

## Hedge fund managers' processes are maturing: GIPS now address issues specific to hedge fund managers

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### Introduction

Hedge funds have regained the trust of institutional investors. The total value invested in hedge funds is back to the level of September 2008, just before the height of the economic crisis.<sup>1</sup> Because of the influx of institutional assets, hedge fund managers (HFMs) are subject to enhanced due diligence requirements, but there is also greater demand for comparability of HFMs' performance figures. Not surprisingly, HFMs have been turning to the GIPS standards as a way to achieve the transparency being demanded in the post-Madoff marketplace.

However, HFMs encountered a number of practical issues when trying to apply the GIPS standards to hedge funds. This was relayed to the GIPS Executive Committee, the body responsible for setting the standards, prompting it to issue an Exposure Draft of the Guidance Statement

on Alternative Investment Strategies and Structures, which has recently been released for public comment (see [www.gipsstandards.org](http://www.gipsstandards.org)). The Guidance Statement, expected to take effect on 1 January 2012, covers specific topics impacting HFMs, such as valuation issues due to illiquidity and definition of the firm challenges due to complex legal relationships and multi-layered portfolio structures.

### GIPS on Alternative Investment Strategies and Structures

Although the GIPS standards already covered alternative investment instruments, including real estate, private equity and venture capital, they did not previously provide dedicated guidance to HFMs and their specific products.

Investment types and portfolio structures that are within the scope of the proposed Guidance Statement include, but are not limited, to the following:

- ▶ Hedge funds and hedge fund-like strategies
- ▶ Funds of funds, where the underlying funds are invested in either traditional or alternative strategies
- ▶ Structured products requiring ongoing management of the underlying investments where there are identifiable elements of asset management embedded in the overall product
- ▶ Investment strategies that materially alter the potential return characteristics of the portfolio using derivative instruments (e.g., currency and interest overlay strategies)
- ▶ Investment techniques, such as portable alpha, liability-driven investment, and long and short strategies
- ▶ Non-index related commodities and their derivatives
- ▶ Strategies that invest in non-traditional assets<sup>2</sup>

1 *Het Financieele Dagblad (The Financial Journal)*, "Hedgefunds have recovered from the crisis," 28 March 2011

2 CFA Institute, 2011. "Exposure draft of the guidance statement on Alternative Investment Strategies and Structures"

## Summary of the proposed Guidance Statement

The proposed guidelines follow the same format as the existing GIPS standards, focusing on specific hedge fund issues with regards to *Fundamentals of Compliance, Input Data, Calculation Methodology, Composite Construction, Disclosure, and Presentation and Reporting*.

In the “Fundamentals of Compliance” section, the Guidance Statement outlines the considerations HFMs should take into account when defining the firm. In reality, this does not differ from the current standards. The guidelines stress that the complexity of hedge funds should not be a reason to exclude certain portfolios or assets from the firm definition. Further, simulated or hypothetical performance figures can only be used as supplementary information to clarify the investment strategy, and must not be linked to actual historical investment performance.

### Input data and calculation methodology

Obtaining up-to-date market values for assets can be difficult for HFMs for a number of reasons; for instance, due to (temporary) illiquidity of the assets or the absence of an active market. The latest version of the GIPS standards, in force since 1 January 2011, already made concessions toward the valuation issues that are important to managers of hedge funds and other alternative investments.

The GIPS standards prescribe the fair value principle, where the assets are valued following a valuation hierarchy. The “Input Data” section of the Guidance Statement explains the GIPS standards requirement that assets must be valued at least once a month. For some hedge funds, this is a challenge due to the limited availability of actual market values; this can be due to illiquidity or the fact that external providers do not deliver such information on a monthly basis. In such cases, the firm must elaborate in its valuation policies how it determines the required monthly valuations; for instance, by using internal models. These internal models should be managed by a division from the firm that is independent of the actual fund managers. Furthermore, the firm must disclose the use of subjective inputs for such models in the presentation of the composite’s performance results.

Another challenge for HFMs is the way fees are handled in the calculation of net returns when a feeder fund participates in several different master hedge funds. Consider, for instance, a master-feeder structure where a firm manages both the feeder and the master funds, where the management fee is not charged at the master level, but instead at the feeder level. The “Calculation Methodology” section explains that if the firm decides to report the net performance of the master fund, the master’s gross return must be adjusted using the feeder’s fees (either by allocating parts of the feeder’s fees to the master, or by determining “model fees,” which are the maximum of all fees charged at the feeder level).

### Side pockets

A common characteristic that impacts the way composites are constructed for hedge funds is the use of “side pockets” – accounts that are held within a fund to separate illiquid assets from liquid assets, or to isolate assets that are held for a special reason. Usually, only investors that participated in the pooled fund when the side pocket was created in the fund will benefit from the performance of the side pocket.

Although the GIPS standards focus primarily on prospective clients, this is no reason to exclude a side pocket from the composite as long as the firm has full discretionary power over it. In this situation, the performance of the side pocket must be included in the performance of the composite. The exposure draft proposes that if the side pocket was created for a specific client, and the firm does not have full discretionary power over it, it can be deemed a non-discretionary part of a pooled fund, and thus be kept outside the fund’s performance calculation. The creation of a side pocket will need to be disclosed.

### Composite construction

Funds with a master-feeder structure also require special attention when constructing composites. The “Composite Construction” section in the proposed Guidance Statement explains that the firm must decide on what level composites should be constructed; for instance, by determining if it is appropriate to include either a master fund in a composite, or alternatively, all of the investing feeder funds (to allocate both would constitute double counting). Criteria that can be used are at the level where the manager makes his investment decisions and the level at which prospective clients can invest.

### Disclosures, presentation and reporting

Because of the inherent complexity of hedge funds, it is crucial to disclose more information when presenting performance information. Things that should be disclosed include the use of derivatives or the amount of leverage, the percentage of assets considered illiquid and market-related events that have impacted the fund’s performance. Finally, the proposed Guidance Statement advises that risk measures should be presented to help a potential investor to understand the strategy’s risk characteristics; this is in addition to the standard deviation of monthly returns required by the GIPS standards. This is especially relevant for investment strategies with a non-linear risk profile, where the standard deviation will not offer a fair understanding of the risk of the fund. An example of a relevant risk measure in such cases would be the omega risk measure.

### Value added

Hedge funds and alternative investment firms that are not yet compliant with the GIPS standards should analyze their operational investment reporting set-up and be prepared for the developments ahead. Today, most investors expect firms to be “GIPS compliant” and rely on performance

reports that are both accurate and verified. In this context, it is important to consider the following strategic aspects as to why the GIPS standards are increasingly important to hedge fund and alternative investment firms and their investors:

- ▶ **Transparency:** the key benefit, as always, is for clients and investors; the GIPS standards require key product data and disclosures to be provided to these parties in a comparable format.
- ▶ **Improved view of the firm’s track record:** many HFMs have started managing separate accounts; GIPS-compliant managers would have one or more composites reflecting the track record of the separate accounts. Current and potential investors could compare performance results between the hedge fund and any separate accounts following the same strategy.
- ▶ **Reputation:** GIPS compliance and third-party verification provides credibility to the performance track record of the firm.
- ▶ **Due diligence:** GIPS-compliant HFMs have adopted many processes and procedures that can reduce operational risk.
- ▶ **Consistency:** the GIPS standards ensure that the same standard of care is applied to the selection and review of alternative investment managers as that applied to traditional investment managers.
- ▶ **Flexibility:** the GIPS standards are accepted and recognized in most regulatory environments around the world. This provides companies with the opportunity to market and sell their products across geographical boundaries, which is a primary benefit of global firm compliance.

Another key benefit for HFMs is that internal processes and procedures must be reviewed and documented. Maintaining GIPS compliance can help firms either improve or establish a competitive advantage by developing stronger operational and technological infrastructure, devising streamlined processes, and training people to support accurate and timely investment-performance reporting. Those that adopt the right processes can go to market with a higher level of confidence that their performance data is accurate.

### Conclusion

As asset managers continue to leverage new and more complex investment products and hedge fund strategies in order to increase assets under management, their ability to compete and effectively market such products is heavily influenced by the credibility of their investment performance track record and reporting to prospective investors. Among other important criteria, HFMs also differ in terms of the quality of service, investment process, experience and qualifications, track record and reputation. HFMs that build a strong process and control framework around their investment performance reporting stand out from competitors. The GIPS standards are a core component of such a framework and the proposed Guidance Statement resolves some of the unique issues faced by hedge funds and alternative investment managers.