INDUSTRY INSIGHTS INTO BEST PRACTICES, RISK MANAGEMENT, FIDUCIARY RESPONSIBILITY & FEES

Survey of Institutional Investors

Copyright Craig Heatter and IMI
123 Mason St, Greenwich CT 06830 USA
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1. Preface

Over the past two years, the impact of the sub-prime mortgage crisis on the capital markets and the economy has been substantial, creating enormous strains within the investing community. Some of the repercussions are that funded ratios of a significant number of pension funds are at historic lows, and a number of endowments and foundations are having difficulty meeting liquidity requirements. In addition, litigation involving hedge funds and securities lending is growing, as well as issues surrounding foreign exchange (FX) fee disclosures with correlations of asset classes not providing downside protection. There are also discussions about potential litigation by 401(k) plans related to fee levels, the value added agent placement fees, and relationship disclosure. Combined, these issues have put increased pressures on funds’ budgets and staffing needs.

With increased focus on fiduciary responsibility, the Investment Management Institute (IMI) – with 30 years of experience working with large institutional investment organizations -- has collected data to assist fiduciaries in identifying ways to enhance their understanding of their responsibilities, as well as to assist them in developing tools and benchmarks to facilitate this process.

The information in this study will be useful in providing insights into controls, policies, processes, transparency requirements, fees, and knowledge across the entire risk spectrum, including custodians, investment managers, consultants, actuaries, and numerous vendors and sub-vendors. Ideally, this will allow better coordination of all services and vendors in numerous areas with the objective to reduce exposure and to increase controls for fiduciaries.

That said, the information includes, but is not limited to, data insights into the following areas of fiduciary responsibility:

1. Operational risk management (custodial platforms)
2. Risk management tools
3. Investment optimization
4. Oversight and due diligence
5. Outsourcing.
2. Executive Summary

The 2010 survey of institutional investors with over $1 trillion in assets under management, conducted by the Investment Management Institute and supplemented by IMI's experiences and contacts in the industry, suggests numerous areas of opportunities to enhance risk management services.

Today's business and market environment require plan fiduciaries to think holistically, i.e., to manage assets and liabilities while ensuring risk management services are best-in-class. Service providers are required to add value to clients, not only in traditional areas of expertise but also across the entire risk continuum.

For the institutional investor this means:

• Monitoring and reviewing best practices for all service providers.
• Finding areas of synergy from all professionals to optimize the investment and operational strategies at competitive costs.
• Clarifying fiduciary responsibilities and liabilities.
• Ensuring total architecture is in place to address current and future regulatory reporting requirements.
• Recommending process enhancements to avoid excessive cost, career risk, and identifying potential gaps and overlaps in services.
3. Major Findings

Institutional investors need assistance in benchmarking operations, trading and risk management services, as well as assessing the value added by service providers. In addition, they seek clarification in defining fiduciary responsibility, liability and due diligence processes.

Operational Risks

• Client reporting and data quality vary by service providers’ technology, data architecture, and investment experience. Reporting is considered key to meeting current and future regulatory, financial, risk controls and investment oversight.

• Securities lending – client splits, returns, fees on collateral management, credit analysis, and risk management – and investment experience, vary significantly by client and/or service provider.

• Opportunities exist to differentiate accounting capabilities include: transparency, global accounting systems, book and record reconciliation processes, and accurate valuation data for difficult-to-price securities. An integrated daily, accounting and performance measurement system is viewed as an enhancement to the risk control process.

Risk Management

• Opportunity to share the oversight of risk management practices utilized by both defined benefit and defined contribution plans in the one organization, is presented.

Investment Optimization

• Alpha is a significant factor beyond fundamental analyses for institutional investors in the evaluation of investment managers and consultants.

• Analyses of asset allocation, liability and spending rules, and liquidity, are key determinants for investors in assessing the value delivered by consultants, actuaries and investment managers.

Oversight and Due Diligence

• Quality of staff and turnover, performance results, back-office operations and controls, are important in assessing investment managers and all service providers.

• Quality and depth of references are key to ongoing evaluation and selection of investment managers and service providers.

• Significant opportunity to account, disclose and benchmark all explicit and implicit fees.

Opportunities for Outsourcing

• Opportunities for outsourcing services such as: performance measurement, alternative accounting (hedge funds and private equity), technology, and investment expertise e.g. CIO, are apparent.
4. Introduction

In early summer 2010, the Investment Management Institute (IMI) and its online business, ECWServices.com, launched a survey that invited members of the institutional market place to share their insights, experiences and opinions about current best practices in risk management covering custodians, consultants, risk management providers and/or consultants.

The purpose of the survey was multi-fold:

a. To gain a better understanding of the comprehensiveness of services necessary to manage effectively a large institution’s assets and
b. To evolve best practices and benchmarks for the industry.

The results of this survey should help initiate the benchmarking of vendor services, provoke ideas to enhance best practices, and identify opportunities to optimize operations, investment and risk management processes.

Additionally, respondents’ answers point to the need for holistic management with a focus on reducing costs, fulfilling fiduciary responsibility, improving operating efficiencies, lowering risks (operational and career), and ensuring that best practices are in place.

Survey Questions

Different types of questions were used to elicit varying responses. An underlying assumption made was that all institutions, to some degree, deal with the complexities of various service vendors.

The gap questions pointedly asked respondents to identify strengths as well as opportunities for improvements.

Value questions anticipated professional observations about skill set.

Opportunity and experience questions referred to observations over time or concerns to be addressed.

By using some questions for all types of institutions we were able to identify areas of concern for managing large funds that may or may not include both defined benefit and defined contribution plans.
5. Respondents
The survey respondents included institutional investors (corporations, state funds, endowments, foundations, faith-based and Taft-Hartley plans) with over one trillion dollars in assets from across the nation. The majority of respondents were located in the New England and Mid-Atlantic regions. Chief investment officers, chief financial officers, and chief executive officers accounted for over 59% of the survey respondents with the mean experience of respondents in excess of five years.

Plan sponsors provided detailed responses to over 119 questions, representing IMI’s largest survey conducted to date. The quality of the responses and the number of questions completed are an indication of the professionalism and dedication of the institutional investment community.

Institutional Demographics

a. By Organizational Type:

Respondents are employed by endowments (38%), corporate funds (29%), and foundations (17%) with the remainder employed by states, Taft-Hartley and faith-based funds. 50% of respondents have $1 billion or more in assets.
b. Location:

The majority (58%) of the respondents are from the eastern part of the United States followed by the Midwest (18%), and the western part of the country (24%).

c. Executive Level:

Executive level professionals (CEOs, CFOs, CIOs) account for 59% of the total respondents. The remaining 41% are treasurers, finance directors, administrators, trustee/board members, and executive directors.

d. Experience:

34% of respondents have over ten years experience while 31% have five or more years. The other 35% have five years or fewer in experience.
6. Survey Findings
6.1. Operational Risk Management

37% of respondents indicated custody operations are not integrated with key services and not managed in a central location.

Opportunities exist to:
• improve tax reclams
• cash reporting and projections
• un-invested cash balances
• risks in sub-custody network.

There is opportunity to enhance accounting for hedge funds, private equity and other alternatives including real estate, commodities and timberland.

Institutions appear to be somewhat satisfied with their defined contribution accounting.
Client reporting architecture integrated with high quality data management that is supported by well designed technology is and will be key to strong client reporting capabilities and risk management processes.

This area is key in understanding and mitigating risks such as counter-party exposure and over concentration of investments, etc. Client reporting demands will only increase in the new regulatory environment.

An end-to-end global accounting, valuation, and performance measurement system that enables reconciliation between book and records is critical.

58% of respondents are not aware or not sure of the process of reconciliation of their book and records. This process should be incorporated to enhance risk management practices.
Securities lending splits vary significantly between client and provider. This creates opportunities to review and benchmark capabilities afforded by various providers. Review of risk and reward should also be taken into consideration. The wide disparity in responses might give institutional fiduciaries pause when they calculate the meaning of these figures to the bottom line.

Nearly half of the respondents see the wisdom and understanding in their securities lending risk and reward relationships. This includes an understanding of the match and mismatch for example, between duration of assets versus liabilities and credit quality of assets. It is prudent to understand risks and investment process of cash collateral pool versus separate account management.

Of the respondents, only 26% have an independent process for accounting and valuation of their securities lending program. The securities lending program should have independent accounting, valuations and no real or potential party-in-interest transactions across the entire firm. In addition, cash collateral pools should be required to produce global performance measurement, gross and net of fees, compliant with GIPS (Global Investment Performance Standards).

Just 9% of respondents appear to grasp their credit risks. A securities lending program with independent third-party credit analysis would have played a key role in mitigating losses during the recent credit crisis.
Securities lending investment management staff credentials and due diligence should be conducted following the same process as reviewing a short-term, fixed income money manager. 62% of respondents report their review as quarterly, while just 25% state this as monthly.

Securities lending operations should be viewed as an investment advisory function and staffed with experienced investment management personnel.

Trading can be a very significant source of risk and return, however, 59% of respondents indicated they do not review this area. Securities trading capabilities execution should be reviewed periodically including a comprehensive commission report.
Foreign exchange is an important service to implement investment strategies and could have positive or negative implications on investment returns. Comprehensive reviews of foreign exchange capabilities must be completed periodically to understand execution and costs.

Outsourcing benefit payments appears more familiar to the responding institutional executives. Review of all aspects of benefit payments including capabilities, costs, floats and control processes, should be key in a risk management review.

Custodian trustee/fiduciary responsibility appears to be well understood. 82% responded that they place their fiduciary responsibility with a trustee. This responsibility should be benchmarked and documented in a contractual agreement.
There is opportunity to understand and control risk. 56% of the respondents said they use custodial insurance and/or other measures to protect custodial liability. Custodian liability and insurance documentation should be in writing.

Disclosure of fees must be done periodically including un-invested cash balances, foreign exchange, floats, and other. In the survey, only 30% reported an understanding of all fees. The other 70% are not sure if they receive full disclosure on fees.

Disclosure of turnover in key executives at all service providers should be required. It should include reasons for departure and new firm when possible. In this survey, 53% do disclose. The remainder either does not, or is not sure if they do.
Nearly one in five institutional executives responded are unfamiliar with this important accounting standard. Custodians must review all SAS 70* exceptions with clients at least annually.

*Statement on Auditing Standards No. 70: Service Organizations, commonly abbreviated as SAS 70 and available full-text by permission of the AICPA, is an auditing statement issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA).

The responses suggest a need for clarification of duties and responsibilities associated with keeper of the book and records of trust. As we have seen, respondents look to custodians for numerous tasks especially, as indicated here, as keepers of book and records. Some firms identify more than one vendor as the responsible party. Contracts should be well documented including clear language and responsibility of custodian.
6.2. Risk Management Tools/Services

The respondents suggest the most important risk management services are asset allocation, target/return and total risk analysis, liquidity risk analysis, and attribution/contribution risk. These services should be key in the evaluation of all service providers.

Opportunities exist to improve market shift analysis, hedge fund and private equity transparency, portfolio construction, attribution and benchmark misfit tools. Counterparty and derivatives/exposure reporting also have room for improvement.
Respondents report performance measurement services as key to their risk management program. There is opportunity to benchmark crucial services with other service providers.

Of the services received, respondents report that performance measurement, monthly performance, and total fund universe analysis, are best. Areas of improvement include attribution analysis, benchmark and security level analysis, and daily valuations.
6.3. Oversight and Due Diligence

Compliance personnel must have investment qualifications and experience.

Compliance services including exception reporting, are key to the risk management process. There is opportunity for clarification of the compliance team’s responsibilities.

A key risk management process is to validate all valuations and rates of return of each manager to book and records of trust. The split between using internal staffers (43%) or a custodian (41%) is almost par, while 16% use an outside auditor. There is opportunity to establish best practices among internal staff, investment managers, auditors and custodians.
The most important factors include quality and turnover of personnel and back office operations. Enhancement of the other areas regarding investment manager due diligence include: win/loss data, references, back office operations, and performance relative to benchmarks and peer groups. GIPS are becoming an increasingly important factor.

68% of respondents report using index and related strategies. Index fund offering(s) and capabilities continue to be an important piece of an asset allocation strategy.

Nearly 70% utilize the S&P 500 as their core investment in their asset allocation, followed by the BGI/Lehman and EAFE indices. Most institutions appear satisfied with index providers, although there is opportunity to improve tracking to benchmarks, performance and staff.
Positive alpha relative to agreed upon policy benchmarks, is an important factor in evaluating a consultant, and positive alpha generation is a valued component in the determination of a consulting fee.

52% of the respondents are aware through disclosure of third party agent fees. This includes agent fees paid directly or indirectly by the service provider.

57% of the respondents do not require or are unsure as to whether they require disclosure of service provider lawsuits. This information should be utilized in the evaluation of service providers, improving the due diligence and risk management processes.
Just 28% of respondents require disclosure of client losses/gains. This information is key to retaining a particular manager.

There is opportunity to obtain insights into service provider commitment to and capability in a market segment.

Understanding outside vendors’ businesses seems a distant thought to institutional executives. 72% do not monitor the growth or operating efficiencies of their providers. Yet how the providers manage these efficiencies is an important metric in managing business, as well as the commitment of the firm to a business/segment.
The service provider offers a product strategy aligned with investors’ operations and objectives. 54% of respondents do not review or are unsure if this analysis is conducted.

93% of investors are satisfied with their consultant. However only half engage their consultant as the fiduciary. This provides for opportunity to clarify consultant responsibility through a well-written contract including liability and insurance coverage.
Asset allocation, manager selection, custodian reviews, and due diligence -- what might be thought of as the more traditional consulting services -- are ranked highest. There is opportunity to improve new strategies, adding alpha, custody reviews and overall risk management.

76% of investor respondents report they know the sources of revenue paid to their consultant. Clarification of fees is paramount to avoid conflicts of interest and drives further disclosure.

89% of respondents report their actuary meets or exceeds satisfaction. Benchmarking actuary capabilities should include analyses of: assets and liabilities (pension funds), asset spending rules (endowments and foundations), and liquidity.
6.4. Outsourcing

44% of respondents outsource while 56% do not. Regardless of whether the investor outsources services or not, the same fundamental analyses suggested in this report merit serious consideration.

Of the five key services that could be outsourced, respondents rated performance measurement and accounting the top two opportunities. Primary reasons for outsourcing include investment expertise, accounting and valuation capability, and costs.
7. Conclusion
Through this survey, IMI has identified a real opportunity for institutional investors to both benchmark and reduce their costs.

In addition, this research has uncovered the need to improve the understanding and clarification of investors’ fiduciary responsibilities.

By instituting such practices in the risk and operational management processes, investors should be better placed to manage their funds effectively and efficiently.

**Reasons to Consider IMI’s Services**

- New financial regulations i.e. risks such as: counterparty, country, operational infrastructure
- Securities lending and foreign exchange litigation and associated fines for institutions and individuals
- Disclosure of agent fees and associated fines for institutions and individuals
- Increase in Ponzi schemes and fraud
- 401k litigation
- Little to no benchmarking of custodial services
8. Next Steps
1. Agree to engage IMI. Sign non-disclosure agreement (NDA).

2. IMI to conduct a high level audit that provides an understanding of the institution’s relationships, sensitivities, fee structures, current service provision and other agreed factors.

3. IMI shares high level findings with institution to determine whether or not to proceed with an engagement.

4. Agree to compensation and deliverables. IMI services provided will include benchmarking of:
   A. People, process, product and fees
   B. Securities lending (including collateral management)
   C. Derivatives and margin reporting
   D. Cash management
   E. Foreign exchange
   F. Index management
   G. Benefit payments
   H. Value-at-Risk
   I. Performance measurement
   J. Fiduciary responsibility and liability
   K. Insurance
   L. Custody
   M. Technology
   N. Accounting
   O. 401K and 457 capabilities
   P. SAS 70 disclosures
   Q. Operational and investment experience
   R. Thought leadership
   S. Other areas as outlined by institution and agreed.

   To accomplish the benchmarking process, custodians will be presented with an RFI/RFP. This information will be collated and industry averages, highs and lows will be established and provided back to the investor. Accordingly, services delivered to the investor will be ranked.

   This detailed analysis will provide opportunities to discuss areas where costs and services can be reviewed and potentially reduced or enhanced respectively.

5. Present findings and recommendations.