreischer Miller is an accounting, tax, and business advisory firm that has been serving clients since 1975. Kreischer Miller's Investment Industry Group provides GIPS compliance, operational due diligence, and audit and tax services for investment firms and asset owners. Kreischer Miller's Investment Industry Group has experience working with firms across the U.S. and Europe in a variety of asset classes. **Learn more at kmiig.com.**