Hypothetical Performance Disclosures: Guidelines and Best Practices

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Hypothetical performance numbers always come with multiple risks attached (we discuss risk guidelines later in the article). First, though, let’s understand what hypothetical performance data means from an advertising and marketing material perspective.

Hypothetical performance data may be derived from actual performance, although not in the same context in which actual performance data is presented. It could be presented in different forms of non-actual performance, as follows:

1. Model performance, which depicts a hypothetical model portfolio created by adding individual securities (stocks and bonds), ETFs and other investment products. The model performance mechanism would have underlying assumptions.

2. Back-tested performance, which relates to testing a particular investment strategy, fund or other investment vehicle for a past period when data was unavailable to demonstrate how it would have performed.

3. Simulated performance, which is virtually the same as back-tested performance and could be ex-post or ex-ante.

4. Ex-post performance, which is non-actual performance that is projected.

5. Ex-ante performance, which is non-actual or actual performance based on past periods. Most investment management firms seek to provide prospective and existing clients with hypothetical or back-tested performance data to simulate actual portfolio performance in marketing/advertising material. This could be due to, but is not limited to, the lack of sufficient actual performance data and could be based on specific client requests.
The SEC periodically publishes cases where investment advisors have violated advertising and marketing rules by not showing hypothetical back-tested performance data in an appropriate manner; such cases also violate SEC regulations. A prime objective of the publication of the SEC’s regulations is to help investment management firms understand and determine the potential risks inherent in the hypothetical performance data they provide to their respective clients.

The following are some risk guidelines gleaned from SEC regulations:

- Hypothetical performance data must be identified and mentioned clearly and correctly along with the hypothetical time period used.
- The material must also provide (in the appendix) a description of the construction of the hypothetical portfolio and methodology.
- The algorithm used to obtain hypothetical performance data must collate the correct performance numbers. Failure to obtain backup data supporting performance claims could be a nightmare for an investment management firm.
- The SEC could come down hard on a firm if the hypothetical time periods or data used is cherry-picked.
- Investment managers who intend to provide their clients with hypothetical/back-tested performance data should ascertain any deviation of such data from live data. A higher deviation could result in the SEC imposing a fine.
- The use of hypothetical performance data when actual data is available for the particular period may also result in a penalty, unless a prospective client specifically requests live data with hypothetical changes in allocation.

Many investment experts believe that an investment management firm should avoid using back-tested performance data; however, SEC rules do not specifically prohibit portfolio managers from using hypothetical/back-tested performance numbers in client presentations.

Please refer to FINRA rule 206(4)-1 available on the SEC’s official website, for a detailed explanation of all advertising and marketing rules that must be followed by FINRA-registered investment management firms.

Many small/mid-sized asset management firms use third-party compliance services. Outsourcing compliance functions to a third party could also prove to be cost-effective for them.
Acuity Knowledge Partners is an influential player in the global market, providing compliance expertise and a wide scope of other services. We have a pool of talented staff experienced in marketing compliance and able to identify risks inherent in marketing material, including risks relating to hypothetical performance data.

Sources:

https://cipperman.com/

https://www.gipsstandards.org

https://www.compliancebuilding.com

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