Investment Reporting – Need for Global Standardization

Working Paper - Number: 25

2009

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in CFA Institute – Investment Performance Measurement Newsletter;

August 2009.

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Version as of 06.07.2009

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Background

As a special case of client reporting, investment reporting can generally be defined as an illustration of the investments made in the portfolio, the results achieved and the risks taken. The financial crisis and recent fraud cases have made it clear that it is now the right time to discuss the need and the value for guidance or even a standard for the investment reporting to asset management clients. What has changed?

The credit crunch and the financial crisis had and still do have extreme implications on the investment reporting: both on its content and on the underlying data and methodology. Suddenly clients ask for more transparency where the data and prices are coming from, how the valuations come about, how and with what methodology the numbers are calculated, whether the risks are appropriately addressed and presented, whether the benchmark presented is appropriate to the underlying portfolio, whether the returns are gross or net of fees, how the effect of leverage is handled and so forth. Everybody who is familiar with the GIPS Standards will surely notice the link between these questions and the questions addressed by the GIPS Standards.

Back in 2006 the former European Investment Performance Committee (EIPC, now renamed as Regional Investment Performance Subcommittee EMEA) issued the Guidance for Recipients of Investment Reporting.[1] The objective of this working paper is to address the transparency needs of asset management clients by providing clients with a questionnaire on investment reporting to be answered by the asset management companies. This specific guidance helps to draw the asset management client's attention to the relevant components of investment reporting and to provide them with a list of possible questions to consider regarding investment reporting. Similar to the GIPS Standards, the former EIPC considered it crucial that investment reporting is provided in a way that does not mislead the clients and contains all necessary details to explain the underlying assumptions and concepts – to enable the client to better understand where the historical returns and risks came from.

Need for an investment reporting standard

Eliminating the lack of transparency

Currently there is no global industry standard or guidance addressing the transparency issue with the investment reporting to asset management clients, except for the hedge fund industry where certain self-regulation has been recently issued in this respect (see www.hedgefundmatrix.com). The GIPS Standards may be seen as such a standard as addressing lot of transparency issues with respect to performance measurement and presentation. But considering the objectives of the GIPS Standards one notices that this industry practice addresses "only" the transparency issues for a prospective client's point of view. Now, what about when a prospective client becomes a so-called existing client, currently we observe the same situation as we had years ago where we did not have the GIPS Standards or the preceding performance presentation standards like the AIMR-PPS: Lack of transparency and standardization – but now in the area of investment reporting to existing clients. Various examples of inadequate investment reporting have been uncovered as a result of the financial crisis, e.g. unvalued holdings, inappropriate pricing, lack of disclosure of counterparty risks, not presenting the effective exposure of leveraged instruments, etc. This gap in the area of industry practices needs to be closed.

Putting the client perspective in the focus

On the technical side, we observe a very frequent situation when the reporting is produced and presented from an asset manager's and not from a client's perspective, e.g. presenting only time-weighted return reflecting the asset manager's performance, but not presenting the money-weighted return which reflects as well the impact of the client-driven capital flow decisions. The fact that investment reporting often only reflects the asset manager's perspective raises a question whether such investment reporting really meets all clients' expectations. As this is of course a rhetorical question the adjacent questions are: Who fills the gap and who provides the clients with an investment reporting covering their perspective? Closing this gap is one of the biggest challenges for the investment reporting industry in the years to come.

Addressing complex technical issues

Investment reporting increasingly becomes a differentiation factor if not a crucial factor for asset managers in terms of client service. Investment reporting has to deal with more complex securities and instruments, such as structured products, derivatives and multi-layered products, and is therefore itself becoming more and more complex. This increasing complexity is the reason why a global standardization and guidance in the area of investment reporting is not only sought-after and welcomed by asset management clients but also as well more often by asset management companies.

Educating investment managers and clients

The quality of investment reporting differs significantly among asset management companies and in addition there is a need for further education and training with respect to the investment reporting in general (structure, contents) and its components in particular (e.g. performance and risk measurement and analysis). On the other hand, there is often a lack of understanding of many important technical reporting concepts by clients which often lead to huge expectations which currently can not be met by the asset management companies. Exemplary, an investment reporting survey conducted by PricewaterhouseCoopers in Switzerland identified the following two major problems: (1) a poor knowledge of investment reporting matters, on one side and (2) individual reporting demands and wishes of clients, on the other side. Standardization and guidance for sure will help to educate both clients and asset managers in the investment reporting matters.

Anticipating future regulations

Regulatory authorities are already thinking about regulating the investment reporting. For example, in the EU the MIFID directive has already provided regulation of some aspects of the reporting and communication towards asset management clients. It is now up to the asset management industry itself to anticipate this trend towards regulation and to come up with self-regulation or industry best practices in the area of investment reporting.

Relation to the GIPS Standards

The above mentioned issues and challenges made it evident that a global standardization and guidance for investment reporting is needed and that a respective industry standard should be developed. Considering the well established GIPS Standards it is obvious that such an investment reporting standard should be based on the same principles as the GIPS Standards: global self-regulation, transparency, consistency and disclosure.

Framework of a global investment reporting standard

A global investment reporting standard may have the following structural features:

- it should be based on the following guiding principles:
    - adherence to ethical standards,
    - reporting philosophy should be identifiable and transparent,
    - reporting should take into account the type of client,
    - reporting should present a true and fair picture,
    - reporting should be timely and accurate,
    - reporting should take into consideration all applicable legal requirements.
- it should be a principle-based “best practice” guidance which should reflect and embed the already existing best practices in the asset management industry. The compliance with the investment reporting provisions would ensure that asset management clients are protected from not transparent and misleading investment reporting.
- it should be a global self-regulation standard similar to the GIPS Standards.
- it should mainly address transparency, fair presentation and disclosure. Comparability may not necessarily be an objective as the design and the content of investment reporting are proprietary to the asset management companies as long as it follows the ethical principle of fair presentation of the investment portfolio.
- it should take into account the existing statutory regulations (e.g. in Europe: MIFID, UCITS, etc.) and self-regulations in the investment reporting area (e.g. the EIPC/RIPS EMEA reporting guidance papers).
- it should be relevant for both institutional and private asset management clients.

To develop such an industry standard and to promote its global acceptance, significant resources, technical knowledge and experience as well as heavy coordination and promotion activities will be necessary. Therefore the global investment reporting standard should be developed by a well established global industry self-regulatory body, such as the CFA Institute. In particular, CFA Institute could set up a dedicated working group on the global investment reporting standard. This working group should not work under the umbrella of the GIPS Standards as investment reporting to existing clients does not fit with the performance presentation to prospective clients, however, should benefit from the huge experience generated within the CFA Institute from the development and promotion of the GIPS Standards.

In terms of the next steps, this working group could start with the following activities:

- surveying market players (both asset managers and clients) to identify their specific needs,
- identifying the best practice in the investment reporting area,
- identifying the regulatory requirements and
- defining the minimum requirements and the desired recommendations regarding investment reporting.

We strongly believe that a Global Investment Reporting Standard (GIR Standard) is needed on a global basis not only for the existing clients but also for the asset management companies as asset management and with this investment reporting is becoming more and more complex. Furthermore such an industry best practice would provide a great contribution to the further development of the asset management industry worldwide.

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[1] The Guidance for Recipients of Investment Reporting is available from the authors. Please contact the authors via stefan.illmer@credit-suisse.com or dimitri.senik@ch.pwc.com.