GIPS® Guidance Statement on Treatment of Carve-Outs

Revised Effective Date: 1 January 2006

Adoption Date: 4 March 2004

Effective Date: 1 June 2004

Retroactive Application: Not Required

Public Comment Period: August – November 2002

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

Introduction

A carve-out is defined as a single or multiple asset class segment of a multiple asset class portfolio. It is used to create a track record for a narrower mandate from a 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, then the calculation of the return is potentially less accurate. The Standards require that returns from cash and cash equivalents held in the portfolio must be included in the total return. 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, cash must be allocated to the returns in a timely manner using a consistent, objective methodology.

Beginning 1 January 2010, 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.

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Guiding Principles

Firms must remember the fundamental principles of the Standards, fair representation and full disclosure, and must avoid presenting misleading information. Any carve-out used as a track record 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 calculation methodology used to calculate and allocate the return achieved on cash should be determined by the firm, documented, and applied consistently.

The GIPS standards state, "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." Accordingly, it is necessary to clarify what is permissible prior to 1 January 2010 and after the provision becomes effective 1 January 2010.

The following guiding principles must be met when a firm considers creating a carve-out:

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 not compelled to carve-out other parts of the portfolio.
- When presenting net-of-fees performance of composites containing carve-outs, fees must be deducted from the carved-out returns. The 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:

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1. *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.
2. *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 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.
- 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 above are met).
- 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, fees must be deducted from the carved-out returns. The 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 must have its own cash. Possible methods for properly accounting for the cash positions include:
    1. Separate portfolios: cash and securities are actually segregated into a separate portfolio at the custodian.
    2. Multiple cash accounts: each segment's cash is accounted for separately (e.g., equity cash account, fixed-income cash account, etc.).
    3. Sub-portfolios: each segment of a portfolio is accounted for as if it were a separate portfolio.

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:

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- 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 composite presentation, the firm must disclose the historical inclusion of carve-outs and the period of inclusion, 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 after 1 January 2010, the composite is discontinued but must continue to be listed on the firm's list of composites for five years after discontinuation.

Acceptable Uses

Effective 1 January 2010, carve-outs must be managed separately with their own cash (i.e., allocation of cash will no longer be allowed as of 1 January 2010). This change will 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 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 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 are presented as part of a single-asset composite, firms must disclose the cash allocation method that was used for periods prior to 1 January 2010. It is recommended that firms disclose any change in the cash allocation methods.

In addition, Provision 5.A.5 requires that 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.

Effective Date

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.

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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.

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