

Suggested Practices: Model, Hypothetical, and Backtested Performance

Many investment firms wish to provide prospective clients with model, hypothetical, or backtested performance results to either enhance actual results or to substitute for actual results when actual results do not exist. While model, hypothetical, or backtested results may not be used as part of GIPS compliant presentations, they may be included as “supplemental information,” as explained in the *Guidance Statement on the Use of Supplemental Information*.

In order to help avoid the presentation or dissemination of possibly misleading information, GIPS Exposure Draft provision 3.A.7 specifically disallows linking model, hypothetical, backtested, or simulated results to actual performance results.

This paper provides suggested practices involving the reporting of model, hypothetical, and backtested performance. Performance results also include statistics based on model, hypothetical, and backtested returns such as standard deviation, drawdown, Sharpe ratio, etc. In all cases, the firm’s legal counsel, compliance staff or internal risk management should be consulted to ensure that all regulatory requirements are met.

Definitions

Model Performance: Investment results of a “model” portfolio where the portfolio does not include any actual assets under management. For the purpose of this paper, “simulated” performance will be included under the definition of “model performance.”

Hypothetical Performance: Results that may have been derived from actual performance but not in the context in which it is being presented. For example, if the performance of actual portfolios in an equity composite are combined with the performance of actual portfolios in a fixed income composite to show what the results *might have been* had they been combined, the results would constitute as hypothetical performance.

Backtested Performance: Performance results created by applying an investment strategy or methodology to historical data. Backtested performance attempts to indicate how a product constructed with the benefit of hindsight would have performed during a certain period in the past if the product had been in existence during such time.

The term “theoretical” will be used to represent all of these types.

Suggested Practices

1. Clearly label all theoretical performance results as such. Labeling can be accomplished by using the word “model”, “hypothetical”, or “backtested” in the title of the exhibit. For example: Backtested Global 130/30 performance.
 - a) Theoretical performance should not be mathematically linked with actual performance in any fashion, including linking performance for an extended period (e.g., a firm has five years of actual results and wants to link the prior five years of backtested results to actual returns in order to provide a 10-year annualized and/or cumulative return). This includes the linking of actual returns with theoretical returns and calling it all “theoretical.” For example: a firm has two years of actual results and eight years of theoretical to make a 10 year track-record. Labeling the entire 10 year track record as theoretical is not advised.
 - b) If actual and theoretical returns are used in the same presentation they should be shown on separate pages and be clearly labeled (e.g., a firm that wishes to display a table that shows five years of theoretical and five years of actual results should show results on separate pages; it is not advisable to show them consecutively in the same column or side by side).
2. A statement that “past performance is not an indication of future results” may suggest that actual performance results are being presented. Disclosures such as “the results do not represent actual results” and “actual results may significantly differ from the theoretical returns being presented” may be more indicative of the nature of the data. The firm’s legal counsel, compliance staff or internal risk management should be consulted for advice on the wording of specific disclosures.
3. Clear disclosure should be provided to ensure that the recipient(s) understands the presentation of theoretical performance. All disclosures should be clear and prominent. *Please refer to the “Recommended Disclosure” section for additional guidance.*
4. Theoretical performance should only be provided to clients, prospects or consultants who are sufficiently experienced and knowledgeable to assess the relevance and limitation of theoretical performance of the financial product.
5. Firms using any theoretical performance results should have sufficient records/documentation to support the calculation of any theoretical performance results.
6. Firms should consult with their legal counsel, compliance staff or internal risk management regarding applicable local or country-specific law or regulation.
7. Firms using any theoretical performance results should have control procedures for presenting theoretical results.

Recommended Disclosures

The following disclosures should be incorporated when theoretical performance results are used:

1. Disclose a basic description of the model, assumptions, inputs, and quantitative parameters necessary to interpret the theoretical performance results. For example:
 - a. “All of the securities used in the model were available during the time period presented.”
 - b. “The model assumes that the markets were sufficiently liquid to permit the types of trading used in the model.”
2. Disclose that the results are theoretical and include a warning that the results are not based on the performance of actual portfolios and that the interpretation of the results should take into consideration the limitations inherent in the results of the model.
3. Disclose if a proprietary model was used to generate the theoretical performance results.
4. Disclose material facts and material differences between any theoretical performance and the benchmark or a similarly managed product to which it is compared.
5. Disclose if theoretical performance has not taken into investment management, account advisory fees, trading costs, or other fees or charges.
6. Disclose that theoretical performance is constructed with the benefit of hindsight, including the ability to adjust the method for selecting securities until returns for the past period are maximized.
7. Disclose material changes to the model, assumptions, or inputs during the period shown and the reasons for such changes.
8. Disclose any actual performance with respect to the portfolios managed during the period under the model strategy (or disclose if materially different).
9. Disclose any assumptions regarding cash balances and external cash flows.
10. Disclose and describe the treatment of reinvestment of dividends, interest, capital gains and withholding taxes.
11. Disclose the possibility of loss.
12. Disclose the dates over which the theoretical performance results are presented and the creation date.

Sample Disclosure for Backtested Performance

Backtested performance is NOT an indicator of future actual results. The results reflect performance of a strategy not [historically] offered to investors and do NOT represent returns that any investor actually attained. Backtested results are calculated by the retroactive application of a model constructed on the basis of historical data and based on assumptions integral to the model which may or may not be testable and are subject to losses.

General assumptions include: XYZ firm would have been able to purchase the securities recommended by the model and the markets were sufficiently liquid to permit all trading. Changes in these assumptions may have a material impact on the backtested returns presented. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representations and warranties are made as to the reasonableness of the assumptions. This information is provided for illustrative purposes only.

Backtested performance is developed with the benefit of hindsight and has inherent limitations. Specifically, backtested results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Since trades have not actually been executed, results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity, and may not reflect the impact that certain economic or market factors may have had on the decision-making process. Further, backtesting allows the security selection methodology to be adjusted until past returns are maximized. Actual performance may differ significantly from backtested performance.

Backtested results are adjusted to reflect the reinvestment of dividends and other income and, except where otherwise indicated, are presented gross-of fees and do not include the effect of backtested transaction costs, management fees, performance fees or expenses, if applicable. *Please note all regulatory considerations regarding the presentation of fees must be taken into account.* No cash balance or cash flow is included in the calculation.