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Global Investment Performance Standards

Guidance Statement on the Treatment of Carve-Outs

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GIPS® Guidance Statement on the Treatment of Carve-Outs

Introduction

A carve-out is defined as a portion of a 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. If the carve-out is not accounted for separately with its own cash balance, then the return is potentially not representative of a stand-alone portfolio. The GIPS standards require that returns from cash and cash equivalents held in portfolios must be included in all 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 carve-out in a timely and consistent manner or have been accounted for separately with its own cash balance.

For periods beginning on or after 1 January 2010, 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 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 not present performance or performance-related information that is false or misleading. Any carve-out included in a 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. For periods ending prior to 1 January 2010, the calculation methodology used to calculate and allocate the return achieved on cash 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 must not be included in a composite unless the carve-out is 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 1 January 2010.

The following guiding principles must be met when 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, 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.

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 included in the 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,

- For periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite includes carve-outs, the firm must present the percentage of composite assets represented by carve-outs as of each annual period 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 terminated but must continue to be listed on the firm's list of composite descriptions for five years after termination.

Acceptable Uses

Effective 1 January 2010, carve-outs must be managed separately with their own cash balances (i.e., allocation of cash is no longer allowed for periods beginning on or after 1 January 2010). This change is not 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 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, provided the firm has the supporting records, and must not be linked to actual returns.

Disclosures

The GIPS standards require that for periods prior to 1 January 2010, if carve-outs are included in a composite, firms must disclose the policy used to allocate cash to carve-outs. It is recommended that firms disclose any change in the cash allocation methods.

In addition, it is required that for periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite includes carve-outs, the firm must present the percentage of composite assets represented by carve-outs 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).