Communicating Accurate Investment Results

Using automation to minimize operational, regulatory and reputational risks

By Amy Jones, CIPM, and Thusith Mahanama

The U.S. Securities & Exchange Commission's Examination Priorities list for both 2013 and 2014[1] included "Marketing /Performance" as an area of specific focus. Regulators are looking more closely at the ways investment managers present performance results to prospective investors, and the SEC is using sophisticated data analysis tools to verify the accuracy of the information being presented. Now, more than ever, asset managers must be vigilant stewards of investment returns, calculation methodologies and associated disclosures for any performance data included in marketing materials. Those who are not leave their organizations open to regulatory sanctions and hefty fines, and put their firm's reputation and competitive standing at risk.

While the Global Investment Performance Standards (GIPS®) provides an overall framework for presenting investment performance — and the SEC provides additional guidance regarding sales practices[2] — even the most well-intentioned investment firm can make a mistake in their performance presentations. After all, compiling effective marketing material requires input across many parts of an organization. Operations, portfolio management, marketing and compliance all have a hand in the process. Every human touch point can be a vector for errors and omissions, especially when "compliance approved" material is modified during the course of a quarterly cycle.

Fortunately, asset managers can mitigate these risks through thoughtful use of automation. While many of the individual processes involved in calculating performance data for marketing may already be automated, they often operate in discrete silos and do not cover the "last mile" of the process: pulling data from disparate systems and sources into a holistic marketing presentation with built-in checkpoints to prevent errors from creeping into prospective-investor-facing materials. In this article, we review relevant GIPS and SEC guidance, identify the most common sources of errors, and recommend ways that automation can help produce accurate marketing material and reduce operational, regulatory and reputational risks in the process.

The Skinny on GIPS and SEC Guidance

Investment advisers registered with the SEC who market performance should establish objective criteria when constructing their performance track record. Firms need to develop a transparent process for calculating and presenting performance, and have documented policies and procedures that address performance advertising. In addition, certain books and records must be maintained to support the entire performance record presented. The GIPS standards provide a framework that firms can adopt for calculating and presenting performance results that can help satisfy these regulatory obligations.

ABOUT THE AUTHOR

Amy Jones is the Founder and Principal with Guardian Performance Solutions LLC, www.guardianperformancesolutions.com. She can be reached at amy@compliantperformance.com.

Thusith Mahanama is co-founder and CEO with Assette, www.assette.com. He can be reached at Thusith.Mahanama@assette.com.

The backbone of the GIPS framework is the Compliant Presentation, or "CP", which is a presentation for a composite that contains all information required by the GIPS standards, including relevant disclosures regarding the firm's performance and related policies. These disclosures also allow the firm to elaborate on the data in the presentation, providing prospective clients with a context for understanding the composite performance. The GIPS standards require that firms make every reasonable effort to provide a CP to all prospective clients.

The GIPS Glossary defines "prospective client" as: any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite.[3] Existing clients may also qualify as prospective clients for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as prospective clients if they represent investors that qualify as prospective clients.

Generally, the CP includes annual results and fits on one to two pages located in the appendix of presentation materials. The CP is also referenced on any page within the marketing presentation that includes performance or other information that supplements the data on the CP.

The Last Mile Problem

The investment management industry has automated almost every aspect of its operations over the last several decades. This automation covers portfolio accounting, performance calculation, pre-trade compliance, order management and trading, analytics, CRM and, more recently, portfolio risk modeling.

Most of this automation has been done in silos. In order to present holistic investment results to prospective clients, investment managers need to combine data from all these disparate systems. In addition to data, presentations often include insights from portfolio managers regarding reasons for purchasing or liquidating large positions or over/underweighting a particular sector. These comments are of great interest to potential clients, as they put meat on the bones of the performance data, and are often a key differentiator that influences hiring decisions by potential clients and their consultants.

But when it comes to pulling all this together into a cohesive presentation for prospective clients, the industry is still quite manual. This last, crucial step is where most asset managers are exposed to risk through human error. We call it the "last mile problem."

For example, printing reports from each silo and manually typing the data into sales materials is still quite common. At certain firms, data is downloaded into Excel and then linked into sales presentations. While this is a safer approach than typing, it still leaves the manager vulnerable to human error.

When it comes to GIPS, most firms' performance calculations are fully automated. But their processes for maintaining composites, preparing GIPS statistics and updating their CPs are still a hodgepodge of manual, semi-manual and automated steps. For example, most midsized firms use their portfolio accounting software for composite maintenance, but calculate statistical data

in spreadsheets and update GIPS disclosures by hand. And while larger firms tend to use specialized composite management systems that calculate statistics and produce disclosures, incorporating GIPS material into marketing and sales presentations still involves manual work and is far from seamless.

This last mile — inserting composite returns in CPs, updating disclosures, adding supplementary information, calculating AUM by different criteria and incorporating portfolio manager insights into sales presentations — is where investment managers are most vulnerable to risk. And since prospective clients use the information produced in this last stage to make investment decisions, it is precisely this information the regulators tend to focus on when assessing a firm's marketing and sales practices.

To Err is Human

Anytime there are human touch points involved in calculating, combining or updating performance information, there is room for error. Using a layer of spreadsheets to house underlying data and then linking presentations to the spreadsheets may seem like a perfectly reasonable automated solution at the outset, but over time these processes tend to fall apart. Spreadsheets and presentations are constantly changing in response to evolving marketing needs, and every update to a spreadsheet is an error waiting to happen. In fact, a broken link or wrong cell reference in a formula is more likely to go undetected than a manual error due to the false sense of security quasi-automation provides.

Multiply this by the sheer volume of inputs that go into a typical investment management marketing presentation and the risk exposure rises. Most firms rely on a portfolio accounting system, one or more internal and/or external analytics and attribution systems, and several Excel sheets to produce marketing information. Certain data is taken directly from these systems, while various spreadsheets calculate items such as assets by client segments, investment vehicles and even GIPS statistics. In addition, qualitative information from portfolio managers must be sourced and woven into the final presentation material.

And then there's the "recycling" problem. Once GIPS composite information is generated and CPs are produced, the data is often used to feed downstream sales materials — each of which may have its own combination of automated, semi-automated and manual processes. For example, a firm may use InDesign documents for specific composite-product fact sheets and white papers, PowerPoint for introductory and final sales presentations, and Excel files to upload performance information into consultant databases. Without automated safeguards in place, it's easy to see how noncompliance-approved or outdated composite information can slip into a sales document — and the hands of regulators.

While checklists, peer reviews, vigilant compliance oversight and standardizing materials can reduce errors, it is impossible to eliminate them, leaving investment managers vulnerable to operational, regulatory and reputational risks.

Operational Risk

In a speech delivered in December 2014,[4] SEC Chairperson Mary Jo White said, "… by 'operational risk,' I generally mean risk from inadequate or failed internal processes and systems." Operational risk includes all errors that can occur in the normal course of doing business, be it setting up new accounts, trading securities, reconciling data, producing client reports or generating information for sales purposes.

Some examples of common performance-related operational bloopers include:

- Copying a 3-year composite return number from an Excel file into the 5-year return column in a PowerPoint marketing presentation or manager database.
- Failing to include required disclosures in sales materials, be it on the GIPS CP slide or on any of the slides with supplementary information. When it comes to GIPS errors, the offending firm can be required to redistribute the corrected CP to all prospective clients who received the original, which exposes the firm to reputational risk. Trust us when we say that no firm wants to go through that process!

Using an existing marketing pitch book as the template for a different strategy presentation. A simple copy-and-paste error can result in the wrong composite information being displayed in the new sales pitch book. Another common error in this category is mismatching the benchmark and the composite returns. Let's say a firm uses their Small Cap Growth pitch book as the template for a Small Cap presentation. It's easy to cut-and-paste Small Cap returns into the existing document but forget to change the benchmark name — and/or data — from the original Russell 2000 Growth Index to the new Russell 2000 Index.

While a single mistake resulting from "fat fingering" a performance number or a broken Excel link probably won't lead to enforcement action, a series of such mistakes could signal broader issues with the firm and its operations. Operational issues are of keen interest to regulators since sound operations form the foundation for accurate marketing communications. If the firm lacks robust controls, they invite regulatory scrutiny. And, by definition, a high level of operational risk opens the firm up to regulatory risk.

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Regulatory Risk

While no investment management firm we know would ever willfully misrepresent information to gain a marketing edge, unintentional mistakes can creep into marketing materials and invite additional scrutiny. The regulatory climate has changed in the post-Madoff era; unfortunately, a few bad apples have upset the entire cart!

Examples of performance-related regulatory missteps include:

- Picking and choosing which GIPS guidelines to follow. If an investment manager claims GIPS compliance, it is on a firm-wide basis, and the SEC will make sure the firm is following all standards for all composites. With GIPS, a firm cannot pick and choose the items to conform to; it's all-or-nothing. The regulators look closely at the numbers in marketing brochures and websites, and expect that GIPS-compliant firms are including all required statistics.

- Cherry-picking past specific recommendations to add color to a performance track record. If a firm unintentionally shows only the top performers and not the detractors, it will be in violation of SEC regulations.

- Changing the time periods of returns presented. If a firm uses different time periods each quarter — for example, presenting 1-year, 3-year and 5-year returns in Q1, and then presenting 1-year, 3-year and 7-year returns in Q2 — it could be deemed misleading. To avoid running afoul of regulators, firms must have policies that address and identify a baseline of mandatory performance periods that must be included in every presentation. With such policies in place, regulators may look more kindly on the inclusion of additional time series in the presentation.

The SEC has widely publicized its data analytics capabilities, including forming specialized units that can analyze mountains of data using very sophisticated software. The SEC continues to increase the volume of data required from investment managers through rulemaking related to regulator reporting.[5] It appears that the SEC seeks to build a mosaic of each firm, and firms want their mosaic to appear clean and intact. Should the SEC call on a firm, it is in their best interest to show off operational efficiency, internal controls and a solid culture of compliance, so the regulators move on to the next firm as soon as possible.

Any action by regulators, even mere investigation with no enforcement action, is sure to tarnish a firm's reputation and raise red flags for prospective clients. Consultants who monitor investment managers are quick to drop a firm from their recommended lists at the slightest whiff of impropriety.

In addition to potential fines and sanctions, regulatory risk can affect new business revenue and existing client relationships far into the future.

Reputational Risk

Both operational risk and regulatory risk lead to reputational risk. If prospective clients see errors in marketing materials or if regulators take note of these mistakes, it will affect the firm's brand and reputation. For example:

- If a portfolio manager or sales professional notices that the displayed benchmark is wrong while in the midst of a prospective client presentation, it can throw them off and impede their ability to tell an effective story.

- Worse yet, if a trustee or consultant in the audience notices the error, it can lead to a series of embarrassing questions that are sure to derail a well-thought-out presentation. While the error might not be a fatal one, its very presence undermines trust in the firm's ability to deliver superior services.

- In the worst case, only the prospective client and their consultant notice the error, yet say nothing to the manager, who loses the finals and never knows the true reason behind the decision. In this situation, the firm goes on their way repeating the error in every subsequent presentation until someone notices and corrects it.

Operational risk can be mitigated through process improvements, use of technology and better staff training. Regulatory risk can be reduced by improving operations and addressing deficiencies cited by regulators. But a tarnished reputation is extremely difficult to recover from; as fiduciaries, investment management firms must have stellar reputations to succeed.

Automating the Last Mile

So, in the face of all these potential risks, what's an investment manager to do about going that last mile? Best practices are to automate the entire process, from the first step to the last — regardless of the size of the firm. Automation helps reduce human error, creates operational efficiencies and includes built-in safeguards that eliminate the possibility of distributing CPs and supplemental information that has not been approved by Compliance.

Getting started on automating the last mile has never been easier. There are lots of options. Firms can develop in-house software, purchase and install on-premises applications, or sign up for cloud-based services. Over the last decade, the cost of software has come down drastically and reliability has improved, so most firms should be able to find a solution that's right for them.

No matter which approach a firm takes, here are three key areas of functionality to look for:

1). Quantitative data goes straight through from source systems to the final marketing materials.

Returns and holdings from the firm's accounting system, attribution and characteristics from analytics systems and GIPS statistics all should flow straight through to the marketing presentation with <u>zero</u> manual updates. If a firm is massaging data because output from the source systems are incorrect, then the root cause for the data errors should be identified and fixed prior to automating sales communications. If data needs to be scrubbed for any reason — for example, preferring to show names of portfolio holdings in Initial Caps instead of ALL CAPS — then automate that, too.

Even calculating AUM by different criteria such as client type, geography and asset class can easily be automated. If accounts are coded by these values, then any sales communications system will be able to produce the AUM numbers.

Remember: Every human touch point increases risks and should be eliminated.

2). Checks for disclosures and mandatory slides.

Any automated last-mile solution should include safeguards against producing a presentation that does not include the most current GIPS CP slide and/or is not otherwise compliance-approved. Further, it is easy to miss a disclosure, like "Past performance may not be indicative of future results" on a page that was added

at the last moment to address performance in a current market environment. A good automated system should have built-in checks for required regulatory elements and compliance approvals, with an alert or do-not-publish default if the presentation is missing vital pieces.

While certain marketing materials such as product factsheets may seem short — typically 1-2 pages — they pack in a lot of information: composite strategy returns, characteristics, overview of the investment philosophy, investment team information and description of the strategy are typical elements. It's easy to leave out updating disclosures such the GIPS verification period when the process is not automated.

When it comes to sales presentations, be it an introductory book discussing multiple strategies or a finals presentation focusing on a single strategy, it is common to have at least 15-20 slides in a presentation. Each slide must be accurately numbered and contain all regulatory required content. A good automated system can manage this process. While it seems mundane, it is a vital step, since "supplemental material" disclosures within the presentation reference the GIPS CP slide that usually appears in the appendix. As sales and client service professionals customize pitch books for specific presentations, old slides are removed and new ones added. It's easy to end up with a disclosure referencing the CP with a wrong or nonexistent page number. This could constitute nondisclosure, so be sure any automated solution includes a solid page-numbering protocol.

3). Provides a single pool of data and content for multiple marketing purposes.

Automated solutions can help investment firms leverage the same pool of data and content beyond product fact sheets and sales presentations, a feature that prevents discrepancies across different types of marketing materials. For example, managers who serve institutional asset owners must constantly update the various manager databases maintained by consultants with returns, holdings, AUM and attribution data, as well as use the same data for completing RFPs.

A robust sales communications platform should allow a firm to automatically gather data from multiple systems, input insights from the investment team and have everything approved by various reviewers. A CIO may need to approve a portfolio manager's rationale for contributors and detractors to verify it is communicated in the context of the overall investment process. The director of research may want to approve analysts' comments on sectors held in the portfolio. Personnel responsible for GIPS compliance may need to approve GIPS statistics.

Without a last-mile automated system in place, this critical information is typically provided through a combination of quasi-automated Excel spreadsheets and manual content updates, leaving it prone to human error. A top-notch software system, however, becomes the single source for all the firm's performance-related information regardless of output format. It helps pool data from various systems, combine this data with input from portfolio managers, and then produce different types of materials, all while ensuring everything meets regulatory requirements. The output format, be it PowerPoint, InDesign, Excel or a website, shouldn't matter.

Remember: Input once, approve within the system, and only then publish it for use in various sales and marketing materials.

Trust but Verify

Automation can increase efficiency while reducing operational, regulatory and reputational risks. However, putting blind faith in technology is never a good idea. Software is only as good as its inputs. There is never a substitute for prudent checks and balances.

While sales communications software can produce materials in a few seconds, spot checking and verifying random samples to make sure all the t's are crossed and i's are dotted is good practice.

In addition, verifying how the sales staff uses the materials is something outside the scope of technology, and any organization should have a handle on how the firm and strategy information is represented.

When evaluating cloud-based offerings, verifying the cybersecurity measures of the vendor is critical. Don't just focus on systematic defenses such as multiple layers of firewalls, but also consider sound security policies and hiring practices. For those considering building the software in-house or taking the install-on-premises route, be sure there is resident expertise to create, maintain and update a secure system that can stay ahead of new cyberthreats.

Technology can help bring the last mile up to par with the automation used in the rest of organization. However, investment managers can never delegate their fiduciary responsibility to software. Firms will always need qualified compliance personnel and other professionals with the expertise to oversee processes and stay ahead of changing regulatory requirements

Conclusion

No matter how vigilant an investment management firm is, mistakes can still slip into marketing materials, leaving the firm vulnerable to unwanted regulatory scrutiny. The key to reducing human error is automation, and most firms rely on automated solutions in their performance and attribution calculation processes. But the final and most important part of the process — pulling all the required information and disclosures into a holistic marketing presentation — is still largely a hodgepodge of manual and quasi-automated events.

Automating this last mile removes human touch points from the equation to help produce accurate marketing material and reduce operational, regulatory and reputational risks in the process. There are a variety of top-notch software solutions available to managers today that pool data from various systems, combine it with input from portfolio managers, and have built-in safeguards to prevent many common errors, all while ensuring the final marketing presentation meets regulatory requirements. In order to communicate consistently accurate investment results — and avoid regulatory attention —investment managers would be well-advised to automate the last mile when producing investment marketing presentations. ✦

Endnotes

1. http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf
2. http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf
3. http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n5.1 (page 36).
4. http://www.sec.gov/News/Speech/Detail/Speech/1370543677722
5. http://www.sec.gov/rules/proposed/2015/ia-4091.pdf

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