Global Investment Performance Standards

Considerations for alternative managers

Part 3

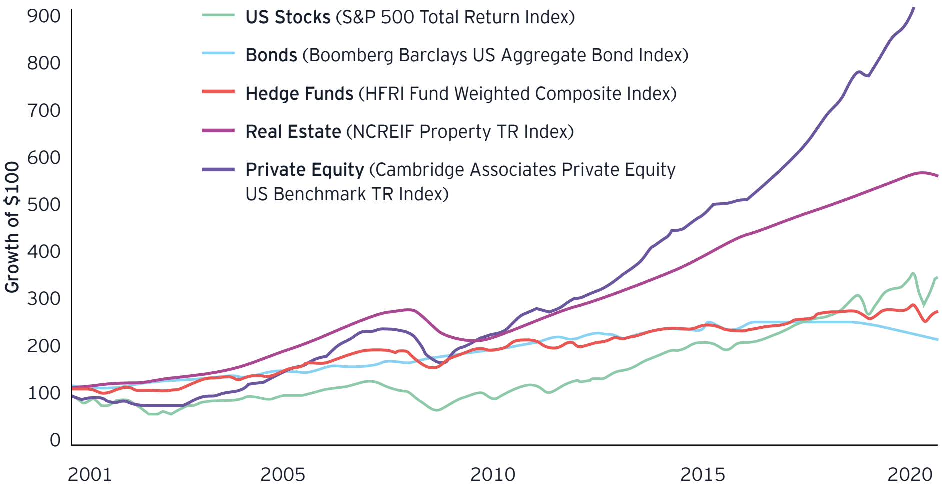
Building a better working world

Introduction

In a world where traditional asset classes are providing fewer returns on investment than ever before, investors are increasingly embracing alternatives. Those capable of identifying opportunities in the alternatives market are rewarded with the potential benefits which are often out of reach for traditional asset classes:

1. **Increased returns**
2. **Lower volatility**
3. **Enhanced diversification**

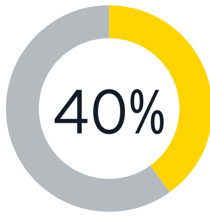
In fact, when comparing to traditional asset classes, alternatives have been outperforming[1]:



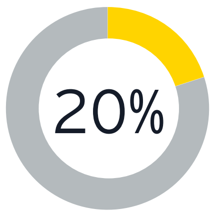
Alternative products encompass asset classes, such as hedge funds, private equity and real estate, and span into complex multi-asset portfolios with higher-risk side pockets, active use of derivatives and intricate fee structures.

The growing variety and complexity of alternative products has meant the demand for transparent performance reporting and requests for compliance with the Global Investment Performance Standards (GIPS®) in request for proposals (RFPs) is at an all-time high. This installment of the EY Financial Services Organization Investment Performance Group's series on GIPS will continue to address specific questions that have come up in recent discussions with alternative asset managers in their journeys to compliance.

For instance, hedge fund managers have been developing unique structures and products in a bid to enter new markets:



of hedge fund managers are offering co-investment vehicles or best-idea portfolios.



of managers are creating side pockets to allow investors an election to participate in illiquid investments within a broader portfolio[2].

[1] https://www.ml.com/solutions/alternative-investments.html
[2] https://www.ey.com/en_uk/news/2020/11/alternative-fund-managers-demonstrated-resilience-in-adapting-to-the-new-covid-19-reality#:~:text=More%20than%2040%25%20of%20hedge,investments%20within%20a%20broader%20portfolio

Benchmarks

We often receive questions from alternative asset managers in relation to GIPS requirements on benchmarks, which act as a reference point against which a composite's or pooled fund's return or risks are compared. Under GIPS, a firm is required to select an appropriate total return benchmark for every composite and pooled fund, if an appropriate benchmark is available. This must be disclosed on the corresponding GIPS report used for presenting performance to prospective investors or clients. These benchmarks can be a key means of improving strategy performance evaluation for prospective investors or clients by providing comparable expectations of success. The recent guidance statement on benchmarks states that these should be the focal point when evaluating a strategy.

However, with the growth of uniquely structured alternative products on offer, how can an alternative investment manager select an appropriate benchmark?

This question is by no means a new one, and has been a longstanding deterrent amongst alternative managers for adopting GIPS. Many have found identifying an appropriate benchmark for their products to be a fruitless endeavor in a market which has been historically overlooked by benchmark providers.

However, the 2020 update provides several solutions for alternative managers when identifying a benchmark for their composites and pooled funds, depending on the relationship of investment strategy to benchmark:

1 Benchmark relative:

- Investment decisions are made relative to benchmark weights, exposures, and risks
- Portfolios are often similar to the benchmark
- Common amongst active and passive index strategies

2 Benchmark aware:

- Investment decisions are not closely linked to the benchmark
- Benchmark often represents the segment of the market from which the securities for the strategy are taken
- Usually distinct differences between portfolio and benchmark
- Common amongst concentrated strategies

3 Benchmark agnostic:

- Investment decisions are not made relative to a benchmark
- Benchmarks are treated as target returns or hurdles to outperform, or there may be no appropriate benchmark
- Common for alternative strategies and strategies not covered by index providers

The third option gives alternative investment managers the freedom to select a benchmark for their often complex products, as it allows firms to choose from a variety of benchmarks including:

1. A peer group index
2. An absolute return target
3. Pension plan liability targets
4. Custom benchmarks for alternative investment strategies
5. Presenting no benchmark

As the underlying purpose of GIPS is to promote transparent reporting, there are some additional requirements for firms choosing to present such benchmarks. If a custom benchmark or combination of benchmarks is presented, the firm must disclose the benchmark components, weights, and rebalancing process. If a firm is unable to identify an appropriate benchmark, a firm must disclose why no benchmark is presented. It is also important to note that opting for a peer group benchmark could have potential limitations, including self-reporting bias, frequency of reporting and survivorship bias. When using benchmarks that exhibit such limitations, firms should describe these in the GIPS reports.

Valuation

We have discussed the benefits of claiming GIPS compliance for alternative investment managers in our previous installments. However, with increasingly complex and intricate portfolios on offer, a question we are often asked is "How can I comply with the valuation requirements of GIPS when my products are not suited to frequent valuation?"

Alternative investment managers were a key priority during the creation of the 2020 GIPS standards, and several important changes have been made to address this question and make it easier to claim compliance, regardless of the nature of the product.

One change that was aimed at encouraging compliance for alternative investment managers was making the valuation requirements less stringent for alternative products. This is particularly the case for pooled funds, such as hedge funds. Previously all portfolios, including pooled funds, had to be included within a composite and therefore were subject to at least monthly valuations (except for real estate and private equity, which had their own valuation requirements).

Firms are now able to hold pooled funds out of composites and perform less frequent valuations:

	Traditional Asset Classes	
	Portfolios in composites	Pooled funds not in composites
Valuation frequency	1. At least monthly 2. At the time of any 'large' cash flows	1. At least annually 2. Whenever returns are calculated

As can be seen above, the updated valuation requirements place less burden on alternative asset managers utilizing pooled funds such as hedge funds and facilitate the claiming of compliance from this perspective.

Another key change to enable compliance for alternative asset managers is the removal of the specific valuation requirements for private equity and real estate assets that were included within the 2010 release of the standards. These have been substituted with broader valuation requirements for underlying private investments, including real assets, private equity and other illiquid and non-publicly traded investments.

	Private market		
	Real estate open-end funds	Other real estate	Other private market
External valuation required?	Yes, every 12 months	Yes, every 12 months, unless: 1. The client agreement stipulates otherwise. In which case external valuation is required at least every 36 months, or more frequently if required by the client agreement. 2. The fund is subject to an annual financial statement audit and the financial statements contain an unmodified opinion. In which case the real estate investments must be accounted for at fair value.	Recommended every 12 months, but not required.

Side pockets

With many alternative investment managers utilizing multi-asset portfolios, we are often asked how performance can be marketed to prospective investors when a portion of the portfolio has become illiquid or distressed (e.g., shares of a delisted company and underlying funds with a redemption suspension).

Under GIPS, investment managers are able to do so by utilizing discretionary side pockets. These are segregated investments that are commonly used in alternative investment pooled funds, such as hedge funds and other alternative investment vehicles, to separate illiquid assets from liquid investments or those held for a specific purpose.

This can be a useful tool for alternative investment pooled funds. Once the portion of the portfolio enters into a side pocket account, it typically cannot be invested in by new investors. As such, only the investors in the pooled fund at the time the side pocket was created are entitled to share of the return. Future investors are unlikely to receive a share of the proceeds if the side pocket's assets are sold.

The standards do not consider the fact that future investors will not participate in the side pocket returns as a reason to exclude it from the performance and track record of the pooled fund. Side pocket performance must be included in the performance of the entire pooled fund if the assets are managed on a discretionary basis. All composite and pooled fund returns must include the effect of any discretionary side pockets held by portfolios in the composite or the pooled fund.

Many alternative managers raise the point that as prospective investors will not share in the returns of the side pocket going forwards, they will want to see the performance without the impact of the side pocket.

GIPS allows for composites and pooled funds to be marketed on this basis, requiring firms to present performance both including and excluding side pockets, if the fund with the side pocket is the only portfolio in the composite or pooled fund, and the side pocket assets are managed on a discretionary basis. This applies to both gross and net-of-fees returns and allows prospective investors to interpret the performance of the fund without the impact of the side pocket. In this way, alternative investment managers are able to present the track record and performance of the fund for the liquid portion, thus giving more freedom to market these pooled funds with illiquid assets.

Carve outs

As previously mentioned, many alternative managers are now operating complex and intricate multi-asset portfolios which, under GIPS 2010, were historically difficult to market when following the guiding principles. This was particularly the case where prospective investors would request to see the performance for a distinct or bespoke sub-strategy of the portfolio, for instance the emerging market real estate portion of a multi-asset composite. Historically, from 1 January 2010, investment managers were not permitted to carve out this portion of the strategy and present it to prospects within a separate composite unless it had its own cash balance.

However, a welcome change under the 2020 refresh of the standards is the ability to once again utilize carve outs with allocated cash, to present a portion of a portfolio that is by itself representative of a distinct investment strategy. In this way, investment managers have the ability to create a track record for a narrower mandate from a multi-strategy portfolio managed under a broader mandate. This change makes it possible for a greater number of private market investments to come into compliance.

There are some prerequisites for utilizing carve outs. Firstly, firms must create carve outs with allocated cash from all portfolios within the firm that are managed to the same strategy. This prevents firms from cherry-picking which portfolios of a similar strategy will be carved out for inclusion in the composite. Further, the carve outs must be representative of a standalone portfolio managed or intended to be managed according to that strategy. This applies to both carve outs with allocated cash as well as those with their own cash (sub-portfolios). This is to prevent firms from creating carve outs that are misrepresentative of their management capabilities. In addition, firms must create and maintain composites that include only standalone portfolios managed in the same strategy as the carve outs with allocated cash. The returns and composite assets from the GIPS Composite Report for the standalone portfolios must be included in the GIPS Composite Report for the composite that includes carve outs with allocated cash. This is to present the performance of the carve out in comparison to the performance of a standalone portfolio.

There is no prescribed methodology for the allocation of cash, and the only requirement stipulated by the standards is that the allocation must be treated consistently and on a timely basis. There are however two acceptable allocation methods outlined in the Guidance Statement, being:

1. Beginning of period allocation: Cash is allocated on a monthly basis based on the opening market value of the carved out section as a proportion of total opening market value for the portfolio (excluding cash).
2. Strategic asset allocation: Cash is allocated based on target strategic asset allocation.

Firms are also required to disclose the allocation policy within the related GIPS report.

In this way, it is now easier than ever for alternative investment managers to present the performance for distinct portions of their portfolios, allowing for more tailored marketing and an ability to respond to bespoke client requests while still complying with GIPS.

How can EY teams help

Alternative asset managers typically have more complexities and unique scenarios than traditional asset managers. The GIPS professionals have extensive experience delivering verification and consulting projects related to GIPS. In addition to verification engagements, these professionals service investment managers in the areas of regulated and unregulated investment company audits, SOC 1 reporting and other advisory-related engagements. With these services, our professionals bring a breadth of knowledge and experience that enable our teams to be proactive in helping clients manage their GIPS compliance – providing added value along the way.

Our EY FSO Investment Performance team has worked with clients in their initial phases of compliance with GIPS by performing gap analyses as well as verification upon their completion. The EY approach to GIPS compliance is client-focused and will vary depending on the situation because we know every alternative asset manager is different. To be effective, the EY approach is co-developed with each client. Our initial verifications always start with a gap analysis and scoping exercise as well as an evaluation of the current state of performance measurement, policies, procedures, the surrounding control environment and the client's goals.

Should you have any other performance-related investment questions you would like to discuss, please feel free to get in touch with us.

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