

# Benefits<sup>CANADA</sup>

This article is courtesy of [www.benefitscanada.com](http://www.benefitscanada.com)

## Operation: Risk

August 14, 2009 | Joseph Morgart



You'd think performance would be the top reason investors fire their alternative asset managers. Not so, according to a recent report by PricewaterhouseCoopers (PwC).

Operational and governance-related risks now trump performance as reasons why investors get rid of managers, says PwC. No doubt, assessing operational risk should be a major part of an investor's approach to evaluating their alternative asset manager. Plan sponsors should look very closely at the programs and practices their managers or potential managers use to control operational risk. Proper due diligence should focus on three key areas related to operational risk at a firm: compliance foundation and history, transparency and reporting, and the manager's overall approach to risk management across the business.

### People, policies and history

A firm's history and roots can tell investors a lot about its approach to compliance and managing risk. To understand whether a firm is founded on a culture of integrity, plan sponsors need to ask questions such as:

- 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?
- And has the board defined clear-cut responsibilities for structuring and executing its responsibilities to monitor the firm's activities?

A similar series of questions can point to operational risks in a firm's investment policies. Plan sponsors should ask how the firm developed policies that seek to avoid securities law violations and whether the board of overseers vetted and approved them. Is there any 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 and approved and monitored on an ongoing basis? Are policies in place for trade allocation and best execution and does the firm regularly evaluate them?

Learning about a manager's compliance culture involves other considerations too, including ongoing guidance and training for personnel in adherence to 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 behavior among their associates. Plan sponsors should examine and discuss all of these areas with the manager and ask if such programs are vetted and audited by internal and/or external parties.

### Transparency and reporting

The PwC report points out that risk management, transparency and reporting quality are also near the top of the list during the manager selection process. Concerns over liquidity and valuation are driving this trend—alternative asset portfolios commonly hold less liquid securities, and fairly valuing them is critical to a strategy's success. Investors have to understand not just what their managers own but how it is valued. As a result, plan sponsors ought to make sure managers document standards and practices for valuing assets. Managers should be able to prove their practices are reasonable and that they adhere to them.

Plan sponsors also need to engage managers in a discussion around any policies that could harm them down the road, including "most favored nation" arrangements, side letters, or side pockets that amend terms for individual investors. Gates, lock-ups and other redemption practices should also be dealt with transparently, and plan sponsors should be aware of any additional liquidity issues that arise from such policies.

### Managing risk

Manager selection is also being driven by concerns over risk management policies and controls. For plan sponsors in particular, ensuring that managers have operational controls and risk management in place across the organization has never been more important. Essentially, every function within the firm—human resources, finance, information systems, legal and compliance, purchasing, marketing, treasury, sales, and client and consultant relations—has a part to play not just in terms of risk management and control but in fostering a culture of integrity that places each investor's best interests above all other

considerations.

Plan sponsors should also understand how a manager intends to address the inevitable growth and evolution of the organization, including how it plans to develop the next generation of talent and how the firm approaches compensation and training. Firms must have business continuity and recovery programs to avoid interruptions in operations so ask questions about contingency plans in areas such as equity research, trading, portfolio management, risk control, client services and communications, and back-office support. An on-site visit and due diligence review with the personnel responsible for operational and risk management can help illuminate areas of potential concern, as well as effective practices.

**Past performance no guarantee**

With the proper degree of due diligence, plan sponsors can help ensure they avoid any missteps with their alternative investment managers. However, the warning, “past performance is no guarantee of future results” doesn’t just apply to performance—it is directly related to a firm’s operational infrastructure and risk control. That means plan sponsors should continually monitor and revisit their manager’s policies and approaches to operational risk on an ongoing basis.

*Joseph Morgart is senior vice-president, alternative strategies with Pyramis Global Advisors.*

*This article originally appeared on [BenefitsCanada.com](http://BenefitsCanada.com)*

529811.1.0