

WRAP FEE COMPOSITES: INDUSTRY CONSIDERATIONS IN LIGHT OF THE NEW CFA INSTITUTE GUIDELINES

By Prima Capital Holding, Inc.

In light of the CFA Institute's recent "Provisions and Guidance" document on wrap fee composites, Prima Capital has taken a look at the issues involved, noting our impressions on the importance of having compliant composites, and the direction, in general, of the industry.

Introduction

To present investment performance, money managers compile an aggregation of portfolios, referred to as composites, to represent a similar investment mandate, objective, or strategy. Investors need a fair representation with full disclosures on these composites, so they can accurately compare various managers. The types and sizes of accounts included, and the dispersion (or difference between the best performing and worst performing portfolios in a composite), are among many factors that must be considered in properly evaluating a composite's significance to an investor.

No formal industry-wide standard on composite construction was available until 1991, when the CFA Institute (formerly the Association for Investment Management & Research or "AIMR") established the Performance Presentation Standards (AIMR-PPS). In 1999, the CFA Institute introduced the Global Investment Performance Standards ("GIPS" or "Standards") to address the need for a single, globally accepted set of performance standards, so managers, worldwide, could be evaluated on an equal basis. The CFA Institute is merging the AIMR-PPS, which have been used in the U.S., into GIPS by January 1, 2006, so there will be one set of standards.

Compliance with the Standards is important to investors, advisors, and consultants, because the quality or integrity of the data is the basis for evaluating performance. Without relevant, verifiable data, all the tables, graphs, and charts that accompany performance presentations would be questionable. By striving to meet the Standards, a manager provides clients with greater confidence in the performance presented and in the manager's general practices. In addition, compliance indicates a commitment to best practices and an industry norm. When a firm does not have compliance, the "Why not?" question will inevitably arise.

The Issue

While performance presentation has been relatively straightforward for transaction-based or direct accounts in which the manager's fee, trading expenses and administrative expenses are known by the manager with certainty, there have been problems in compiling composites for wrap fee/SMA ("wrap") programs.

Wrap programs are different than traditional brokerage or investment management relationships, as the manager typically has no involvement in, or knowledge of, the total fee that is charged by the program sponsor to the client. Since GIPS require that trading expenses be deducted from performance, managers are required to separate this expense from the other expenses (e.g., custodial fees, reporting fees) that are included in the wrap fee. The manager will usually be unable to do this without the cooperation of the sponsor. In addition, the sponsor serves as the intermediary between the manager and the client, creating a communication problem. Although it is the manager who must maintain records to support the performance presented to satisfy the requirements of the Standards, it is typically the sponsor who maintains the underlying portfolio records to which the manager may not have access. Without information on the various fees and access to records, many managers have found it difficult to comply with the Standards. This situation has resulted in managers using composites consisting of their institutional or high-net-worth clients, whose accounts they control, but not their wrap fee business. Performance differences between wrap clients and institutional or high-net-worth (direct) accounts can be fairly substantial due to differences in cash flows, trading, and even holdings. The net effect has been inadequate performance reporting for wrap clients.

The Solution

To address the problem, the CFA Centre for Financial Market Integrity (the thought-leadership and policy-setting arm of the CFA Institute that is charged with administering the Standards globally) underwent a lengthy process and held two public comment periods before designing the "Wrap Fee/SMA Managed Account Provisions and Guidance for GIPS Standards." These new guidelines were adopted on August 10, 2005 and will go into effect on January 1, 2006.

The biggest takeaway from the "Provisions and Guidance" document is that firms can separate their non-wrap or institutional accounts from their wrap accounts by defining each as a separate business. This was not viewed by the CFA Institute as a change, but rather a clarification of the original GIPS that provided several options for defining a firm, but did not specifically address these two types. Some managers have hailed this as a means of isolating their institutional business, where compliance with the Standards is considered a requirement, from their wrap business, which is viewed as less reliant on compliance, although this may change in the future. The implication is that firms could maintain compliance for their institutional business without needing to bring their wrap business into compliance.

Two Options

Regardless of how a firm is defined, the CFA Institute has provided two options for helping to bring wrap portfolios into compliance for periods beginning January 1, 2006 (although managers are not required to gather historical performance data prior to this date, they are encouraged to apply the ‘guidance’ to all periods as well):

1. Utilize “shadow accounting” in which managers maintain duplicate records of portfolios overseen by the sponsor, so the manager is able to determine beginning and ending reporting period values and cash flows. This method is obviously preferable to everyone in that it ensures a complete set of records under their management. “Shadow accounting” is being used by many of the larger management firms, which can fund the considerable expense (estimated at \$10 to \$12 per account by one manager) for the necessary technology and personnel or outsource the task to third-party vendors. However, for most mid-sized and smaller managers, “shadowing” is viewed as too great an expense for a lower-margin part of their business, leaving the second option as the most likely for them.
2. Rely on the sponsor to provide the “aggregate level” performance (i.e., viewing all portfolios as one) or performance at the underlying “portfolio level.” Both require the manager “to take the necessary steps to satisfy that the information provided . . . can be relied on to meet the requirements of the Standards.” The CFA Institute is vague on the “necessary steps” to ensure validity of the data, but “the CFA Centre stands ready to help firms through this transition,” according to a CFA news release. Firms can contact the GIPS Help Desk via GIPS@cfainstitute.org.

The difference between “aggregate” and “portfolio level” relates to how the sponsor provides information to the manager (e.g., some provide only aggregate information); however, it would seem that “portfolio level” would be preferable when possible, as this would ensure more detailed information. In addition, dispersion at the “portfolio level” is more meaningful, as discussed later. If the manager seeks Performance Examination (formerly Level II) compliance, the wrap fee accounts are subject to the same level of testing as all of the portfolios with the firm, meaning that the firm must maintain as complete records as they do for their direct accounts. The ramification of this is that unless the manager has a high-level of cooperation with each sponsor (an optimistic assumption), Performance Examination-level compliance will be unlikely.

The challenges that managers and sponsors face include integrating different software systems (i.e., some sponsors use proprietary systems, rather than the industry standard, Security APL), overcoming the inflexibility in software for customized reporting and ensuring that the calculation methodologies are the same, all of which consume time and cost money.

There is also some vagueness in terms of a situation in which, for example, a manager has 45 sponsors, but only has satisfactory supporting records for 44 sponsors. The manager may not exclude the one program sponsor for which it does not have the information. The firm is told to focus on the records from that one sponsor “that are available” and make an assessment of reliability. “Acknowledging that the level of detail may not be ideally what the firm would like to have, the firm may be able to determine that the minimal records available are enough to satisfy the firm’s recordkeeping requirements,” the guidelines state. That statement is clearly too vague for managers to put into practice, which the CFA Institute needs to address. In addition, there is the implication that if that “one” sponsor has sizable assets, it is quite likely that a manager would forego compliance to keep that sponsor. This is an example of how the Standards will likely have to evolve over time to address implementation issues.

Other Changes

Another issue concerns the composite dispersion measure if firms choose to rely on and report “aggregate” information from the sponsor. Under the GIPS guidelines, one program may constitute a single portfolio. Therefore, if there are five programs in a composite, the dispersion calculation would be for the five “accounts,” not the thousands of individual accounts that may underlie each. Such a measure would be considerably less relevant to clients in evaluating a composite’s performance record and would make a sponsor-specific composite a necessity for proper evaluation of dispersion. Clearly, the dispersion calculation on portfolio-level returns would be preferable. Other than dispersion, a style-based composite that includes portfolios from all sponsors would be most desirable, as this would facilitate the comparability of results and prevent firms from cherry-picking their best performing portfolios for presentation, a key aim of the Standards.

Other provisions and guidelines include: disclosing each year as not having any wrap accounts when linking to non-wrap performance; using the highest total wrap fee when reducing non-wrap fee performance; using net-of-fee performance when presenting to prospects; and, using either net or gross-of-fee performance when presenting to an existing sponsor.

The Consequences

Managers who fail to bring their wrap accounts into compliance could place themselves at a competitive disadvantage, as the Standards become better known in the wrap market, which we feel they inevitably will. It took less than 10 years from the time that the AIMR-PPS were introduced, for these standards to become the required “stamp of approval” in the institutional world; it will likely take less time for a similar level of “authentication” in the wrap market, as scrutiny in the money management business, in general, has intensified due to the mutual fund trading scandals. In addition, those firms that do achieve wrap compliance will be demonstrating a strong commitment to remaining in the wrap market.

There are also operational benefits to compliance. Documented processes and procedures are required that would result in strong internal controls, and regular reviews of performance returns can be used to identify and adjust outliers.

For firms that do decide to define their institutional and wrap businesses separately, the managed assets have to be split as well, meaning that “other” assets can only be listed as supplemental information. This would be a significant detriment to many managers, as many consultants use assets under management as a key screening factor (i.e., the larger the managed asset base, the more likely a product will be included in a search).

Conclusion

Overall, the “Provisions and Guidance” are a step in, hopefully, encouraging more managers to seek compliance for their wrap accounts. However, for many managers and sponsors, there will be a need for more cooperation, in terms of accessing data and detailing wrap fees, for compliance to become a standard as it is now for institutional clients. There may also be a need to share more of the costs between sponsors and managers, whether directly, by installing compatible software and necessary processes, or indirectly, through the negotiation of fees.

For investors and consultants, this period of bringing wrap composites into compliance is likely to be murky. We do not expect a sudden rush of managers to begin seeking compliance, so there will likely be a transition period in which managers and sponsors try to determine the best way to proceed. There are also some implementation issues that the CFA Institute needs to address, such as, the one out of 45 sponsors, cited in the example above, who does not supply the necessary information.

The short-term result will be that some firms will continue to use institutional composites to represent wrap performance, some will progress toward wrap compliance, and others will begin wrap compliance in 2006. Leeway will be necessary in evaluating how managers are progressing down the compliance path. Consultants will likely have to ask for and evaluate non-compliant wrap composites, which are not presented for performance in lieu of institutional composites. In addition, they will have to assess if managers are pursuing compliance and how they are progressing. Longer term, though, we feel that wrap compliance will become the industry norm that the CFA Institute intends and will likely become a key issue in manager searches, as it is now for institutional clients.

Ensuring the integrity of performance data, exhibiting industry best practices, and demonstrating a commitment to wrap clients, are all factors that make compliance with the Standards worth the time and expense.

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