PORTFOLIO MANAGEMENT

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Assessing Manager Operational Risk

Up-front Analysis Pays Off on the Back End

When considering a new investment relationship, investors typically begin with the investment strategy. And substantial attention is given to other areas such as governance, fee structure, sourcing capabilities, reputation, track record and the like.

However, investor due diligence often ends before in-depth consideration of areas such as asset and property management. And due diligence rarely includes a "deep dive" into back office operations such as accounting, compliance and information technology. We believe institutional investors are overlooking these key operational aspects in their manager due diligence.

There is a substantial risk that inefficiencies or errors could occur in these "middle office" and "back office" functions that would negatively impact investment returns due to lost revenues or greater than required costs. The best managers recognize this operational risk and generate additional positive returns by identifying risk areas and mitigating them. Managers who are not as concerned with operational risk create a potential for degraded investor returns through inadequate middle- and back-office operations.

There are a number of potential operational risks that investors should review in the areas of manager operations relating to asset management, fund or joint venture management, and the manager's internal management.

Executive Summary

- **In-depth operational reviews can be time consuming, but the advantages justify the effort.**
- **Generally, when reviewing a manager's operations, investors should carefully examine asset decision-making procedures, investment vehicle back-office systems and major internal decision processes.**
- **If a manager has effective operational risk management, it likely has a culture of continuous improvement and resource optimization.**

DEFINITION OF OPERATIONAL RISK

Operational risk is defined as the risk of monetary losses resulting from 1) inadequate or failed execution of a company's business functions, or 2) external events, such as natural or economic disasters. Monetary losses include obvious factors such as theft or fraud. Losses also include items such as uncollected revenue, greater than required operating costs due to inefficiencies, or penalties due to noncompliance. In addition to identifying the risk of losses, we believe there are two additional benefits to a review of operations. The review also allows an investor to determine 1) how effectively the manager can execute the investment strategy, and 2) how well the manager can meet specific requirements of the investor.

Bard Consulting has performed many operational reviews. Samples of some of the issues we review are cited below.

OPERATIONAL RISK ASSESSMENT

In our opinion, the first step in an operational risk assessment of an investment manager is to determine the culture of the firm and if operational risk is part of its daily vocabulary. The subsequent steps are to look at the actual processes involved in asset management, fund/joint venture oversight and internal management.

FIRM CULTURE

Note the manager may not call the concept "operational" risk. It might be generally embedded in the internal audit function. It might be deemed "business" or "enterprise" risk. The two most important aspects of determining if a manager has appropriate operational risk monitoring are:

1. If the concepts of operational risk identification and mitigation are embedded in the firm's culture and organization from the highest to lowest levels. The concept is not just given "lip service."
2. If the firm has an open and transparent communication style that acknowledges the importance of all company functions, and encourages individuals at all levels to be involved in the risk review process.

To determine if these aspects are present in a manager, investors need to look at where operational risk fits into the organizational structure. Who is involved in managing it? Is it a mandate of a subcommittee of the board of directors or management committee? Are the CEO and senior management on board with the concept? Is their compensation tied to meeting operational risk objectives? Are there committees that are charged with identifying, mitigating and monitoring operational risk?

Also, personnel at all levels need to be interviewed in order to determine how far the concept permeates the organization and whether people feel empowered to participate in the risk review process. These interviews would include analysts and junior accountants, mid-level management, and senior executives.

ASSET MANAGEMENT OPERATIONS

Generally, when reviewing a manager's operations, investors should carefully examine asset decision-making procedures (how strategies are determined and who can approve what), budgeting processes and valuation procedures. Other points to consider include:

- **Appropriate allocations —** Some managers will allocate the cost of certain corporate functions to the assets or investment vehicle. How are these allocations determined? What are the dollar volume and the impact on returns? Are all the allocations appropriate?
- **Accurate lease accounting —** Lease revenues drive the real estate train. Are there controls in place to accurately capture all contractual lease revenue and to effectively monitor lease rollover?
- **Effective contract administration —** Third-party contracts can be a significant cost. Are contracts regularly reviewed to ensure the terms are complied with (to prevent fines or lawsuits) and payments made in a timely manner (to capture discounts and minimize mechanics' liens)?

FUND/JOINT VENTURE OPERATIONS

We define "fund/joint venture operations" to include the processes involved in managing the investment vehicle. Investors typically look at the adequacy of information in the investor reports and the fund/joint venture management structure (advisory board duties, investor decisions, etc.). Other factors to consider include:

- **Accuracy in accounting and reporting systems, and the interface between the two —** Accounting and reporting systems can be inefficient or manually intensive, which increases costs and the risk of errors. Are a manager's accounting and reporting systems of sufficient size and complexity to handle the accounting and reporting needs? How is data input into accounting systems from the field? How is data transferred between accounting and reporting systems? What are the checks and balances to ensure accurate reporting?
- **Cash management —** Cash is king in asset management. Are there controls in place to ensure there is sufficient cash for operations and to safeguard against unauthorized cash transfers?
- **Compliance —** Regulatory compliance with local requirements can become a major, costly issue if not adhered to. This is especially a concern for multinational companies. Is there sufficient monitoring to ensure regulatory compliance at both the asset and fund/joint venture level?
- **Performance measurement and incentive fee calculations —** The manager generally calculates the fund/joint venture performance and the resulting incentive fee. What is the process for populating the data used in these models? Are the models accurate in terms of calculations? We have found more calculation errors and places where errors could occur than one would expect.

MANAGER INTERNAL OPERATIONS

When evaluating a manager's internal management, investors will almost always review ownership and control, key-person succession plans, personnel retention and compensation, and conflict management. Other factors to consider include:

- **Strategic decision making —** New strategic initiatives have an embedded degree of risk, in part, simply because the manager may not yet have the requisite experience or systems. How are strategic decisions made and implemented?
- **Reputational risk —** A decline in the manager's reputation could diminish its future viability if there are negative impacts on its access to corporate credit, or its ability to raise new investment capital. What are the procedures in place to ensure appropriate ethical decisions and to maintain investor confidence?
- **Growth management —** Sometimes successful real estate managers experience rapid growth in assets under management. Is the "back office" keeping up? Are additional personnel needed? Are new accounting and reporting systems required?
- **Information technology —** IT is the backbone of a company. Are the systems serving the needs of the user? Are there sufficient backup and recovery systems? Are they tested regularly?
- **Internal audit —** This is an important function regarding risk identification and mitigation. If the manager has this department, does it appear to be well respected within the firm, and do the audits cover all types of operating processes? If the manager does not have this formal department, is another department not immediately involved in the processes being reviewed, such as the chief counsel's office, performing the function?

SUMMARY

There are substantial benefits in performing an in-depth review of a manager's operations. In addition to the benefits mentioned above, if the manager has effective operational risk management, it likely has a culture of continuous improvement and resource optimization. This type of culture can increase the bottom line for both investors and managers.

In-depth operational reviews can be time consuming, but the advantages justify the effort. Although an operational review is ideally performed at the beginning of a new relationship, existing relationships will likely benefit from an independent operational review as well. ❖

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