

custody

In custody

Employing an investment custodian can be a beneficial experience for charities, particularly when done well. Stuart Anderson finds out what charities need to consider when choosing a custodian to look after their assets

If your charity employs a fund manager, as opposed to investing through pooled vehicles, you should give consideration to your custody arrangements. It's not the most exciting element of what is already a pretty dry area, but a good custody arrangement can deliver real economic and governance benefits to the management of a financial portfolio.

At its most basic, a custodian (usually a dedicated arm of a large US or European bank) looks after your assets. While investment managers decide what to buy and sell, the custodian holds your share certificates, property deeds, cash etc, and executes and settles trades as instructed by the fund manager. It is also responsible for informing you of opportunities, as a shareholder, to cast your vote – and for casting it, as your proxy, in accordance with your wishes.

These are known as “core” services – and the big custodians can carry them out, either directly or through a global network of sub-custodians, in all the international markets in which you might invest. Custodians can also provide a range of value-added services (see box), ranging from reporting on managers' performance and compliance with their mandates to sweeping unused cash into interest-bearing accounts and even arranging the loan of assets to other investors (securities lending).

Smaller charities that invest only in pooled funds will already have custody of their assets bundled into the package but anyone employing an asset manager directly to manage their funds according to an individual “segregated” mandate will, in some shape or form, already employ a custodian.

Adding value

Until the mid-1990s most investment

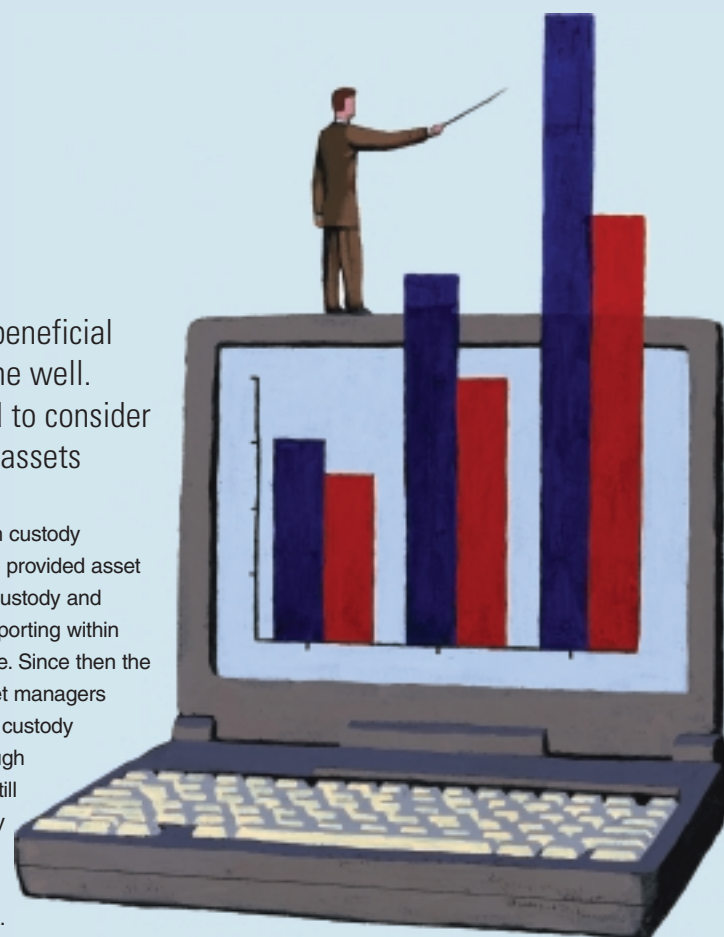
houses also ran custody businesses and provided asset management, custody and performance reporting within one catch-all fee. Since then the majority of asset managers have exited the custody business – though they will often still arrange custody for clients through a “nominee” bank.

There is now, though, an increasing trend among institutional investors to employ a single independent “global” custodian to look after all of their investments. In general this is something at which those charities large enough to employ segregated managers – usually with funds in excess of £50 million – should be looking, although size is not the only consideration.

According to James Brooke-Turner, assistant director (finance and administration) at the Nuffield Foundation, though: “If a charity has moved to a multi-manager structure, with a number of segregated mandates, it will need to look at appointing its own independent custodian.” The Nuffield Foundation has employed Northern Trust in this capacity since 2003.

Another Northern Trust client, Tom Sterry of the Henry Smith Charity, agrees: “It's more a question of the number of investment managers you employ than the size of your fund. If you have a few then it can be quite good – if you only employ one or two then it probably doesn't add a great deal.”

Some custodians would balk at admitting they were of little value where a single segregated manager is employed, but all would agree that a multi-manager,



single custodian structure has a number of clear advantages, not least of which is the ability to see your entire portfolio on aggregate and receive performance reports on a standardised basis.

Nuffield's Brooke-Turner would concur. He says: “All the pricing data comes from one common source and we can also be much more specific on the presentation of reports than when they came direct from the investment manager. For instance, we can now see performance net of fees. The data isn't being presented to us by someone who has a vested interest in making it look better than it is.”

Quality and transparency of reporting are increasingly important, claims Lucille Knapp, head of wealth management for Northern Trust's EMEA operations. She says: “This has largely come out of the pensions industry but the trustees of a charity are now more likely to ask searching questions about its investments and finances.”

Benjie Fraser, managing director and head of European pensions at another custodian, Bank of New York, agrees: “The advantages to a charity of employing a custodian are the same as those enjoyed by pension funds and are a result of being

custody

in a position of trust. They include transparency, safekeeping and independent record-keeping.”

Compliance monitoring is another of the “value-added” services most suited to the charity market, which is more likely than other institutional investors to place constraints on its investment mandates. René Wiegel, head of relationship management – Europe at custodian ABN AMRO Mellon, explains: “Charitable foundations are cautious about where they invest. They obviously don't want a scandal because of investments in the ‘wrong’ industries. A charity that funds research into healthcare would not want to risk being discovered to have inadvertently invested in a tobacco company, for example. This is why compliance monitoring is such an excellent tool to monitor the mandates of investment managers and to notify any breaches.”

Less relevant to the majority of, even relatively large, charities are services such as securities lending and commission recapture. These normally require a substantial fund to generate much in the way of income – although Alisdair Reid, head of asset owners for State Street (whose custody clients include the mammoth Wellcome Trust) claims they should not be dismissed out of hand.

“Securities lending requires a certain critical mass but it's not just a question of

the size of your fund, it's also the nature of the shares you hold,” he says. “A relatively small fund, if its assets are in demand, can get involved.”

Another useful by-product of employing a single custodian is access to transition management. Northern Trust's Knapp explains: “If you sack one fund manager and appoint another the custodian can make sure that the process runs smoothly, that the account with the old manager is closed and all the money transferred to the new one.”

Charging structure

How much, though, will all of this set you back? Core custody costs are split into two: an annual safekeeping charge, based on the value of assets under custody, of between one and two basis points (0.01-0.02 per cent) and an additional charge for each transaction carried out. These core charges will often vary depending on how much money the custodian believes it can make out of you from value-added services – which all attract an additional charge.

One custodian willing to divulge its fee structure is KAS Bank – a big player in the Dutch domestic market that has recently moved into the UK, where it is focusing on smaller institutional investors. A £100 million fund in the UK could expect to pay KAS an asset fee of £10,000 per year and a per-transaction fee of between five and

ten pounds. KAS includes investment accounting in its core fee. Among added-value services it charges around £2,500-£3,000 per fund manager for performance measurement and risk analysis.

The custody sector has consolidated over the years to the point at which, as Nuffield's Brooke-Turner puts it: “Selecting one is an unenviable task, with little to choose between them except the colour of their ties.” Once appointed, however, it is always worth keeping your relationship with your custodian reviewed. Actually changing them is a laborious process, to be avoided unless, for instance, your investment managers are consistently reporting an unacceptable level of failed trades. The market, though, is increasingly competitive and reminding your custodian of this fact may help you negotiate a better deal than you originally signed up for.

Cost, though, is just one part of the equation when appointing or reviewing a custodian. Although core services are much the same it is important for you to be happy with your custodian's credit rating and security. Most important of all, though, you have to be happy that the custodian you employ takes you seriously. Charities are never going to make up the core business of any custodian but the existence of other non-profits on their books should give an indication that they are in it for the long haul.

Value-added services

Investment accounting. Although custodians recognise the provision of relatively detailed reports on the assets held in your portfolios as a core requirement, this is often charged for separately as a value-added service.

Cash management. Running an investment portfolio always generates some redundant cash – custodians offer a range of options for the short-term investment of this money.

Commission recapture. Convincing the investment banks to whom your fund managers pay brokerage commissions on your behalf to return some of that commission in return for your continued business.

Compliance monitoring. Custodians can programme investment guidelines into their systems and report back if fund managers breach them.

Regulatory reporting. Custodians should offer a variety of tools for the generation of reports required by national regulatory authorities.

Performance measurement. Employing one custodian to hold all your assets means they have all the information necessary to provide benchmarked reports on your fund's performance.

Securities lending. Involves selling a proportion of your share holdings in a given company on the understanding that the borrower will resell them to you on a given date at an agreed price.

Transaction cost monitoring. Custodians can report on costs incurred by managers when buying and selling investments, e.g. broker commissions.