

# Global Investment Performance Standards

## *Exposure Draft*

### **INVITATION TO COMMENT:**

#### **Exposure Draft of the Guidance Statement on Real Estate**

CFA Institute established the GIPS Executive Committee as the governing body for the Global Investment Performance Standards (GIPS®). The GIPS Executive Committee seeks comment on the proposal set forth below regarding proposed revisions to the Guidance Statement on Real Estate.

Comments must be submitted in writing and received no later than 25 November 2010. Responses will be accepted in hardcopy and via fax, but should also be submitted via e-mail. Please submit your comments as early as possible to facilitate the review process. Unless otherwise requested, all comments and replies will be made public on the GIPS standards website ([www.gipsstandards.org](http://www.gipsstandards.org)). Comments may be submitted as follows:

E-mail: [standards@cfainstitute.org](mailto:standards@cfainstitute.org)

Fax: 1-434-951-5320

Post: CFA Institute  
Global Investment Performance Standards  
Re: Guidance Statement on Real Estate  
P.O. Box 3668  
Charlottesville, Virginia 22903

### **Executive Summary**

The current version of the Guidance Statement on Real Estate became effective 1 January 2006. The GIPS Executive Committee, in collaboration with various technical subcommittees including the GIPS Real Estate Working Group, has revised the Guidance Statement on Real Estate to reflect the 2010 edition of the GIPS standards and to improve existing guidance on the real estate requirements and recommendations. A red-line version of this document, highlighting each proposed change, is available for review on the GIPS standards website.

The questions & answers (Q&As) originally included in the Guidance Statement on Real Estate have been removed and will be reviewed and updated as deemed necessary by the GIPS Executive Committee and Real Estate Working Group. Additional history and background on the GIPS standards can be found on the GIPS standards website.

### **Effective Date**

The expected effective date of the revised Guidance Statement on Real Estate is 1 January 2011 to coincide with the effective date of the 2010 edition of the GIPS standards. When bringing past performance into compliance, firms may comply with this updated 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.

### **Summary of Proposed Revisions to the Guidance Statement on Real Estate**

The following is a summary of some of the significant revisions to the Guidance Statement on Real

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Estate, other than changes made to conform to the 2010 edition of the GIPS standards.

1. Enhanced guidance on discretion as it relates to real estate portfolios has been added to the Guidance Statement. This includes both examples of situations where the firm may characterize the portfolio as discretionary as well as situations where the firm may characterize the portfolio as non-discretionary.
2. The composite construction section of the document has been clarified. Guidance has been added to the Guidance Statement describing investment-level and property-level performance. In addition, composite construction for closed-end real estate funds is addressed and a separate section has been added specifically for determining the non-GIPS-compliant performance period for real estate closed-end fund composites.
3. A new section of the Guidance Statement on fees and expenses has been included.
4. A new section has been added addressing when new real estate portfolios are to be included in a composite.
5. Various sections of the existing document (e.g., valuation) have been removed primarily because this information is addressed elsewhere within the GIPS standards, such as in Section 6 of Chapter I of the GIPS standards, the GIPS standards Glossary, or the GIPS Valuation Principles.

### **Comments Requested**

The GIPS Executive Committee is seeking comments from the industry on the proposed revisions to the Guidance Statement on Real Estate. In addition to commenting on the items listed below, please provide feedback on the entire document, including items you support. With respect to the proposed requirement regarding the inclusion of new portfolios in composites noted above, the GIPS Executive Committee would specifically like feedback on the following items:

1. Do you agree with the proposed requirement to include new portfolios in a composite upon portfolio inception? Should this be a recommendation? Should this be an optional policy?
2. Do you believe this requirement should be limited to new portfolios in real estate closed-end fund composites?
3. Do you believe there should be a corresponding disclosure requirement regarding partial-period returns? If so, please explain.
4. Alternatively, if a portfolio experiences an event that materially impacts performance prior to the portfolio's inclusion in a composite (the period from a portfolio's inception up to the beginning of the first full period), should this impact be brought forward and reflected in performance once the portfolio is included in the composite? If so, should this be required or recommended?
5. Should portfolios be required to remain in composites until the portfolio is terminated?
6. Are there any composite construction or calculation issues that arise as a result of the proposed changes?
7. Would the proposed changes create any issues in regards to benchmarks?

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### Guidance Statement on Real Estate

Effective 1 January 2011

#### **Introduction and Scope**

The real estate provisions in Section 6 of Chapter I of the Global Investment Performance Standards (GIPS<sup>®</sup>) apply to:

- Wholly owned or partially owned properties;
- Real estate commingled funds, separate accounts, and unit trusts;
- Unlisted, private placement securities issued by private real estate investment trusts (REITs) and real estate operating companies (REOCs); and
- Equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where some portion of return to the investor is related to the performance of the underlying real estate.

Real estate includes land, buildings under development, completed buildings, and other structures or improvements held for investment purposes.

The real estate provisions apply irrespective of whether a real estate investment is producing revenue and also apply to real estate investments with leverage (gearing). It is important that firms managing real estate investments understand that compliance with the GIPS standards refers to firm-wide compliance which requires adherence not just to the real estate provisions but to all the applicable general provisions of the GIPS standards. The general provisions that do not apply to real estate composites are noted parenthetically within Section 6 of Chapter I of the GIPS standards.

The following investment types are not considered real estate investments and, therefore, must follow Sections 0–5 in Chapter I of the GIPS standards:

- Publicly traded real estate securities;
- Mortgage-backed securities (MBS, CMBS); and
- Private debt investments, including commercial and residential loans where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying real estate.

The following guidance includes a discussion of issues relating to real estate investments.

#### **Investment Discretion**

The GIPS standards require that all actual, fee-paying, discretionary portfolios be included in at least one composite. Discretion is the ability of the firm to implement its intended strategy. Each firm must document its definition of discretion and must apply the definition consistently. As stated in the Guidance Statement on Composite Definition, there are degrees of discretion and not all client-imposed restrictions will necessarily cause a portfolio to be non-discretionary. The firm must determine if the restrictions will, or could, interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy.

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The firm's definition of discretion must include criteria such that if the firm has sole responsibility, or sufficient decision-making authority for major investment decisions, the real estate portfolio must be considered discretionary. Major decisions include, but are not limited to, determining investment search and selection, acquisitions, dispositions, investment structuring, financing, capital improvements, leasing, and operating budgets. In some cases, client-imposed restrictions may result in some decision-making authority being retained by the client. However, if the manager has sufficient decision-making authority to implement the intended investment mandate, objective, or strategy, the portfolio should, where possible, be considered discretionary.

The following is an example of a discretionary portfolio:

- The manager, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions and therefore can fully implement its investment strategy. This is often the case for products sponsored by the investment manager such as real estate pooled or commingled investment fund vehicles.

The following are examples where the firm may be able to characterize the portfolio as discretionary, consistent with its definition of discretion:

- The manager, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions so long as the firm does not exceed specified thresholds agreed to with a non-pooled or non-commingled investment vehicle client.
- The manager retains control over property management (day-to-day operations) and makes strategic acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition recommendations but has to obtain client approval for these items prior to transaction execution.

The following are examples where, in most instances, the firm would characterize the portfolio as non-discretionary, consistent with its definition of discretion:

- The client has complete investment discretion regarding real estate investments.
- The client prohibits or significantly limits repositioning of the portfolio through dispositions.

### **Composite Construction**

One of the key principles of the GIPS standards is the presentation of composite performance, where a composite is defined as an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The real estate provisions of the GIPS standards embrace the notion of composite-level reporting. Real estate investment management firms are required to present performance in composites defined by investment mandate, objective, or strategy. Real estate closed-end fund composites must be defined by vintage year and investment mandate, objective, or strategy, and the composite definition utilized must remain consistent throughout the life of the composite. The vintage year concept is an important factor for real estate closed-end fund composites and could potentially limit real estate closed-end fund composites to one fund per composite because managers are unlikely to raise another fund with the same strategy in the same vintage year.

Users and recipients of real estate performance frequently request only an aggregation of property-level performance, which is not consistent with the composite construction principles of the GIPS standards that are based on investment-level performance. Although firms are not prohibited from presenting

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property-level performance outside of a compliant presentation or as supplemental information to a compliant presentation, firms are required to make every reasonable effort to provide a compliant presentation to all prospective clients. Please see the Guidance Statement on the Use of Supplemental Information for further information.

The term “investment- level” is intended to reflect the impact of ownership and financing structures and includes all underlying property-level activity. Investment-level returns are distinct from property-level returns, which exclude all of the non-property (investment-level) balance sheet as well as income and expense items.

A real estate investment management firm may be asked to provide an aggregation of historical performance by property type, which is much narrower than any of the broader investment strategies managed by the firm. For example, the firm may be asked to provide investment performance consisting of only its office building investments, which requires extracting the performance of all office building investments from their broader real estate investment strategies. Such an aggregation is not a composite. This performance can be shown outside of a compliant presentation or as supplemental information to a compliant presentation. If the aggregation is representative of a distinct investment strategy the track record of the narrower mandate may be able to be presented as a carve-out. Please see the Guidance Statement on the Treatment of Carve-Outs for further information.

For periods ending on or after 1 January 2011, the composite construction requirements for real estate closed-end fund composites mandate that closed-end real estate funds, if any, be in separate composites. In addition, provided all composite construction requirements are adhered to, a firm may choose to include open-end and closed-end real estate funds in the same composite because firms are permitted to include a portfolio in more than one composite. If a firm includes both open-end and closed-end real estate funds in the same composite, the firm should consider disclosing the types of portfolios included in the composite as part of the composite description. Please see the Guidance Statement on Composite Definition for further information on composite construction.

### **Fees and Expenses**

When calculating returns, the following guidance should be used to help determine how real estate investment management and other fees and expenses are treated.

Gross-of-fees and net-of-fees returns must be net of all property-level expenses. Gross-of-fees and net-of-fees returns must also be net of debt service, including preferred equity dividends.

The difference between gross-of-fees and net-of-fees returns should reflect only investment management fees that the manager charges for providing investment management/advisory services. Investment management fees typically include a recurring base management fee (often calculated on the basis of invested or committed capital) and a performance-based fee (carried interest).

Fees and expenses should be evaluated to determine their proper treatment when calculating returns. Acquisition, disposition, financing, and development costs on a particular transaction are considered “transaction expenses” and must be deducted from both gross-of-fees and net-of-fees returns regardless of whether the service is performed by the investment manager or a third party. If any of these services are performed by the investment manager, the description of such services performed by the investment manager should be disclosed in the compliant presentation.

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Investment-level administrative costs are not required to be deducted from gross-of fees or net-of-fees returns. In many jurisdictions, however, it is common practice in the real estate industry to deduct such items when computing gross-of-fees and net-of-fees returns. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses.

### **Inclusion of New Portfolios in Composites**

The GIPS standards state that composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. When computing time-weighted rates of return, a “partial period” or “stub period” can occur for the period from a portfolio’s inception up to the beginning of the first full period when a portfolio is placed into the composite. A question that often arises is whether the stub period portfolio performance must or should be captured for time-weighted composite construction purposes. Historically firms have used different approaches to address the partial period issue. The nature of the real estate asset class is unique and is often composed of illiquid investments with infrequent acquisition and disposition activity. In order to standardize the treatment of partial period performance for new portfolios when calculating time-weighted returns, for periods beginning on or after 1 January 2011, real estate composites are required to include new portfolios in composites on the portfolio’s inception date, which is typically the date of the portfolio’s first external cash flow.

### **Determining the Non-GIPS-Compliant Performance Period for Real Estate Closed-End Fund Composites**

The GIPS real estate provisions require that real estate closed-end fund composites present the net-of-fees since inception internal rate of return (SI-IRR) of the composite through each annual period end in the compliant presentation. Firms must initially present at least five years of performance (or for the period since the firm’s inception or the composite inception date if the firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, the GIPS real estate provisions state that firms must not link non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. However, firms may link non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006. For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The period for a SI-IRR is from the inception date through the end of the period that is being reported. Unlike time-weighted rates of return, the beginning period for a SI-IRR remains constant and does not change. Therefore, it is necessary to use the period end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the real estate closed-end fund composite history begins 1 January 2003, SI-IRR are required to be presented from 1 January 2003 (inception) through each annual period starting with the period ending 31 December 2006. If the firm chooses to present SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

### **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](http://www.gipsstandards.org)).