

How Does GIPS (or AIMR) Apply to a Hedge Fund?

Hedge funds are often asked if their performance numbers are AIMR or GIPS compliant. These abbreviations refer to the Association of Investment Management & Research Performance Presentation Standards (AIMR-PPS) and the Global Investment Performance Standards (GIPS®). AIMR-PPS was conceived in 1993 and evolved during the 1990s, with an international version – GIPS – appearing in 1999. As of 2006, a newly updated version of GIPS superseded and replaced AIMR-PPS. GIPS is administered by the CFA Institute (www.cfainstitute.org/cfacentre/ips/).

Note that GIPS is oriented to the managed account business, specifically providing rules to deal with the creation of composite returns among many accounts with varying starting and ending dates, differing asset sizes, and each with cash flows determined by the underlying investors. Accordingly, the objective is a set of rules whereby one number can fairly reflect the performance of perhaps thousands of accounts.

Additionally, an importance nuance of GIPS is that it provides guidance on performance presentations of firms, not funds. A substantial amount of ink is expended in defining just what a “firm” is and how to determine which accounts should be included in its composite returns. As well as addressing computation standards, GIPS provides guidance on relevant qualitative disclosure. GIPS is divided into 7 sections:

1. Input Data
2. Calculation Methodology
3. Composite Construction
4. Disclosures
5. Presentation and Reporting
6. Real Estate
7. Private Equity

For fund administration purposes, we believe that Input Data and Calculation Methodology are the most relevant sections, addressing such things as:

- Trade date accounting
- Valuation
- Accruals of income and expense
- Time-weighted returns
- A total return approach – net of fees and expenses

While the Disclosure and Presentation and Reporting Sections primarily address firm-level (not fund-level) disclosures and composites, there are some relevant requirements and recommendations that would apply to presentations of results, at least as calculated by APM:

- Display performance since inception or at least five years
- Prohibition of annualizing returns of less than 12 months
- Use of total return benchmarks

Compared to a composite, performance is actually much more straightforward with a fund in that it is a single entity with discreet entry and exit periods, a single investment objective, and legal documents that specify the exact method for allocating income to each participant.

Accordingly, a hedge fund is not a composite, but a single portfolio with individualized fee arrangements. It is unnecessary to aggregate the participants’ returns because the return for an ordinary, fee-paying investor is readily available. At APM, we present the fund return as the investment results for “a single contribution at the inception of the Fund with no subsequent additions or withdrawals.”

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Managers should note that aggregating participant returns to determine a fund return, on the other hand, would be less accurate. For example, some investors may pay no incentive compensation during a period due to waivers or being under high water marks, while others will. Aggregating those returns would be misleading and, at best, inherently flawed because no one person could have received the aggregate return if there are multiple openings or differing fee rates. At worst, it could be considered deceptive because including non-fee payers (such as the manager) in the composite would be known in advance to overstate the return possible to an unaffiliated investor.

So, "Is my performance GIPS compliant?" The short answer is that APM methods conform to the relevant "Input Data – Requirements" and "Calculation Methodology – Requirements" of GIPS (Sections 1.A & 2.A).

A longer answer requires us to point out that APM cannot claim to provide a "GIPS compliant" report, since compliance is something that is determined at the level of the management firm as a whole. In addition to the issues of proper disclosure for a manager's other funds or separate accounts and any possible "composites," there are qualitative disclosures both recommended and required. For example, a manager must disclose sub-advisors and significant derivatives usage, plus "all significant events that would help a prospective client interpret the performance record." Accordingly, only the manager can determine GIPS compliance.

Unfortunately, GIPS is a 59 page document and is not particularly easy to read or to interpret. Fortunately, there are a number of firms that are in the business of verifying GIPS compliance and helping conform presentation materials to GIPS. A manager having a number of funds and/or managed accounts and frequently fielding GIPS questions might consider the engagement of such a firm.

In responding to questions about GIPS and your fund, APM suggests that managers note the following:

- The fund has governing documents that determine the accounting process.
- Your fund's accounting is in accordance with GAAP (with the possible exception that you may be spreading formation costs over several years in the interest of fairness).
- Fund results are determined by APM, an experienced and highly regarded independent third-party administrator.
- APM methodology conforms to the relevant "Input Data – Requirements" and "Calculation Methodology – Requirements" sections of GIPS.
- The fund is audited annually.
- GIPS is intended to create a single number that fairly represents the performance of a composite of accounts, while the numbers provided by APM are actual fund results, in the form of "the investment results of a single contribution at the inception of the Fund with no subsequent additions or withdrawals."

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