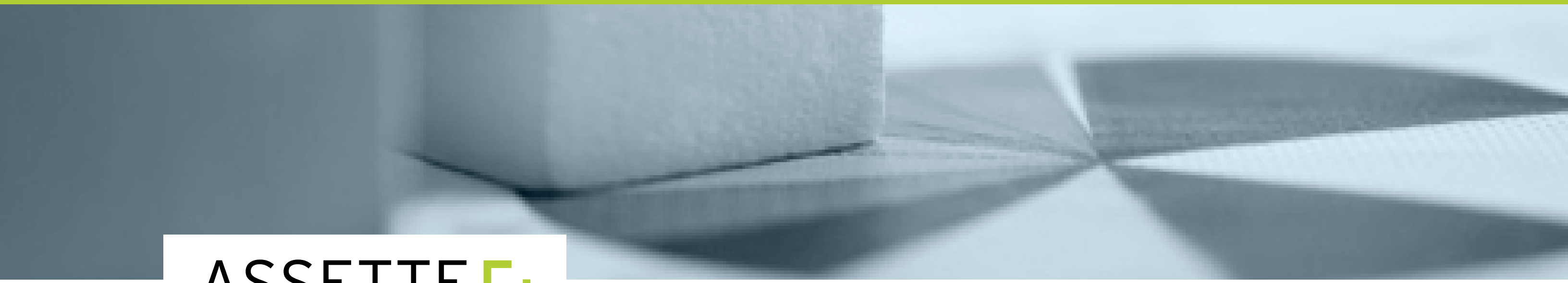

ASSETTE

Shining a Light on the "Last Mile" at Investment Management Firms

An under-the-hood look at the hidden risks inherent in investment results presented in manager marketing and client presentations—and what asset owners can do about them

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As a fiduciary, you rely on investment results provided by managers to make almost every important decision regarding the assets under your stewardship. Portfolio performance and attribution data play a big role in helping you vet potential investment managers, make hiring and termination decisions, and reallocate assets across managers.

You ask a lot of questions about performance calculations during the RFP/RFI/due diligence process. Managers are usually very thorough about answering them, and you are vigilant about asking for detailed descriptions of methodologies and exceptions. During the bidding process, you access performance data through marketing materials provided directly from the management firm or indirectly through data the manager has provided to a consultant's database.

Once you've hired a manager, ongoing portfolio performance and attribution information come in the form of the manager's monthly and quarterly investment performance reports. Many consultants also augment this information with their own manager performance and attribution analyses.

But all these questions tend to focus on how the numbers are produced in a manager's systems, not how they are imported into the marketing and client materials you base your decisions on. If there's a failure in that last step — what we refer to as the "last mile"— then it doesn't matter how rigorous their performance calculation and attribution process is. You'll still be looking at incorrect data.

Considering how important this data is to your fund, your organization, the beneficiaries of your asset pool — and your career — it's rather amazing how little time and attention the industry expends on understanding just how those numbers get into those presentations and reports.

The purpose of this paper is to help you understand the types of risks inherent in the last mile — and the risks you run by taking the investment results presented by your managers at face value. We also offer ways you can address these risks when conducting manager due diligence.

A Bit of History

Over the last couple of decades, investment managers have automated most aspects of their operations: trading, security prices, index information, performance measurement calculations and portfolio attribution data. Unfortunately, most of this automation has been done in silos, meaning each data set has its own supporting system, but those systems don't necessarily always "talk" to one another. As a result, managers need to bring those separate data elements together so they can be included in marketing materials and client reports.

To do that, most managers still rely on a hodgepodge of manual and quasi-automated processes. Spreadsheets are widely used to take specific values from their source and import them into presentation and report templates. Sometimes the manager relies on manually typing the right numbers into the right places. Either way, people must perform these tasks, and as we all know, people can make mistakes.

To Err is Human

Anytime there are human touch points involved in calculating, combining or updating investment results, there is room for error. Using a layer of spreadsheets to house underlying data and then linking presentations to the spreadsheets may seem like a perfectly reasonable automated solution at the outset, but over time these processes tend to fall apart. Spreadsheets and presentations are constantly changing in response to evolving communication needs, and a broken link or wrong cell reference in a formula is more likely to go undetected than a manual error due to the false sense of security quasi-automation provides.

Multiply this by the sheer volume of inputs that go into a manager database, not to mention the investment manager's own marketing presentations and client reports, and the risk exposure rises. Data like assets under management (AUM) by fund type and investment mandate are usually calculated using spreadsheets. And qualitative information from portfolio managers — what stocks they bought last quarter and why, for example — is almost always woven into final output by hand.

Without rigorous quality control procedures in place, it's easy to see how incorrect or outdated information can slip into a sales presentation — and into your manager selection and monitoring decisions.

Last Mile Problems Put Asset Owners at Risk

Operational Risk Exposure

In a speech delivered in December 2014, SEC Chairperson Mary Jo White said, "... by 'operational risk,' I generally mean risk from inadequate or failed internal processes and systems." Operational risk includes all errors that can occur in the normal course of doing business, be it setting up new accounts, trading securities, reconciling data, producing client reports or generating information for sales purposes. Managers who use manual or quasi-automated processes in the last mile are potentially exposing themselves to this type of risk.

Here are some examples of common performance-related bloopers that can occur:

- **Copying return numbers into the wrong return period column.**
  It doesn't take much to copy a 3–year composite return number from a spreadsheet into the 5–year return column in a marketing presentation or manager database. This common type of cut-and-paste error is easy to make and hard to spot during a presentation.

- **Failing to include required regulatory disclosures in sales materials.**
  While this can — and does — happen to all types of investment management firms, those claiming Global Investment Performance Standards (GIPS) compliance are doubly vulnerable. When it comes to GIPS errors, the offending firm can be required to redistribute the corrected Compliant Presentation (CP) slide to prospective clients who received the original.

  Trust us when we say that no asset owner wants to have to redistribute corrected GIPS information to their trustees, boards or committees after the manager has been vetted by you and/or your consultant!

- **Using an existing marketing pitch book as the template for a different strategy presentation.**
  Manager's often take a compliance-approved presentation or pitch book for one type of mandate and use it as the template for another strategy. Let's say the manager uses their Small-Cap Core pitch book as the template for a Small-Cap Growth presentation. It's easy to copy-and-paste Small-Cap Growth returns into the existing document but forget to change the benchmark name — and/or data — from the original Russell 2000 Index to the correct Russell 2000 Growth Index. The result can distort returns relative to the (wrong) benchmark.

In addition to the risk of making fund decisions based on these types of mistakes, a series of such mistakes could signal broader issues with the firm and its operations. Consultants and investors need to be vigilant in their due diligence of managers' entire operational processes, including the last mile.

Regulatory Risk Exposure

Regulators are becoming more aggressive about protecting investors — and the funds they oversee — from managers who misrepresent investment results and/or fail to disclose errors to affected parties. Needless to say, regulators pay attention to managers' marketing materials during reviews and examinations, since they play such an important role in investment decisions.

While most investment managers act in good faith and most marketing materials are carefully vetted, human errors can creep into these materials, inviting regulatory sanctions. If you're in the process of considering a sanctioned manager for a new mandate, your investment guidelines might call for dropping them from the list of potential candidates. Even if they don't, you'll likely think twice about continuing to put them forth. In fact, many consulting firms will put a manager on "hold" from consideration until the issue is resolved, or even drop them from their recommended list if the offense was severe enough.

Things get more complicated if the firm is already managing fund assets. Depending on the severity of the sanctioned action, you might need to withhold additional contributions for a time or, in the worst case, terminate the manager. Either way, a manager's regulatory missteps can have real financial consequences for your fund in the form of opportunity costs, transaction costs, and the time and expense of finding a replacement manager for the affected asset strategy.

Given the intense regulatory focus on manager marketing materials, investors and consultants need to be especially vigilant in their due diligence to understand exactly how potential and current asset managers handle that last mile.

Reputational Risk Exposure

As a fiduciary, you are responsible for finding and monitoring managers for your fund. When managers make mistakes in their marketing presentations, be they unintentional, harmless or costly, it hurts their reputation. Association with that manager can also tarnish the reputation of your organization and your fund.

If the error is serious enough, it can trigger disclosure requirements, necessitating costly and embarrassing communication to stakeholders, grantors, trustees, participants and/or their beneficiaries. And, let's face it, even if the error is minor and doesn't cause a material loss to the fund or plan, you will likely have some egg on your face as a result of the incident. No one wants that.

Avoiding Last Mile Problems

So, in the face of all the potential risks, what are asset owners and consultants to do about shining a light on a manager’s last mile process?

You should always ask prospective managers how they treat the last mile. That means including specific questions about the last mile in the request for proposal (RFP) process and following up for more detail during subsequent due diligence meetings. Be sure you are aware of, and prepared to investigate, the operational processes a manager uses to import investment data and other information from source systems into their marketing presentations.

Here are some examples of the types of questions you should be asking:

1. Please describe the people, processes and infrastructure in place to support the production and communication of investment results at your firm. In such description please describe the risk controls, including compliance policies and procedures, in place to verify the accuracy of the reported information.

2. Please describe the processes used to calculate investment performance and portfolio attribution data for this product. Include systems used.

    a) Does your firm employ any additional manual or desktop technologies in your performance measurement calculations? If so, please describe. (For example, if a portfolio accounting system is used to calculate performance, but GIPS statistics are calculated in spreadsheet form by importing performance data from the accounting system, the spreadsheet-GIPS process would be considered use of an “additional technology”.)

    b) Please describe the quality assurance review process to verify accuracy of calculated data.

3. Does portfolio performance and attribution data flow directly into client reports and marketing presentations through a fully automated source-system-to-output process?

    a) If the answer to #3, above, is “no,” please answer the following:

        - Describe steps taken to include portfolio performance and attribution data in client reports and marketing material.

        - Describe the quality assurance review processes to verify accuracy of data presented.

    b) If the answer to #3, above, is “yes,” please answer the following:

        - Describe the automated process you use. Was it developed in-house? A purchased and install on-premises application? A cloud-based software service?

            - If you developed an in-house system or purchased an on-premises application, describe personnel, policies and procedures in place to monitor and protect the system from cyberthreats.

            - If you use a cloud-based software service or in-house developed/purchased software is hosted for you by a third party, describe the vendor’s personnel, policies and procedures in place to monitor and protect the system from cyberthreats.

        - Describe your policies and processes for verifying accuracy of automated output.

4. Has your firm been required to re-state investment results for any investment product presented to prospective client or existing clients over the past 5 years?

    a) If so, explain the reasons for such re-stating. Provide specifics such as whether the calculations were wrong, whether the reports provided to investors had errors (even though the calculations were correct) or both, and what corrective action was taken to prevent future similar occurrences.

5. Has any regulatory body issued a deficiency notice or other notice to you with respect to misstatement of investment results in advertising, marketing or client reporting materials for any investment product?

    a) If yes, please describe the circumstances that resulted in the notice, and explain the reasons for deficiency notice.

    b) If yes, was the deficiency corrected per satisfaction of the regulatory body?

    c) If yes, describe the steps taken to correct the deficiency and what corrective action was taken to prevent such deficiencies from arising in the future? Explain steps such as altering processes, building in reviews and checklists or use of information technology.

For existing managers, consider including how they treat the "last mile” in your next quarterly or annual review process. Consultants may want to include similar questions in their manager database questionnaires and follow up in more detail during manager due diligence meetings, especially with those managers who have been retained by multiple clients.

Summing Up

You rely on the investment results managers present in their marketing and client materials to help you make critical investment decisions. Failure to understand how managers navigate the "last mile” to get portfolio performance and attribution data into their marketing presentations and client reports can expose you — and the funds under your stewardship — to serious and costly risks. It’s time to shine a light on this often-neglected area of manager due diligence and start asking investment managers how their firm addresses the last-mile problem and what steps they take to reduce the operational and regulatory risks inherent in most current processes.

If you rely on outside consultants to conduct operational due diligence on your behalf, make sure your consultants have the experience and resources to do the work and are asking the right questions. Remember, you can outsource work but never responsibility and fiduciary duty.

About Richard Kerr

Richard Kerr is a partner in the firm's Boston office, where he is a member of the Investment Management, Hedge Funds and Alternative Investment practice group. Mr. Kerr focuses his practice on counseling financial institutions on corporate, regulatory, and transactional matters. Mr. Kerr has experience advising investment companies, investment advisers, broker-dealers, banks, and other financial institutions on a broad range of corporate, regulatory, and transactional matters, including: formation and registration of investment companies, investment advisers and broker-dealers; reorganization transactions; mergers and acquisitions; public and private offerings of debt and equity securities; de novo bank chartering; holding company formations; and new product offerings. He has extensive experience representing financial institutions before federal and state securities and banking regulators, and self regulatory organizations (including FINRA and NSCC) in connection with such matters. In addition, Mr. Kerr has extensive experience advising financial institutions with respect to: development of their compliance programs; and marketing and advertising related matters. Mr. Kerr also has significant boardroom experience, including representation of the independent directors of registered investment companies and the Boards of Directors of banking clients.

About Peter Mixon

Mr. Mixon has a broad practice focused on institutional investors (including public pension plans) and public entities. As a member of the firm's institutional investor group, he concentrates on trust law in the context of investment strategies, regulatory investigations, municipal insolvencies, and complex litigation. His practice includes crisis management for both public and private entities. Mr. Mixon also has extensive experience advising public boards and committees on governance and fiduciary issues.

Mr. Mixon began his career in private practice in 1985, representing public and private entities in business and constitutional litigation.

Prior to joining K&L Gates, Mr. Mixon served as General Counsel for the California Public Employees' Retirement System for eleven years. As in-house counsel, Mr. Mixon provided counsel to the Board and Chief Executive Officer on all aspects of operations, strategy, and governance.

[1] "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry." Mary Jo White, Chair. U.S. Securities & Exchange Commission. Speech delivered at The New York Times DealBook Opportunities for Tomorrow Conference. One World Trade Center, New York, N.Y. Dec. 11, 2014. http://www.sec.gov/News/Speech/Detail/Speech/1370543677722