

By Joseph Morgart
Senior Vice-President
Alternative Strategies
Pyramis Global Advisors

SECOND QUARTER 2009

Operational Risk Assessment Is Key to Effective Manager Evaluation

Control of investment risk is obviously an essential issue when conducting due diligence on an alternative asset manager. But operational risk – the quality of the related risk management infrastructure and controls – is also crucially important.

Institutional investors are well aware that in selecting a new money manager, they must thoroughly investigate the systems that organization has in place to manage investment risks. Strong communication and transparency across functional areas can deliver a solid value-add for clients (see Exhibit 1). Increasingly, however, fund governance issues are becoming paramount. A March 2008 survey by PricewaterhouseCoopers (PWC) found the most common reason investors dismiss a manager of alternative assets was dissatisfaction with the quality of the manager’s compliance and risk management controls. The second most common reason was poor transparency – the failure to provide clear information about the manager’s investing and business operations. The manager’s actual performance ranked third among the most common reasons a manager was dismissed.¹

This white paper, based on information from investors, consultants and asset managers, as well as guidelines developed by industry overseers and associations, reviews practices aimed at protecting investors’ interests in the following areas:

- **operational infrastructure** – how investor interests are protected across the entire range of an organization’s activities
- **transparency and reporting** – how key tasks are accomplished and investors are informed
- **administration and compliance** – a firm’s structural integrity

In the following pages, we will outline specific points to investigate as part of a due diligence process. It is important

Exhibit 1: Strong communication and transparency across functional areas can deliver a strong value-add for clients.



For illustrative purposes only. Source: Pyramis Global Advisors.

¹ "Transparency versus returns: The institutional view of alternative assets," PricewaterhouseCoopers, March 2008.

to remember, however, that in all of these areas an organization's history can also provide significant clues. How long has the firm been in business? What is its reputation? What is its track record regarding compliance with governance regulations? Answers to these key questions should provide some understanding of a firm's culture when it comes to operational risk management. If a firm has adhered to and established a heritage of integrity, it is more likely to protect its hard-earned reputation. At the same time, the admonition "past performance is no guarantee of future results" applies just as much to a firm's operational infrastructure and risk control as it does to the firm's investments. Investors must be thorough in their investigation of how an asset manager operates today and continue to monitor how well that manager sticks to its standards.

1. Operations – The foundation

An asset manager's administrative operations can include everything from how the firm was established to how it receives investors' assets, how it accounts for and reports on those investments and how it processes redemption requests.

The people: Investors are taking more time to understand who founded a firm and who now operates it. This includes reviewing the background of key personnel with direct ownership interests, as well as other firms and individuals who may have financial or other indirect ownership roles. Investors should ensure that asset managers' interests and motivations are fully aligned with theirs.

Questions to ask might include the following:

- What registrations with regulatory authorities do principals and others at the firm maintain?
- What interactions with regulators have occurred in the past, and have any regulatory inspections been completed?
- Is a board of oversight in place, composed of internal and external members?
- Has the board defined clear-cut responsibilities for structuring and executing its responsibilities to monitor the firm's activities?

Good governance depends on sturdy, well-structured oversight. Exhibit 2 shows a typical division of responsibilities for board and management that allows a manager to maintain strong internal controls.

Examining administrative features can help investors better understand whether a firm has created a culture of integrity as part of its development. To augment their reviews, investors should check with other investors and seek third-party references from those who have completed their own due diligence.

The policies: Investment policies associated with an investment strategy can have operational risk implications for investors.

For example, managers should consider the asset level at which the strategy would be closed to new investors to ensure the effectiveness of the strategy.

Other policy questions could include the following:

- Has the management firm developed, and has the board of overseers vetted and approved, policies that seek to avoid federal securities law violations, including side-by-side trading among portfolios managed at the firm?
- Are steps in place for identifying, addressing, managing and resolving conflicts of interest?
- What counterparty risk management procedures are in place?
- How are counterparties evaluated initially, approved, and monitored on an ongoing basis?
- Are policies in place for trade allocation and best execution, and are they regularly evaluated by the firm?
- Is there ongoing guidance and training for personnel in the areas of adherence to federal and state regulatory requirements, fiduciary responsibility, personal trading, entertainment and gifts, and fraud?

Managers should have clearly stated policies and programs to ensure the highest levels of understanding and behaviour among their associates. Investors should examine and discuss these areas with

Exhibit 2: Governance: individual committees responsible for segregated functions and escalation processes provide the structure for internal controls.



For illustrative purposes only. Source: Pyramis Global Advisors.

the manager. In addition, they should ask if these programs are vetted and audited by internal or external parties, or both.

The practices: Investors should also engage a manager in a discussion of policies that could, potentially, disadvantage them. These could include “most favored nation” arrangements, side letters or side pockets that amend terms for individual investors.

Investors should also understand a manager’s approach to establishing gates, lock-ups and other redemption policies. Liquidity became a significant concern among many alternative asset investors during 2008, after declining asset values forced some managers to restrict or suspend withdrawals for periods of time. A survey by Deutsche Bank Securities, Inc., in May 2008, found nearly half of investors require quarterly liquidity after a lock-up expires, and 20% require monthly liquidity. The same survey found that investors in Asia and Europe are three times more likely than those in the Americas to require monthly liquidity.²

2. Transparency and reporting – the client connection

Performance emerges as the number-one criterion for manager selection in several investor surveys, including PwC’s March 2008 survey of alternatives investors. However, risk management, transparency and quality of reporting were cited as the most important considerations after performance.

Information: Deutsche Bank’s survey respondents also said they expect transparency from their alternative asset managers, with 69% requesting reporting on performance, risk exposure, asset classes, regional breakdowns, largest positions and industry breakdowns. Producing such reports regularly, and making them fully available, is becoming a best practice in the industry.

Insight: Because alternative asset portfolios can often hold less liquid securities, the ability to value them fairly is critical to a strategy’s success. Investors must understand not only what their managers own but how it is being valued.

Interpretation: Accordingly, managers should document standards and practices for valuing assets. They should be able to prove their

Exhibit 3: Established oversight groups, policies and metrics for adherence to investment guidelines, regulations, industry practices and ethical standards support a firm’s commitment to risk control and governance.

Account Intake and Monitoring	Investor qualification, subscription process, activity monitoring, reporting, anti-money laundering Monthly reviews; quarterly results presented to the board
Errors, Loss, and Event Analysis	Oversight and correction of identified incidents through incident review and research committee Effective and prompt resolution; review and analysis of trends
Risk Assessment and Control Evaluation	Risk Oversight Committee Asset and Liability Committee Process for approval of fund evaluations
Audit and Trading Oversight	Trade Oversight Committee Audit Committee; annual audit SAS 70 review of internal controls
Third-Party Service	Provider Oversight Oversight by Treasurer’s Office Shadow accounting Fair Value Committee
Side-by-Side Oversight	Pyramis Compliance, FMR Investment Compliance and the Ethics Office regularly review account holding reports and trading activity Significant conflict issues escalated to the Pyramis Trade Oversight Committee

For illustrative purposes only. Source: Pyramis Global Advisors.

practices are reasonable and that they adhere to them consistently. This capability underpins the investment process and the trust that investors have in managers. The Alternative Investment Management Association has issued guidelines on valuation that could serve as the basis for further exploration of a manager’s practices (see “Resources”).

Exhibit 4: The structure and implementation of a business continuity program are critical to providing uninterrupted service.

Pyramis Business Continuity Program	Pyramis Information Security Team	Fidelity Risk Oversight Group
Provides redundant facilities and equipment for all critical business functions, including: –Trading –Research –Investment Management Facilities and equipment tested two or more times per year	Oversees operational policies and procedures related to handling and storing information Monitors access to Pyramis buildings, workspaces, networks and applications	Provides guidance, training, expertise and governance to divisions Works closely with executive management to provide guidelines and common resources Maintains relationships with external agencies

For illustrative purposes only. Source: Pyramis Global Advisors.

² “Global Markets Alternatives Investment Survey,” Deutsche Bank Securities, Inc., May 2008.

3. Operational infrastructure – the commitment

In the May 2008 Deutsche Bank survey, risk management displaced manager pedigree as the third most important criterion in selecting a manager; performance, philosophy and pedigree ranked first, second and fourth, respectively. Clearly, risk management and controls have moved up in investor concerns.

Operational controls and risk management extend across the enterprise and require a robust program to support, expand and advance investors' best interests. As an example, Exhibit 3 sets out Pyramis' approach to identifying, monitoring and systematically addressing operational risks. Essentially, every function in the management firm – human resources, finance, information systems, legal and compliance, purchasing, marketing, treasury, sales, and client and consultant relations – must not only adhere to programs of risk management and control but foster a culture of integrity that places investors' interests above all other considerations.

Depth: Business risks should be addressed through redundancies and development programs that anticipate potential issues such as personnel departures and succession planning. Investors should understand how a manager intends to address the inevitable growth and evolution of the organization. Just as important as how a manager retains key personnel is how a manager intends to develop the next generation of talent. Compensation and training policies are key to organizational development and should be available to investors.

Breadth: Business continuity and recovery programs help to avoid interruptions in key operations such as equity research, trading, portfolio management, risk control, client services and back-office support. Information security access to buildings and workspaces, networks and applications are sometimes overlooked, but are crucial components of effective operational controls. Exhibit 4 on page three describes how Pyramis addresses these issues, using programs and controls to

ensure that services and operations continue reliably.

An on-site visit and due diligence review with those responsible for operational and risk management can help illuminate areas of potential concern, as well as highlight effective practices.

Preliminary due diligence before investing with any asset manager – especially an alternatives investment manager – is crucial to avoid missteps. It is easy to pay attention to a manager's performance, but ongoing monitoring and assessment of a manager's policies, programs, practices and procedures is also essential.

Joseph Morgart is Senior Vice-President, Alternative Strategies, at Pyramis Global Advisors, a unit of Fidelity Investments.

Resources

Best practices for the Hedge Fund Industry Principles and Best practices for Hedge Fund Investors

Issued by the President's Working Group (www.amaicmte.org), these two reports are designed to help both investors and managers in strengthening due diligence procedures.

Hedge funds: A discussion of risk and regulatory engagement

The Financial Services Authority (www.fsa.gov.uk), the financial regulator in the U.K., has also issued this discussion paper.

Alternative Investment Management Association (<http://www.aima.org/>)

This organization provides a number of helpful resources, including sample due diligence questionnaires and guidelines on valuation that could serve as the basis for further exploration of a manager's practices.

Pyramis Global Advisors, a Fidelity Investments company, is an investment management firm focused on serving institutional investors, including corporate and public retirement funds, endowments, foundations and other institutions, as well as international investors. Fidelity Investments Canada ULC is proud to distribute Pyramis Global Advisors products and services, including actively managed Canadian equity, U.S. equity, international and global equity, fixed-income, asset allocation and alternative strategies.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities.

Pyramis products and services are sold by Fidelity Investments Canada ULC, an affiliate of Pyramis. The business unit of Pyramis Global Advisors (Pyramis) consists of Pyramis Global Advisors Holdings Corp.; Pyramis Global Advisors Trust Company, a New Hampshire limited purpose trust company (PGATC); Fidelity Management Trust Company, a Massachusetts trust company (FMTC); Pyramis Global Advisors, LLC, a U.S. registered investment advisor (PGA LLC); Pyramis Canada ULC, an Ontario registered investment advisor; Pyramis Global Advisors (UK) Limited, a U.K. research provider; Pyramis Global Advisors (Hong Kong) Limited, a Hong Kong registered investment advisor (Pyramis-HK); and Fidelity Investments Canada ULC (FIC). Investment services are provided by PGATC, FMTC, PGA LLC, Pyramis Canada ULC and/or Pyramis-HK. Investment services are provided by PGATC, FMTC, PGA LLC and Pyramis Canada ULC. Pyramis has prepared this material for, and only intends to provide it to, certain qualified investors. Do not distribute or reproduce this material.

The views expressed herein are those of the individual contributors and do not necessarily represent the views of Pyramis Global Advisors. For more information, please contact Joseph Morgart, Senior Vice-President, Alternative Strategies, Pyramis Global Advisors, at 401-292-4936.

Certain data and other information in this research paper were supplied by outside sources and are believed to be reliable as of the date presented. However, Pyramis has not verified and cannot verify the accuracy of such information.

The information contained herein is subject to change without notice.

Pyramis does not provide legal or tax advice, and you are encouraged to consult your own lawyer, accountant or other advisor before making any financial decision.

All trademarks and service marks presented herein belong to FMR LLC or an affiliate, except for third-party trademarks and service marks, which belong to their respective owners.

© 2009 FMR LLC. All rights reserved.