GPS INSIGHTS

September 2024

HIGHLIGHTS FROM THE 2024 GIPS® STANDARDS ANNUAL CONFERENCE

The 28th Annual Global Investment Performance Standards (GIPS®) Conference, held in San Diego, California on September 17-18, 2024, brought together over 360 attendees from 20 countries. Throughout the conference, two topics frequently emerged across sessions: treatment of fees for calculating returns and the role of Artificial Intelligence (AI) in investment performance. These themes were woven into almost every session, driving insightful discussions and proposing innovative solutions.

Conference Recap

The SEC Marketing Rule (the "Marketing Rule") has been in effect for nearly two years and remains a central focus of the SEC's 2024 exam priorities. As in previous years, the opening session of the conference addressed the challenges firms face in complying with the Marketing Rule. The session featured Michael McGrath, CFA, Partner at Dechert; Robert Shapiro, Assistant Director of the SEC's Division of Investment Management; Karyn Vincent, CFA, CIPM, Senior Head of Global Industry Standards at CFA Institute; and Ken Robinson, CFA, CIPM, Director of Global Industry Standards at CFA Institute. The panel provided valuable insights into how firms are managing regulatory risk related to the Marketing Rule and discussed findings from a recent survey conducted by the USIPC and Investment Adviser Association (IAA) on current practices for meeting the Marketing Rule's performance requirements. Key highlights and takeaways from this session are detailed in the section below: *Challenges Firms Continue to Face When Complying with the SEC Marketing Rule*.

The conference included several practical sessions, such as *Best Practices for Maintaining GIPS Compliance* and *Marketing Review Dos and Don'ts*. Sue Pike, CFA, CIPM, Global Head of Portfolio Oversight at Newton Investment Management, and Dan Whitley, CIPM, Head of Product Data & Information at Lord, Abbett & Co., emphasized the importance of ensuring policies and procedures are both robust and reflective of actual business practices. Panelists also stressed the need for regular organization-wide training to ensure a clear understanding of the obligations associated with claiming GIPS compliance across the firm. An audience poll revealed that 55% of firms include various stakeholders from across the organization on their GIPS compliance oversight committee, while only 12% indicated that the committee is made up solely of performance professionals.

Noteworthy: Examiners noted that, although most firms have updated their policies and procedures to comply with the Marketing Rule, there is a disconnect between these updates and their actual implementation. Many firms are not fully meeting disclosure and presentation requirements, highlighting the need to ensure that practices are properly aligned with established policies.

The final session of the first day focused on the use of Artificial Intelligence (AI) in investing and performance. Similar to other industries, AI tools are being carefully evaluated across various departments within investment management, although their full impact has yet to be widely realized or implemented. Max Gokhan, CFA, Head of MosaiQ Investment Strategy at Franklin Templeton Investment Solutions, shared his experiences with AI and discussed its potential to revolutionize the investment performance industry by streamlining routine tasks, enhancing human capabilities, and transforming professional workflows. From improving data security to reshaping operational processes, AI's long-term impact on the industry is expected to be profound. As he emphasized, now is the time to begin adapting, with AI likely to bring transformative changes to the investment world over the next 5-10 years. The journey ahead promises to be an exciting one. Key highlights and takeaways from this session are detailed in the section below: *Use of AI in Investment Performance*.

Other conference sessions included a *GIPS Standards Update*, an overview of best practices related to *Performance of Private Funds,* a *Deep Dive into Performance Calculation Issues* which also focused extensively on private funds, and *Attribution Reporting Practices*. If you are interested in learning more or were unable to attend the conference, we recommend checking out the digital content package that will be made available October 3, 2024. You can find more information for accessing the digital content at the end of this newsletter.

Challenges Firms Continue to Face When Complying with the SEC Marketing Rule

The USIPC and IAA conducted a survey to evaluate current practices for complying with the performance requirements of the Marketing Rule. The survey results showed that it is becoming increasingly more common for firms to calculate composite net-of-fees returns using a model fee rate, rather than actual fees. Larger firms reported that using actual fees to calculate net-of-fees returns can be operationally challenging, especially when portfolios have more complex or negotiated fee agreements. In contrast, firms with more standardized fee structures may find it simpler and more practical to use actual fees. However, when the panelists polled the conference audience, the results showed a roughly 50/50 split between firms using model fees and those using actual fees to calculate net returns. In practice, we have observed firms moving away from using actual fees and instead are now reducing gross returns by a model management fee for some if not all of their composites.

Key Take Away: To comply with the SEC's general prohibitions, some firms are shifting away from advertising net returns based on actual management fees and are instead using a model fee to calculate net returns.

- Robert Shapiro, Assistant Director in the SEC's Division of Investment Management, expressed concerns about advisors presenting returns net of actual fees to prospective investors who would be paying higher fees. Karyn Vincent echoed this concern, agreeing that unless a firm has maintained consistent fees over time, it can be challenging to argue that a net return using actual fees complies with the Marketing Rule.
- Mr. Shapiro pointed out that, although the SEC recognizes firms are presenting various "performance-derived" statistics in marketing materials, they do not consider metrics like standard deviation and attribution effects as "performance." However, contribution remains a gray area, subject to interpretation. Mr. Shapiro also cautioned firms to be mindful when making statements that could be interpreted as "performance." For example, claiming that your firm outperformed other managers requires substantiation. Firms must ensure they can back up and can support such performance-related statements.
- Another repeat topic of conversation from last year's conference was the presentation of gross and net IRR by managers of private funds that use subscription lines of credit. The requirements of the Marketing Rule are intended to facilitate comparison and to help investors understand the impact of fees on their accounts. While there are many valid ways of calculating performance, when gross returns are presented, the Marketing Rule requires net and gross returns to be calculated for comparison purposes using the same methodology and for the same time period. The SEC issued an FAQ on February 6, 2024, that provides some clarification on this topic, specifically how the SEC views "time period" and "same methodology." If the manager presents gross IRR from the time of a fund's first investment, it must also present the net IRR calculated from the time of the first investment. If the manager presents net IRR from the time of the first LP capital call, it must include either (a) net IRR calculated from the time of the first investment (i.e., the return without the impact of the subscription line of credit), or (b) disclosure describing the impact of the subscription line of credit on net performance. Mr. Shapiro stated that presenting performance exclusively over the shorter time period would be misleading. Panelists agreed with Mr. Shapiro and felt that the degree to which the track record has been truncated should determine how prominently the accompanying disclosure is presented.
- SEC staff has been thinking a lot about the concept and issue of a "portfolio" versus "extracted performance." There was much discussion and debate between Mr. Shapiro and Mr. McGrath on the topics of carve-outs and extracted performance which remains to be a gray area for firms trying to comply with the Marketing Rule. The panelists encouraged firms to document their interpretation in their policies and procedures manuals. In the absence of guidance, this practice can help the SEC understand where a firm is coming from and why they felt their interpretation was appropriate.

- The panelists discussed several case studies, but one of the more interesting case studies related to the Marketing Rule's requirement that when gross and net performance are shown, the net performance must be (1) presented in equal prominence to, and in a format designed to facilitate comparison, and (2) be calculated over the same time period, using the same type of return methodology. The panelists concluded that to help standardize marketing materials for firms that offer different fee schedules to different types of prospects, firms could consider including multiple net return series in one marketing piece and an example was offered (replicated in the table to the right). Karyn Vincent reminded firms that, while it doesn't have to be in exactly the same format, this approach is permissible for firms claiming compliance with the GIPS standards.

		Net returns			
Year	Gross returns	Actual fees	2% model fee	1.5% model fee	1% model fee
2023	18.86%	17.90%	16.54%	17.12%	17.70%
2022	-9.72%	-10.47%	-11.53%	-11.08%	-10.63%
2021	21.57%	20.59%	19.20%	19.79%	20.38%
2020	15.15%	14.21%	12.89%	13.45%	14.02%
2019	19.28%	18.31%	16.95%	17.53%	18.11%
4/18-12/18	2.23%	1.60%	0.71%	1.09%	1.47%
Annualized returns					
1 year	18.86%	17.90%	16.54%	17.12%	17.70%
5 year	12.37%	11.45%	10.17%	10.71%	11.26%
Since inception	11.10%	10.19%	8.92%	9.46%	10.00%

Use of AI in Investing and Performance

AI is rapidly transforming industries across the globe, and investment performance is no exception. Max Gokham, Head of MosaiQ Investment Strategy at Franklin Templeton Investment Solutions highlighted the increasing role of AI in this space and its potential to revolutionize jobs and processes across portfolio management, performance measurement, operations, and compliance.

Key takeaways from the session:

- AI is particularly effective at handling repetitive tasks, such as gathering and organizing data, integrating different datasets, and detecting patterns. While there are concerns about AI replacing jobs, panelists suggested that the technology is more likely to enhance roles by automating routine tasks rather than eliminating them. For example, AI could be used to compile performance reports and flag exceptions, allowing professionals to focus on higher-level strategic decisions. Mr. Gokhan predicts that over the next 5-10 years, AI will evolve significantly—from functioning in an "analyst" capacity to taking on responsibilities more similar to a "VP" role, managing increasingly complex tasks. As this shift occurs, humans may transition to overseeing AI agents or bots, ensuring the quality of their outputs while scaling overall productivity.
- As AI becomes more integrated into investment performance workflows, certain skills will become essential. Data science, in particular, is crucial; Mr. Gokhan mentioned that when hiring for roles that don't necessarily require experience but do require a willingness to learn, he specifically looks for candidates with a data science background. While AI will undoubtedly transform the investment performance landscape, the general consensus is that it will shift jobs rather than eliminate them. Entry-level roles, such as data gatherers and analysts, are most at risk. However, instead of fearing

replacement, professionals should ask themselves: "How can I collaborate with AI?" Those who learn to work alongside AI will lead the way in driving innovation. While some positions may disappear, new opportunities will arise for those equipped with the skills to partner with AI.

- One of the most crucial discussions around AI in investment management revolves around data security. As AI processes vast amounts of client data, there are concerns about potential breaches. However, algorithms exist to anonymize data, making it untraceable. Still, cybersecurity remains a critical area to watch as AI continues to evolve.

At the start and end of the session, Mr. Gokhan polled the audience on how much they expected AI to impact their work over the next 24 months. Initially, when asked whether they believed AI would significantly influence their work during this period, the audience displayed a relatively low level of confidence in its transformative potential. However, after the session, which explored AI's practical applications and future possibilities, the same question was posed again. This time, there was a notable shift in opinion, with significantly more attendees believing that AI will indeed reshape the way we work in the next near future.

In a CFA Institute *Future of Finance* survey, nearly 8 in 10 industry leaders said they expected how people will work in the investment industry to change significantly over the next decade. In anticipation of this, CFA Institute developed a Data Science for Investment Professionals Certificate that is designed for investment professionals seeking to build practical knowledge of data science and machine learning techniques. Check out the CFA Institute website to learn more.

GIPS Standards Update: New and Proposed Guidance

CFA Institute is preparing to introduce several important updates and guidance statements to address challenges within performance measurement. Upcoming whitepapers and guidance include:

- A whitepaper on best practices for attribution reporting is in progress. While not an official GIPS standards guidance document, this whitepaper is expected to provide a detailed overview of how firms can effectively measure and report performance attribution across portfolios.
- A whitepaper on trade errors is also in development, offering firms a framework for managing errors that impact performance. Although it won't cover every type of operational error, it is expected to provide guidance on creating effective policies and procedures for handling trade errors.
- As Outsourced Chief Investment Officers (OCIOs) become more prevalent, the need for standardized guidelines has become increasingly clear. To address this, CFA Institute is preparing to release new guidance that applies the GIPS standards specifically to OCIOs, aiming to bring consistency and transparency to how performance is calculated and presented in this evolving space. The Exposure Draft of the Guidance Statement for OCIO Strategies is available on the GIPS standards website. It was reported that over 30 comment letters were received, and the guidance has recently been finalized, with plans for release by the end of the year.
- Two additional guidance statements for verifiers will soon be issued for public comment: one focused on verifying asset owners and the other related to verifying Fiduciary Management Providers (FMPs).

GIPS Standards Conference Digital Package Still Available

For those who were not able to attend the GIPS Standards Conference, CFA Institute has made available a Digital Content Package which contains all of the resources and session recordings from the conference, plus additional content. Those who are interested in purchasing the digital content can register for access on the CFA Institute website. The conference session recording and resources will be available for on-demand viewing from October 3, 2024 – January 31, 2025.

GPS OFFERS MANAGED SERVICES & OUTSOURCE SERVICES

Guardian Performance Solutions LLC (GPS) is proud to offer both managed composite performance services and fully outsourced options, utilizing industry-leading platforms such as Confluence Revolution Composites (RC), CompositeBuilder, and Opturo's SAYS Platform. For clients seeking a fully outsourced solution, GPS licenses and operates composite management systems, managing the composite construction, performance validation, and reporting process. This approach takes the composite management burden off the firm entirely. Alternatively, under our composite managed service model, GPS will manage the composite construction and reporting process working remotely using the firm's composite system.

Regardless of the service model, GPS offers comprehensive GIPS compliance management, SEC Marketing Rule compliance support, and serving as a liaison to ensure timely verification administration. All services are delivered by experienced professionals who specialize in constructing composites, validating performance, and developing policies and procedures to comply with the GIPS standards and SEC Marketing Rule.

Please contact us at info@guardianperformancesolutions.com if you would like more information.

ABOUT US

Guardian Performance Solutions LLC (GPS) is a specialty compliance consulting firm dedicated to providing customized solutions to the investment management industry with the objective of supporting firms to achieve and maintain compliance with the Global Investment Performance Standards (GIPS®) and the SEC Marketing Rule. Because GPS does not provide verification services, GPS is free from independence concerns and can take a hands-on approach to developing and managing an adviser's GIPS compliance program, which may include constructing composites, calculating, and validating performance results, and writing GIPS compliance policies and procedures. Additional information can be found at www.GuardianPerformanceSolutions.com.