Global Investment Performance Standards (GIPS®)
Guidance Statement on Overlay Strategies
Adopting Release

The Exposure Draft of the Global Investment Performance Standards (GIPS®) Guidance Statement on Overlay Strategies (Exposure Draft) was available for public comment from 29 August 2017 through 27 November 2017. We delayed finalizing and issuing this Guidance Statement until the 2020 edition of the GIPS standards was released because the 2020 edition could, and did, affect the final Guidance Statement. We received comment letters from 30 groups and individuals, 26 of which gave permission to have their comment letters posted. We evaluated and considered every comment, resulting in proposed changes to the Guidance Statement. These proposed changes were then reviewed with, and approved by, the GIPS Standards Technical Committee.

The Exposure Draft and public comments received were taken into account when we drafted the 2020 edition of the GIPS standards, which contains the following provisions specific to overlay strategies:

> 2.A.5 Total firm overlay exposure must include all discretionary and non-discretionary overlay strategy portfolios for which the firm has investment management responsibility.[1]
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> 2.A.6 When calculating overlay exposure, the firm must:[2]
> a. Use the notional exposure of the overlay strategy portfolios, the value of the underlying portfolios being overlaid, or a specified target exposure.
> b. Use the same method for all portfolios within a composite.
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> 2.A.7 When calculating overlay strategy portfolio returns, the firm must:[3]
> a. Use as the denominator the notional exposure of the overlay strategy portfolio, the value of the underlying portfolio being overlaid, or a specified target exposure.
> b. Use the same method for all portfolios within a composite.
>
> 4.A.14 For overlay strategy composites, the firm must present composite overlay exposure as of each annual period end. For those periods for which the firm presents composite overlay exposure, the firm may choose not to present composite assets.[4]
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> 4.A.15 For overlay strategy composites, the firm is not required to present total firm assets and may instead choose to present total firm overlay exposure as of each annual period end.
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> 4.C.45 For overlay strategy composites, the firm must disclose:
> a. The methodology used to calculate composite overlay exposure.
> b. If collateral and collateral income are reflected in the composite returns.

The explanation of the provisions found within the GIPS Standards Handbook for Firms also includes guidance from the Exposure Draft as well as feedback from the public comments received. Although the GIPS Standards Handbook for Firms incorporated some of the guidance, the Guidance Statement on Overlay Strategies contains additional guidance and is a more comprehensive resource for firms managing overlay strategies.

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[1] Required for periods beginning on or after 1 January 2020.
[2] Required for periods beginning on or after 1 January 2020.
[3] Required for periods beginning on or after 1 January 2020.
[4] Required for periods ending on or after 31 December 2020.

This Adopting Release addresses key changes to the concepts included in the Exposure Draft.

1. Geometric and arithmetic linking of returns

The GIPS standards require firms to geometrically link periodic and sub-period returns when calculating time-weighted returns. In the Exposure Draft, we proposed an exception from this requirement, whereby when the exposure remains constant over time, the overlay portfolio's return must not be geometrically linked. Instead, returns must be calculated arithmetically as the cumulative profit/loss for the calculation period divided by the denominator. We also proposed that firms be required to geometrically link returns when a change in exposure occurred. We asked if firms agreed with this approach.

Some comment letters stated that geometrically linking overlay returns is not the correct methodology for overlay portfolios. Non-overlay portfolios generate profits and losses that can be reinvested, which affects the amount of assets that are assumed to be invested in the subsequent period. The profits and losses generated by overlay portfolios, however, are not assumed to be reinvested into the overlay portfolio in the next period because the returns are based on an economic exposure value and not on actual assets. For example, if a firm manages an overlay portfolio with $1,000 exposure and the overlay portfolio has a gain of $100, the $100 gain is not added to the $1,000 exposure amount. In the subsequent period, the exposure amount continues to be $1,000. For this reason, these commenters support arithmetically linking (i.e., summing) overlay returns rather than geometrically linking them.

Other comment letters supported the use of geometric linking. Overlay portfolios do create real profits and losses, which may be reinvested. When geometric linking is used, it assumes that profits and losses are reinvested and earn the overlay portfolio return in the next period. Additionally, most performance systems are built to geometrically link returns.

Because of the unique nature of overlay portfolios, firms are permitted to either geometrically link or arithmetically link overlay portfolio and composite returns. A firm must be consistent with the methodology used to link returns over time at the portfolio and composite levels. Once a firm has chosen whether to arithmetically or geometrically link returns, it must consistently use the methodology selected for each composite. A firm must disclose if it chooses to arithmetically link overlay strategy portfolio or composite returns.

2. Treatment of collateral and collateral income in the return calculation

The Exposure Draft contained proposed requirements to include collateral income in the numerator of the return calculation and the collateral value in the denominator of the return calculation if the management of the collateral is part of the strategy. We asked if this proposed approach was appropriate or if it should be changed to a recommendation. Comment letters generally agreed with requiring collateral and collateral income to be reflected in return calculations when management of the collateral is part of the strategy. Several comment letters, however, noted that determining whether management of the collateral is part of the strategy was not always a straightforward exercise, and that collateral income is often a very small amount.

We decided that collateral income is similar to securities lending income and that we should take a similar approach. The GIPS standards recommend that firms include income from securities lending when securities lending is part of the strategy. We changed the requirement to a recommendation, and firms are recommended to include collateral and collateral income in return calculations when management of the collateral is part of the strategy. The GIPS standards also require firms to disclose if collateral and collateral income are included in composite returns.

3. Treatment of external cash flows

The concept of external cash flows for overlay portfolios does not directly relate to physical cash flows into and out of the overlay portfolio but rather to changes in the overlay exposure (i.e., the notional exposure of the overlay strategy portfolio, the value of the underlying portfolio being overlaid, or a specified target exposure). Client or underlying manager-directed overlay portfolio exposure changes are considered external cash flows. GIPS standards guidance on external cash flows, large cash flows, and significant cash flows applies to overlay portfolios in this context.

The Exposure Draft stated that, similar to non-overlay portfolios, firms may establish a significant cash flow policy and use temporary new account accounts. We determined that temporary new accounts typically would not be appropriate for an overlay portfolio, given that cash flows are changes in the overlay exposure, not actual cash moving into or out of a portfolio. As a result, we removed the language about temporary new accounts from the final Guidance Statement.

4. GIPS Composite Reports

The Exposure Draft proposed several presentation and disclosure items, many of which were incorporated into the 2020 edition of the GIPS standards. The final Guidance Statement includes two new required disclosures:

- The firm must disclose if it chooses to arithmetically link overlay strategy portfolio or composite returns.
- If a firm chooses to apply the Guidance Statement on Overlay Strategies retroactively, it must disclose if any restatement of the historical track record was necessary as a result of the retroactive application.

5. Effective Date

Given the delay in issuing this Guidance Statement, we needed to change the effective date. This Guidance Statement has an effective date of 1 January 2022. We decided that 1 January 2022 was an appropriate effective date because the only new requirements relate to disclosures and no new calculations are required. GIPS Composite Reports that include performance for periods beginning on or after 1 January 2022 must be prepared in accordance with this Guidance Statement. Firms are encouraged, but not required, to apply this Guidance Statement prior to the effective date. This Guidance Statement is not required to be applied retroactively, and no restatement of GIPS-compliant performance is required. Firms may choose to apply this Guidance Statement retroactively and, in this case, must disclose if any restatement of the historical track record was necessary as a result of the retroactive application.