



Global Investment Performance Standards

Guidance Statement on the Treatment of Carve-Outs

Adoption Date: 28 September 2010

Effective Date: 1 January 2011

Retroactive Application: Not Required

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GIPS® Guidance Statement on the Treatment of Carve-Outs (Revised)

Introduction

A carve-out is defined as a ~~single or multiple asset class segment~~ portion of a ~~multiple asset class~~ portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a ~~multiple-strategy~~ portfolio managed to a broader mandate. For example, the Asian securities from a Euro-Pacific portfolio or the equity portion of a balanced portfolio could be considered a carve-out. Carve-outs are generally based on asset class, geographic region, or industry sector.

Inherent Problems

Carve-outs have several problems associated with them. Because they represent only a portion of a broader, more diversified strategy, carve-out returns are only a valid track record if they are representative of what would have been achieved in a portfolio dedicated to the carved-out strategy. The use of carve-outs gives the impression that the firm has experience managing portfolios dedicated to a particular strategy, when this may not be the case. For example, a carve-out of the U.K. equities in a global equity portfolio that holds only two U.K. equities is not representative of a diversified U.K.-only portfolio.

A second problem occurs if cash is not accounted for separately ~~and, therefore, must be allocated to the carved-out segment~~. If the carve-out is not accounted for separately with its own cash balance, then the ~~calculation of the~~ return is potentially ~~less accurate~~ not representative of a stand-alone portfolio. The GIPS S standards require that returns from cash and cash equivalents held in ~~the portfolios~~ must be included in ~~the total~~ return calculations. Unless the carved-out portion is accounted for as a separate portfolio, there will be no cash associated with the returns. For periods prior to 1 January 2010, if carve-outs were included in a composite, cash must have been allocated to ~~the returns in a the~~ carve-out in a timely manner using a and consistent, objective methodology manner or have been accounted for separately with its own cash balance.

For periods beginning on or after 1 January 2010, if a carve-out must not be included in a composite unless the carve-out is managed separately with its own cash balance. Cash allocation is no longer allowed. If the firm intends to carve-out an asset class, sector, industry, size range (e.g., large cap), or style type (e.g., value), each carved-out segment must have either its own cash balance or be accounted for separately with its own associated cash position.

The rationale behind the inclusion of cash at all times in total returns is based on the principle of fair representation—~~a~~ A composite that includes portfolios without any cash would not be representative to the typical prospective client who hires the firm on a fully discretionary basis where cash allocation and management would be implicit. It would be misleading to present returns without cash, since this does not fairly represent how a separate portfolio would be managed.

Guiding Principles

Firms must remember the fundamental principles of the GIPS standards, fair representation and full disclosure, and must ~~avoid presenting misleading~~ not present performance or performance-related information that is false or misleading. Any carve-out ~~used as included in a track record composite~~ must be representative of an actual segregated portfolio managed to that strategy. The carved-out segment must be discretionary and structured materially the same as a portfolio dedicated to that strategy and have a risk profile that is substantially similar. For example, the equity segment of a balanced portfolio may be structured differently than a separately managed equity portfolio because additional risks taken in the equity segment may be offset by lower risk taken in the fixed-income segment. The firm must determine if the carved-out segment is representative of a separately managed portfolio dedicated to the same strategy.

Firms must establish a policy for the creation, use, and calculation of carve-outs and apply the policy consistently. ~~The~~ For periods ending prior to 1 January 2010, the calculation methodology used to calculate and allocate the return achieved on cash ~~should~~ must be determined by the firm, documented, and applied consistently.

The GIPS standards state, “For periods beginning on or after 1 January 2010, a carve-out ~~returns are~~ must not ~~permitted to~~ be included in single asset class composite ~~returns~~ unless the carve-out is actually managed separately with its own cash balance.”

Accordingly, it is necessary to clarify what is permissible for periods ending prior to 1 January 2010 and for periods beginning on or after ~~the provision becomes effective~~ 1 January 2010.

The following guiding principles must be met when ~~a firm considers creating~~ using carve-outs.

For Periods Ending prior to 1 January 2010:

- The carve-out should be managed separately (i.e., the segment should be managed as if it were a separate portfolio, rather than a segment of a larger portfolio).
- The carve-out must be representative of a stand-alone portfolio managed to the same strategy.
- If a firm creates a carve-out of a particular strategy, then all similar portfolio segments managed to that strategy must also be carved-out and included in the composite (e.g., if the equity segment of a balanced portfolio is carved-out and included in an equity composite, then all similar equity segments of the firm’s portfolios must be carved out and included in the equity composite, provided the conditions outlined in this Guidance Statement are met).
- If a firm chooses to carve-out a portion of a portfolio, ~~they are~~ the firm is not compelled to carve-out other parts of the portfolio.
- When presenting net-of-fees performance of composites containing carve-outs, investment management fees must be deducted from the gross-of-fees carved-out returns. The investment management fees must be representative of the fees charged for a separately managed portfolio for the asset class carved-out considering the fee schedule for the composite containing the carve-outs.
- The carve-out should have its cash accounted for separately. If the segment does not have its own cash, cash must be allocated to the segment on a consistent basis. Acceptable allocation methods include:

- *Beginning of Period Allocation.* Identify the cash allocation percentage for each portfolio segment at the beginning of the period. For example, at the beginning of January, identify the percentage of residual cash that will be allocated to the carve-outs at month end.
- *Strategic Asset Allocation.* Base the allocation directly upon the target strategic asset allocation. For example, if the portfolio is targeted to have 40% in equities and 60% in bonds, then the allocation will relate to the actual amounts invested. If the portfolio had a target allocation of 40%, but at the beginning of the period only held 35% in equities, then the cash return would constitute the difference (5%). Firms must determine which method to use, document it, and apply consistently.

As of For Periods Beginning On or After 1 January 2010:

- The carve-out must be managed separately (i.e., the segment must be managed as if it were a separate portfolio, rather than a segment of a larger portfolio).
- The carve-out must be representative of a stand-alone portfolio managed to the same strategy.
- The carve-out must have its own cash. Cash allocation is not permitted. Possible methods for properly accounting for the cash positions include:
 - Separate portfolios: Cash and securities are actually segregated into a separate portfolio at the custodian.
 - Multiple cash accounts: Each segment's cash is accounted for separately (e.g., equity cash account, fixed-income cash account).
 - Sub-portfolios: Each segment of a portfolio is accounted for as if it were a separate portfolio.
- Firms must determine which of the segments of multiple-strategy portfolios are managed separately with their own cash balances to determine the universe of possible carve-outs. If a firm creates a carve-out of a particular strategy and wishes to include the carve-out in a composite, then all similar portfolio segments managed to that strategy and managed separately with their own cash balances must also be ~~carved out and~~ included in the composite ~~(e.g., if the equity segment of a balanced portfolio is carved out and included in an equity composite, then all similar equity segments of the firm's portfolios must be carved out and included in the equity composite~~, provided the conditions above are met).
- Segments not managed separately with their own cash balances are not eligible for inclusion in composites because they do not meet the definition of a carve-out as of 1 January 2010.
- If a firm chooses to carve-out a portion of a portfolio, they are not compelled to carve-out other parts of the portfolio.
- When presenting net-of-fees performance of composites containing carve-outs, investment management fees must be deducted from the carved-out gross-of-fees returns. The investment management fees must be representative of the fees charged for a separately managed portfolio for the asset class carved out considering the fee schedule for the composite containing the carve-outs.

Performance Record for Discontinued Carve-Outs

When a firm, which has created carve-outs using cash allocation methods for periods prior to 1 January 2010, does not choose to apply any method for accounting for the cash

position to the carve-outs and thus discontinues the carve-outs for periods after 1 January 2010, then the firm must meet all of the following conditions:

- The past performance record of the carve-outs using cash allocation methods must be left unchanged within the same composites in which the carve-outs were included,
- ~~In the~~ For periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite ~~presentation~~ includes carve-outs, the firm must ~~disclose~~ present the ~~historical inclusion~~ percentage of composite assets represented by carve-outs ~~and the~~ as of each annual period ~~of inclusion~~ end, and
- If the firm has a composite consisting of only carve-outs using cash allocation methods and does not apply any method for accounting for the cash position to any of the carve-outs in the composite for periods beginning on or after 1 January 2010, the composite is ~~discontinued~~ terminated but must continue to be listed on the firm's list of composites ~~descriptions~~ for five years after ~~discontinuation~~ termination.

Acceptable Uses

Effective 1 January 2010, carve-outs must be managed separately with their own cash balances (i.e., allocation of cash ~~will~~ is no longer ~~be~~ allowed ~~as of~~ for periods beginning on or after 1 January 2010). This change ~~will~~ is not ~~be~~ retroactive, so the history of existing carve-outs must not change. Carve-out track records that are representative of the composite strategy may be used like any other portfolio provided that the carve-out is ~~accounted for~~ managed separately with its own cash.

Firms are not permitted to combine different carve-outs or composites to create a new, simulated strategy composite for purposes of compliance with the GIPS standards. For example, a firm may not combine an equity carve-out and a fixed income carve-out to create a simulated balanced composite. Although comprised of actual returns, this type of composite is hypothetical because it does not reflect real asset allocation decisions and therefore is viewed as model or simulated results under the GIPS standards. This information can be presented as supplemental information ~~only but~~ , provided the firm has the supporting records, and must not be linked to actual returns.

Disclosures

~~According to Provision 4.A.11, when a single asset class is carved out of a multiple asset portfolio and the returns~~ The GIPS standards require that for periods prior to 1 January 2010, if carve-outs are presented as part of a single asset ~~included in a~~ composite, firms must disclose the ~~cash allocation method that was~~ policy used ~~for periods prior to 1 January 2010 to allocate cash to~~ carve-outs. It is recommended that firms disclose any change in the cash allocation methods.

In addition, ~~Provision 5.A.5 requires~~ it is required that for periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite includes ~~or is formed using single asset class~~ carve-outs from multiple asset class portfolios, the ~~presentation~~ firm must ~~include~~ present the percentage of ~~the~~ composite ~~that is composed of~~ assets represented by carve-outs ~~prospectively for~~ as of each annual period end.

Effective Date

The effective date for this Guidance Statement is 1 January 2011. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).

~~This Guidance Statement was originally effective 1 June 2004 and was revised to reflect the changes to the GIPS standards effective as of 1 January 2006.~~

~~Firms are encouraged, but not required, to apply this guidance prior to the original Effective Date of 1 June 2004; however, the original guidance must be applied to all presentations that include performance for periods on and after that date.~~

~~The revisions made to this guidance (effective 1 January 2006) must be applied to all presentations that include performance for periods after 31 December 2005.~~

Key GIPS Provisions Specifically Applicable to Carve Outs:

~~3.A.7 Carve-out segments excluding cash are not permitted to be used to represent a discretionary portfolio and, as such, are not permitted to be included in composite returns. When a single asset class is carved out of a multiple asset class portfolio and the returns are presented as part of a single asset composite, cash must be allocated to the carve-out returns in a timely and consistent manner. Beginning 1 January 2010 carve-out returns are not permitted to be included in single asset class composite returns unless the carve-out is actually managed separately with its own cash balance.~~

~~3.B.1 Carve-out returns should not be included in single asset class composite returns unless the carve-outs are actually managed separately with their own cash balance.~~

~~4.A.11 For periods prior to 1 January 2010, when a single asset class is carved out of a multiple asset portfolio and the returns are presented as part of a single asset composite, firms must disclose the policy used to allocate cash to the carve-out returns.~~

~~5.A.5 Beginning 1 January 2006, if a composite includes or is formed using single asset class carve-outs from multiple asset class portfolios, the presentation must include the percentage of the composite that is composed of carve-outs prospectively for each period.~~

Application:

- ~~1. Firm B manages balanced portfolios and would like to carve out the equities to create an equity composite. Firm B charges 0.75% for its fixed income strategy, 1.50% for its equity strategy, and 1.00% for its balanced strategy. How should the investment management fee be allocated to the equity carve-out for presenting a net-of-fees return?~~

~~Firms must allocate fees to each segment that are appropriate to the asset class. In this case, the firm must use the 1.50% that it charges for equity management.~~