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Reputation is key

Setting rules is all well and good; asset managers are required to comply with a number of industry regulations established to act as safeguards against the misappropriation of a fund's assets; yet fraud and theft still occur when these regulations fail or are not followed. What controls exist within an asset manager and how 'safe' are these 'safeguards'? Even more importantly, what role does internal culture play in the manifestation of an ethical approach to investors and the decisions that very few investors are privy to?

Does the fund do what it sets out to and the role of independent trustees in ensuring adherence to investment mandates

Investment parameters consist of guidelines and restrictions imposed either by the client, by regulations, or the asset managers' own internal investment rules. For example, a limit on the amount of equity in a fund might be set. Fund managers are obliged to invest accordingly, and are obliged to disclose how they are invested which assists investors to monitor the investment portfolio to ensure the parameters are adhered to.

Every unit trust is compelled by law to appoint an independent trustee who looks after all the assets the unit trust owns. The trustee is usually a bank or a financial institution that is not affiliated to the unit trust company or its asset manager. Every fund has a mandate or legal contract that sets out its investment aims and how it intends to invest to achieve these aims. This covers a range of issues from return objectives and performance benchmarks, to liquidity requirements, fees and specific investment parameters with which the fund manager must comply.

The trustee ensures that the asset manager adheres to the fund's investment objective and safeguards the unit trust assets. In addition, in terms of the Collective Investment Schemes Control Act that regulates unit trusts, funds are prohibited from taking certain risks. For example, they may not invest more than 10% of the fund's money in the shares of unlisted companies and they may not invest in any one class of the shares of a listed company more than 5% of the market value of the portfolio, where the market capitalisation of that company is less than R2bn.

Investment selection – adherence to rigorous fundamental analysis and investment discipline

Then, within the overall parameters, fund managers need to select individual investments. This should be done according to a rigorous process. In Allan Gray's case, the equity investment process begins with a painstaking fundamental analysis of the company. This analysis must pass the scrutiny of an investment committee before it can appear on the firm's 'buy' list.

Independent trading and allocations

The trading process is also extremely important. Trading must be independent, most importantly there should be no conflicts of interest between the asset manager and the stockbroker executing the trade. Asset managers should have no financial interest in the stockbroker, either direct or in the form of 'softing' - a harmless sounding term that actually refers to the practise of a stockbroker paying a portion of the fee paid by the unit trust (the client in this circumstance) to the asset manager. Finally, because asset managers typically manage a number of funds, it is critical that trades should be allocated to clients' portfolios using a fair process as applied by a separate allocations department. This ensures fair allocation of best ideas and similar performance being enjoyed by clients with similar mandates.

Compliance processes

Compliance should be monitored on a number of levels on a <u>daily</u> basis and any transgressions of the investment parameters including those caused by market value movements should be highlighted (as Allan Gray does). An independent compliance department should prepare a transgressions report which must be provided to the independent trustee, and together ensure that the correct course of action is taken to resolve each transgression.

But while proper procedures and processes are important, ultimately reputation is the best protection for investors. Aside from the ethics involved, the reputational risk that accompanies untoward action is a powerful incentive for an asset manager to monitor and prevent this. Good asset managers understand that the single most important precondition for operating a successful investment management company is the trust of its clients.

In conclusion, investors should take time to find an asset manager that not only has the necessary regulatory licenses, processes and procedures in place, but also has a track record of investment excellence and a reputation for transparent and ethical behaviour.

Commentary by Greg Fury, Chief Operating Officer, Allan Gray Limited