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What to Look for From Asset Managers

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Key Points

- Independence
 - Independence does not require hiring a sole proprietorship
 - Understand how asset manager bias can impact investment decisions
- Transparency
 - Capitalize on the investment transparency tools available to corporations
 - Structural transparency: Segregated duties and targeted Type II SAS 70s
- Track Record
 - Work with firms whose primary focus is delivering asset safety for all of their clients
 - Consider raising your manager's disclosure requirements

Post the credit crisis, portfolio companies are reminded of the importance that their asset managers satisfy three crucial parameters: independence, transparency and a track record of investment safety and financial stability. One element that can be difficult to assess is independence. Independence in terms of managing your cash can be boiled down to two key questions: 1) does the asset manager have an explicit fiduciary responsibility to you as their client, and 2) have they disclosed and taken steps to minimize conflicts and potential conflicts of interest. To that end, make sure you are informed to your satisfaction on the following issues.

Independence*Working with an RIA or broker-dealer*

Independent investment oversight means companies should only engage asset managers that have an explicit direct fiduciary obligation to their clients. RIAs have a fiduciary obligation, which means they are legally bound to act in their clients' best interests ahead of their own in all instances. In comparison, a broker-dealer has a suitability standard, which means that they are required to make suitable recommendations but not to avoid potential conflicts of interest. Investment advisers are generally compensated based on a percentage of assets under management, fixed or hourly fees. Barring other potential conflicts recommending one product over another isn't impacted by compensation. Commissions are the dominant form of compensation for broker-dealers and compensation can vary greatly among

products. This is a potential conflict of interest because there is usually a financial incentive for brokers to choose one product over another.

Independence does not require hiring a sole proprietorship

A misconception that some companies have about utilizing asset management resources of a larger financial services firm is that separating their asset management provider from their other banking needs allows borrowers to “separate the debt from the cash”, in effect protecting the cash from the lender’s blanket lien so that it cannot be “swept”, or foreclosed upon, following a default. According to Article 9 of the Uniform Commercial Code, all lenders must protect their security interest in deposit and investment accounts the same way — either through possession (i.e., a bank lender where the cash is on deposit with the same bank), or through a vehicle known as an Account Control Agreement — essentially an agreement signed by the borrower, lender and the institution holding the funds, often an asset manager, where the asset manager is required to turn over the funds to the lender upon demand.

The practical effect of this legislation is that borrowers have the same protections, and both bank and non-bank lenders have exactly the same rights, with neither having an advantage in claiming a company’s cash or other collateral.

Whether working with a sole proprietorship RIA or an RIA that is part of a larger financial services firm (e.g., SVB Asset Management – SAM), the level of independence and objective oversight legally required as your fiduciary is the same. A bank client who uses a sole proprietorship RIA and a bank client who uses SAM have the exact same set up structurally and legally. There is no structural advantage in using two separate providers of asset management services. In fact, it could be argued that there are some disadvantages: there is more work for the client, more relationships to manage, clients give up the benefits of a wider relationship

with their bank and eliminate the ability of their banker to see the whole asset picture.

Understand how asset manager bias can impact investment decisions

There are a number of asset manager strategy elements that while perhaps not immediately obvious, are worth considering and understanding as an investor. The following practices are recommended as they enhance the focus your manager has on their objectives of preserving principal and liquidity above all else:

- Any securities purchased must be on the approved issuer list of an investment manager with a corporate cash focused credit team, exclusively dedicated to “buy-side” research.
- The securities offered should not be underwritten by the investment manager or a related party.
- The securities offered should not be purchased from inventory by the investment manager or a related party.
- In order to preserve objectivity in the event of financial stresses on the fund, any money market fund employed, regardless of treasury, government or prime investment approach should generally not be owned/run by the same entity as the investment manager or fund provider.
- In order to ensure liquidity, the asset manager must through its clients or directly, own no more than 5 percent of the money fund being offered.

Transparency

Capitalize on the investment transparency tools available to corporations

Either through your asset manager or independently, seek financial reporting tools that on a daily basis can deliver:

- Cash flow, income statement and balance sheet updates
- Credit downgrades, credit watch histories
- Parameter-by-parameter Investment policy compliance
- Total exposure to specific issuer names across multiple investments

For money market funds employed, a company should be able to independently confirm on a same-day basis the following information:

- Percent change in assets MoM
- Percent maturing within 5 days
- Weighted average maturity (WAM) and weighted average life (WAL) of the portfolio
- Fund expense ratio
- A summary of percentage allocation to each security type employed
- Maintenance of at least 20 percent of the portfolio in overnight liquidity
- Maintenance of at least 40 percent of the portfolio maturing within one month

Structural transparency: Segregated duties and targeted Type II SAS 70s

- Whenever possible, companies should utilize custody, reporting and asset management services that are independent of one another. Each of these services should provide the client an unqualified Type II SAS 70 report on the effectiveness of the controls they have in place on behalf of the client.
- An independent segregated custodial account in the name of the company ensures assets are separate from the assets of other clients and separate from the assets of the bank. In short, custody ensures assets of the firm are protected in the case of financial problems or bankruptcy of the bank. Utilize a major custodian with at least \$500 billion under custody.
- Independent reporting around performance, pricing, and investment policy compliance.

Track Record

Work with asset managers whose primary focus is delivering asset safety for all of their clients

Asset managers that subjected their corporate clients to illiquid investments or principal impairments either through auction rate securities, mortgage-backed securities or money funds that halted redemptions over the past two years can and should be avoided.

Consider raising your manager's disclosure requirements

Companies can ask for and should receive any of the following disclosures from their asset manager choices to help evaluate their investing options:

- Monthly: 1) a schedule of markups or “spread” taken by the manager, its parent, or other subsidiaries for any securities purchased on behalf of the company; 2) the commission in basis point and dollar terms received by the manager, its parent, or other subsidiaries for any securities purchased on behalf of the company; and 3) a summary of the percentage of the portfolio that is comprised of securities purchased from inventory and/or underwritten by the manager, its parent, or other subsidiaries, including a list of the individual securities purchased.
- Annually: a comprehensive summary document reviewing all portfolio-wide and per security sources of potential revenue and transaction fees or markups passed on to the client for work performed on the client's behalf. The summary should also disclose and explain any business structures that represent a real or potential conflict of interest with regard to the services they employ for the client.

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