Institutional investors – How well do you know your portfolio?

In December 2008, FBI agents arrested Bernie Madoff – a man who famously used the cash of new investors to pay older investors. Depending on your source, this so-called Ponzi scheme generated somewhere between twenty billion and fifty billion dollars.

Explaining this to the man on the street tends to lead to bewilderment – how can so-called “professional” investors have the wool pulled over their eyes so easily by largely one man? It is quite simply a case of while the going is good and returns are made, investors seem unlikely to ask the difficult questions.

Madoff, of course, isn’t an isolated example of investors being unwilling to ask questions if the returns on offer are so good. A trader at the now defunct Lehman Brothers was quoted as saying “we didn’t know or understand what we were buying”. And we’re talking about what was an AAA-rated financial institution.

What these high profile incidents highlight, is a gap between the retail and the professional. More casual investors rely on regulation to keep quoted markets true, but the professional ones have access to the high-risk and reward of the alternatives sector, with no public overarching governance. It is slightly ironic then that those with bigger wallets take a more relaxed approach than those with small holdings in quoted companies.

Accounting scandals in listed entities are widely reported, but what of failures in alternative investment funds?

Unlike the quoted markets, fund “ownership” is usually made up of a fairly small number of high value investors. As the fund will most likely be formed as a limited partnership, there is no company law structure or reporting framework to place faith on, and so a bond of real trust is built between the fund manager and investor. It is for the general partner then to provide a decent level of governance and, more critical to those that provide the cash, fair treatment across their investor base. Onshore in the UK, fund activities are largely regulated with a light touch, however, perhaps ironically, offshore regulation and the resultant forced outsourcing of administration, immediately creates a more transparent approach to reporting and governance.

You'd expect that an industry built on a largely closed group of investors would be forced into more transparent reporting, but information can often be difficult to source. Added to this is a lack of consistency in accounting, and information on portfolio companies being controlled through the quarterly investor reporting cycle, leading the industry to largely work on the basis of 'if you don't ask, you don't get'.

This isn't to say investors are lied to. Far from it. The issue lies in the simple fact that the quarterly reporting cycle tends to paint an overall picture, which makes it very difficult to know what's going on at the level of the underlying investments.

So, what are the implications?

First of all, you just never know when you might need this information. Take the (largely unforeseen) economic upheaval of the 07/08 financial crisis; in such circumstances, having accurate data on the locations, currency, gearing and other exposures of underlying portfolio companies would have been invaluable.

Legal structuring means it isn't as simple as picking up the domicile of a fund – it's highly likely a Mauritius fund would be investing in Asia, but it's just as likely that a Delaware or Cayman Islands fund would have a similar level of commitment, or that the Mauritius fund invests in Africa or Americas. Then you have the task of "looking through" each and every fund manually and without the tools in place to do this, it can become a time consuming and costly process.

Obviously, this is not a scenario where investors are necessary looking to understand performance, but what it does show is a situation where a vast amount of data may be needed at fairly short notice to manage an unexpected potential major risk. We've heard of some investors having to physically trawl through each investee fund's quarterly report to get the figures into shape – a laborious process,, which ultimately can take days or even weeks.

As with funds, "value" is not just about cutting costs, but about making the right decisions in the first place. Questions don't tend to be raised while things are going well, but what about if being proactive in fund manager selection enabled investment teams to make the right decisions before returns started to drop?

Keeping your eye on the ball

Often the decision will come down to if the institution has invested in the past, or if there are commitments of similar size, geography and investment policy, but what does the return curve really look like as a comparison tool – is there over-investment in European retail, but under-representation in the Americas? Asking those questions and having the answers before the next round of commitment is allocated can often be the difference between success and loss of capital.

And it’s not just a case of having full visibility, there’s also reputational risk in not going down this data collation route. Institutional investors are largely acting as trustees for employment pension schemes around the world and, therefore, this data will always be in the public interest. Having that data reconciled and to hand and being in a position to highlight concerns with both managers and regulators has to be the default mode. Knowledge is power – who holds it?

And finally, fees. Many investors are often unable to answer questions on what fees they are paying over the term of a fund. This is a classic case of when the going’s good, don’t ask! With management fees and carried interest added together, are investors getting up-front value for money when dealing with certain managers?

Warren Buffet once said “only when the tide goes out do you discover who’s been swimming naked” – this couldn’t be more appropriate. Those investors that fail to interrogate performance run the risk of being left red-faced. Finding a service provider that can help you develop a better understanding of your portfolio is the starting point.