



## Improving the Investment Management Back Office: What does it mean for a record to be fully reconciled?

Jon Anderson  
VP, Market Street Advisors  
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Market Street Advisors

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Few doubt that the asset management industry is moving into a new era. Revenues are down, investor confidence is low, and fees are likely to go lower. However, the amount of work required to support the business is relatively the same, if not increasing. As a result, what has changed is the margin that a firm can make on its business. And in this era of margin compression, the middle and back office are often burdened with expectations for restoring profits. If a firm's only strategy to restore its margins is through headcount reduction, then quality will suffer. Instead, firms should seek an operating platform that can support the complex needs of the new environment, simply and cheaply. A basic question to ask regarding any operating platform is: "What does it mean for a record to be considered fully reconciled?"

At its most basic, reconciliation will *account* for discrepancies between two sets of records. For investment managers, this typically means reconciling a custodian's records to those of their portfolio accounting system. Investment managers maintain records for performance measurement and trade order management purposes, as well as client support. It cannot be assumed that one set of records is "correct" and the other "incorrect" because the veracity of each is determined by their underlying purpose. A custodian's records are dominated by their need to account for accurate cash and settlement of securities. An investment manager's records must focus on accurate trading and performance measurement needs. In effect, both are correct when viewed individually, but can conflict when compared one to the other because they often have separate, competing goals. A custodian's records often reflect settlement date, whereas a manager's must necessarily have a trade-date focus. As stated in requirement 1.A.5 of the *Global Investment Performance Standards* (GIPS®) published by the CFA Institute, "For periods beginning 1 January 2005, FIRMS MUST use TRADE DATE ACCOUNTING."

Assuming that "the custodian is always right" does not always fit with an investment manager's needs. Instead, an investment manager may consider its accounts fully reconciled only when all differences between its records and the custodian's have been identified *and adjusted* on the manager's portfolio accounting and performance measurement systems. Simply matching a custodian's records does not insure compliance with current standards. Because of both the importance of accurate performance presentation and regulatory scrutiny, it is not an exaggeration to say that reconciliation is the foundation of a manager's data integrity.

Until recently, reconciliation has been done through a highly manual, time consuming and error prone process. While computers have sped the process of comparing two sets of records to identify differences, it has been up to the processor to note the "whys" for the breaks, and manually adjust their records as necessary; often twice, once when the break occurs and again when it is "fixed." This is further complicated when considering that different custodians often treat similar transactions differently. The back office platform must be able to easily assimilate all these differences onto one common record, and it must do so in an environment of tightening resources.

For example, here is a brief survey of how some major custodians handle transactions and cash:

	<u>Transaction Booking</u>	<u>Cash Booking</u>
Custodian #1:	Settlement Date	Settlement Date
Custodian #2:	Settlement Date	Trade Date
Custodian #3:	Trade Date	Trade Date
Custodian #4:	Trade Date	Settlement Date

Now, however, technology can be employed to significantly automate the reconciliation process. At a minimum, there are at least two requirements for this automation: an accounting system that corrects errors through the automatic reprocessing of all relevant transactions, and a highly customizable custody interface. These capabilities allow processors to focus on true discrepancies, like position breaks, and to ignore the "false" breaks caused by accounting system and/or policy differences. Additionally, the reconciliation process can be further simplified if the system is able to adjust true breaks at a global or company level, as opposed to just the portfolio level.

Here are some examples of how an investment manager can simultaneously account *and* adjust for problematic breaks. These include missed corporate action transactions, cash withdrawals, and unmanaged assets. Corporate actions are troublesome when one system misses a scheduled action, causing a break until it has been caught and fixed. Global processing can account for the problem should the investment manager miss a corporate action. However, when a custodian misses a corporate action, the discrepancies are often “noted” by the manager, with accounts effectively remaining discrepant until the custodian processes the action. This can lead to delays in finalizing performance or in trading accounts. A system that adjusts for the difference by automatically entering an entry on the side that is missing the corporate action allows the manager to present its performance and trade with confidence.

On the surface, a simple transaction such as a withdrawal request does not seem to be one that would prove difficult to account for. However, when taking the view from an investment manager’s perspective, it can effectively highlight the advantages of adjusting for differences rather than merely noting them. For an investment manager, when a client requests a cash withdrawal from an actively managed account, any amount raised to comply with the request can be considered to be non-discretionary – an account’s percentage of cash was not increased because of a strategic decision by the investment manager – yet it is often reflected as part of a portfolio’s assets until the cash has been removed from the custodian’s records. This can be particularly troublesome during periods of volatile markets. Instead, if an investment manager removes the cash from its portfolios on the requested date, and then automatically adjusts for it until it is removed from the custodian’s records, false breaks are eliminated and the performance record will accurately reflect investment expertise.

Lastly, with unmanaged assets, the custodian shows the asset belonging to the investor, however, the investment manager does not want to reflect it as part of a portfolio for trading, performance and account billing reasons. An automated process, once programmed, will recognize the asset as unmanaged and adjust for the difference between records automatically. Thus, it is not reflected in the investment manager’s records, but nor does it cause a “break” between the records because it is actively being accounted for.

In essence, being “fully reconciled” for successful investment managers means that their records reflect their needs by accurately accounting and adjusting for differences with custodians. With technology available today, this can be achieved on a daily basis through a highly automated process, placing less strain on human resources while providing other benefits, including:

- Trade Error Reduction: Because all positions in all accounts are fully reconciled, portfolio managers can confidently trade from correct positions.
- Accurate, daily performance: Since flows are properly recognized on the day they occur, performance calculations are the most accurate possible.
- Increased client responsiveness: All positions in all accounts are fully reconciled. Therefore, current performance can be calculated, and clients can be provided with the most accurate daily reports.
- Simplified regulatory compliance: Accurate, timely data makes it easier to respond to regulatory discovery requests.
- Lower Cost: The high level of automation described herein will lower labor costs without lowering service levels while increasing data accuracy.

Assuming the existence of an electronic custody interface, accurate, daily reconciliation provides many benefits ranging from the reduction of trade errors to the timely creation of performance reports. With the right technology, manpower should not be a limiting factor. When a highly automated reconciliation process is driven by an intuitive user interface (UI), the result is an intelligent work flow that supports data integrity simply and efficiently. Purchasers of middle and back office systems and services should remember this. While data accuracy is a paramount concern, the timeliness and accessibility of the data across a firm is of equal importance for both cost efficiency and customer support. This is further complicated when considering the ever-increasing compliance and regulatory demands the investment management industry faces. Here again, timely, accurate, and accessible data will be a hallmark of successful firms.