Willis Towers Watson PODfolio_episode_4

Are the asset managers coping?

[MUSIC PLAYING]

JOSH HALL: Investors don't get paid for taking operational risk.

SPEAKER: Welcome to the PODfolio, Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolio.

LOK MA: Hello, and welcome to episode four of the PODfolio podcast. I'm your host, Lok Hall. With me, we've got Josh Hall from our New York office. He is our global head of operational due diligence. And what we're going to be talking about today is around how well the asset managers are coping through the COVID-19 crisis and whether there are any things an investor needs to be worried about.

Now, obviously, we're living through some pretty unusual times. The investment markets are being very volatile. To be honest, we have seen big falls in the market in the past. This isn't the biggest one. What feels a little bit unprecedented is the speed at which some of these things are happening. And of course, what feels very unprecedented at this current time for the investment industry, at least, is that we're trying to deal with this crisis whilst working under some very unusual conditions as well because of the need for social distancing and the need for working from home.

And I think it's that double whammy of very unusual market conditions combined with very unusual working conditions that feels like something that none of us really has experienced before. So Josh, welcome to the show, and thank you very much for your time. Are the asset managers coping in general with this double whammy?

JOSH HALL: Thanks very much, [INAUDIBLE], for inviting me to this. Much appreciated. Managers are being challenged operationally in a number of different areas throughout this crisis. There are technology issues because of what you just mentioned, the unusual working conditions. Security valuation is challenging in certain strategies. There's increased counterparty risk and additional operational risk because of stressed service providers.

But for the most part, from what we've seen, managers are coping fairly well. From a technology perspective there was kind of this slow roll out for some in the beginning of this crisis, but everyone seems to have the equipment they need now to work from home. We have heard of minor problems ranging from issues with third-party teleconference providers, lack of home equipment, brief connectivity issues, but all seems to have been resolved in the last few weeks.

We do see some managers struggling with some of their counterparties. So administrators may be slow to publish navs, trading counterparties may be slower to post collateral, et cetera. We often forget that there are counterparties and service providers that asset managers rely on to conduct their everyday business. And so by extension, we also need to concern ourselves with how those businesses are coping with the pandemic as well.

LOK MA: And if I think about the people that are working at an asset manager, is it the case that everybody is working from home or are there some people who really have to be on the site to make things happen and make the trades happen?

JOSH HALL: Yeah. It really varies based on the size of the firm, the strategy of the firm, where their offices are located. If I truly generalize, I'd say, for the most part, we see some facilities management going to the office for general maintenance-- picking up the mail, things you'd expect. The IT professionals here are pretty crucial. They need to go in, check on the servers, address any issues so that the rest of the world can continue to operate remotely. And in some cases, we see some of the traders going into the office, depending on the investment strategy. But this seems to be more of a function of their own personal preference. So they may prefer to be on-site because they have access to their six monitors as opposed to their home setup where they only have four monitors, so a nice-to-have thing.

LOK MA: So the majority of people, then, working from home, apart from these IT professionals and traders by preference. And what are some of the unique challenges brought about by COVID-19 and by this need to be working from home, then?

JOSH HALL: Yeah. In addition to dealing with the investment and market-related challenges, putting pressure on performance, putting pressure on liquidity. There are a number of operational challenges that are also bubbling up. So what you mentioned right at the beginning, where everybody is working from home, this is an untested situation from a business continuity perspective. Most firms do periodically check their disaster recovery plans, but it's usually with a portion of their workforce, not having their entire workforce log in remotely, again, causing those connectivity issues. We've seen some firms scramble to upgrade firewalls to try to increase bandwidth to manage the additional traffic.

One big area that I would highlight is cyber crime. Cyber crime has ramped up and is one of the biggest risks we're seeing right now. There's an increase in ransomware attempts, there is an increase in attempts at identity theft over the phone, so hackers trying to get people to click on COVID-19 related links or to get employees to give out personal info. And all of these risks are being exacerbated by the weak security with home setup, so think about routers, password policies, outdated software at the at-home setups, Wi-Fi security. So really this cybersecurity is kind of a critical area right now. You also have to consider that firms are doing cash movement and wires from their home setups. Previously, the home setups haven't been paid attention to much because they were a temporary solution, so I'd say we're seeing some material vulnerability there.

So the last thing I'd mention is there are some processes and procedures that were previously manual in nature which have been difficult to perform as managers scrambled to automate and use technology more. So it may sound silly, but businesses are still writing paper checks to pay vendors, and those checks very often need two signatures. So the challenge of getting someone to draw up a check-- a paper check-- get signature one then scramble around to get signature two and then mail it to the vendor, something as simple as that now has become a challenge.

LOK MA: Yeah. I'm particularly interested, Josh, by what you just said around cyber security concerns. I dare admit it's given me some food for thought. How many of us have actually reviewed our Wi-Fi security when we went into lockdown and started working from home so much more? I would suggest probably not many. So, certainly for me, after this call I'm going to have somethings to think about and maybe look into.

One of the things that I've been wondering is around how well the investment industry would have coped if this COVID-19 had hit us 10 years or even 5 years ago without all this technology present.

JOSH HALL: Yeah. That's a good question. I think managers just would not have been prepared to function remotely. I think business continuity has always been a focus of operational due diligence groups but I think, really after Hurricane Irene hit New York, you saw a bigger push by people like me, by ODD groups, to get asset managers to adopt best practices with regards to business continuity, disaster recovery, cybersecurity. So in our vetting process, we have really forced asset managers to be more prepared. Business continuity and cybersecurity is a criteria by which we judge all of our asset managers. And if they're not up to speed, that might actually prevent clients from adding that asset manager to their portfolios. So the short answer is, not very prepared 5 to 10 years ago but much more prepared today.

LOK MA: Good, good. And if I think about the role of an operational due diligence team-- this is my understanding-- is your team go into the asset managers and scrutinize their internal processes and to flag up any concerns you have around the possibility of failure. Can you just give us a sense of what are the kind of scenarios that you're trying to prevent? In other words, what's the worst that can happen if these processes do fail?

JOSH HALL: Yeah. This is why I exist, I think. This is why my profession exists. Asset managers, when they're under duress from enough number of different perspectives, whether it's market impact on the strategy, inability to manage their operations remotely now, investor outflows, counterparty risk or failure, it's during these times when we see these immense pressures cause asset managers to engage in riskier behavior or, even worse, just act badly.

So the previous credit crisis, we saw increases in insider trading activity, so think Galleon. Fraud, think about the mortgage securitization industry, and it even uncovered Ponzi schemes. So Madoff was in business since, I think it was 1960, and it all was flushed out during the credit crisis. So unfortunately, I think it's in these times where we see the desperate attempts to save businesses, whether that means bending of compliance rules where managers may take more risk to make up for losses or managers may utilize leverage in excess of what they're allowed to.

I can point to the regulatory activity right now. There appears to be an enhanced focus on insider trading given the market turmoil and ongoing disruption to routine processes that both the FCC and Department of Justice have sent messages about the importance of not abusing and trading on non-public material information. So we've already seen senators in the US accused of selling securities based on classified briefing on the threat of COVID-19. So it's not uncommon for asset managers to come in contact with material non-public information during the normal course of their investment research process. And so with managers suffering performance-wise, inside information, this is the time where it might be misused to stem the bleeding. So the risk is really heightened right now.

LOK MA: And, sorry, Josh, obviously I know you can't name any names, but can you just give a sense, are there any managers that you're now starting to have some more serious concerns about that you might not have had going into this period?

JOSH HALL: Yeah, I can be pretty general here. I think managers with relatively low AUM or lean infrastructures right now are presenting potential sustainability risks, so we have our eyes on them. Managers running liquid portfolios where they can be used as an ATM by investors seeking cash, we have to monitor their flows as well. And then I'd say those strategies with illiquid portfolios that don't have the proper investor redemption terms, who may be forced to suspend trading or set up side pockets or liquidating share classes, those we're keeping our eye on.

I think real estate strategies are especially challenged right now, specifically the open-ended real estate funds. By nature, these portfolios are very illiquid. The added uncertainty of the effect this will have on real estate valuation, on the ability of property managers to function, on the ability of tenants to pay their rent-- all of which may impact the cash flows for the real estate managers-- makes for uncertain times.

LOK MA: And so tell me if you can't say. I'm going to push you a little bit. Is there any manager where your finger is kind of poised over the ODD fail button that you're very close to giving a [INAUDIBLE]?

JOSH HALL: Yeah. I will-- so in mid-March, we started a massive exercise to get our heads wrapped around any increased operational risk with all of the managers we cover as a result of the pandemic. So that exercise involved a conversation with each and every manager to discuss any issues they were facing with their business continuity, all the things that we talked about-- the valuation of their portfolios, counterparty risk, redemption pressure. We've been conducting this exercise every two weeks and will continue to do so for the foreseeable future, which, as you can imagine, is very exhausting.

LOK MA: And this is because of what's happening now, right?

JOSH HALL: That's right. Yeah. Normally we would talk to a manager probably annually. This is now an every two week exercise. But as a result of this ongoing exercise, there are a number of managers we're keeping our eye on more closely, and we're in constant dialogue with our portfolio management group about. And yes, I can tell you that as a result of that exercise there have been some managers who have been downgraded, and that, of course, means that clients will redeem from those opportunities. And there may be more in the future.

LOK MA: And do these include our preferred rated managers, so to speak, or just managers in general?

JOSH HALL: So this exercise is being conducted on our preferred manager population. Yes, the entire population.

LOK MA: And given how serious some of these nightmare scenarios are that you mentioned-- cases of fraud, insider trading, even money going completely missing as opposed to taking a drop in the value-- I would imagine you need to be fairly cautious in your assessment. So you're not just failing people when you're expecting them to have a problem, but potentially where they can potentially have a problem, you would still also have to fail them. But at the same time, of course, if you do fail somebody, there are some pretty drastic consequences as well for the asset manager, but especially for the investors who might then need to pull money out of some of these places. So can you just give us a sense of where you need to draw that line in terms of erring on the side of caution?

JOSH HALL: Yeah. It's a difficult question to answer but I can somewhat sum up how cautious we are in pretty much one statement. Investors don't get paid for taking operational risk. But with that in mind, most ODD professionals tend to be extremely cautious. There are thousands of investment managers to choose from, and many of them have robust, industry best practice operational environments. So why would we, as ODD professionals, allow our clients to take on added operational risk with those managers who don't have robust operational environments when there are so many managers that do?

Now having said that, I think it's important to point out just how subjective and qualitative an ODD analysis is. There is no check box or magic formula that can tell you whether something is too risky or not. It's really up to the ODD professional to assess the risk tolerance of its client base and to exercise their best judgment on whether or not to pass or fail the manager.

LOK MA: And finally, Josh, there's a lot of talk in the media about how, when we emerge from the other side of this COVID-19 crisis, that lots of ways in which we live our lives will be different. In a professional context it might mean more remote working and all that kind of stuff. How do you think the ODD process itself, in terms of how you go and look at some of these processes, how do you think that might change over the longer term as well?

JOSH HALL: I think you're right, [INAUDIBLE]. I do think more people will likely work from home, as the current situation proves that firms can be just as effective with their day job working remotely. We'd probably like to see firms continue to pay increased attention to testing and improving their disaster recovery and cybersecurity preparedness, and we look forward to working with them on that. I think that doing ODD, the actual process of conducting ODD, might be challenging going forward. So a big part of what we do is the on-site due diligence that offers a number of benefits, from interviewing people firsthand to doing some direct observation and trade demos, and things of that sort, which we obviously can't do in the current environment.

But we're finding workarounds. We can still do third-party verifications, and we have been doing virtual observance and interviews. But there is an adjustment, and we'll continue to refine it going forward.

LOK MA: Well, thank you very much, Josh, for your time. And from my perspective, I think my personal takeaway is I'm going to now just have another look at the security of my own Wi-Fi system. And I would suggest many of the people listening at home are probably in a similar situation as I am as well. So we hope you all enjoyed listening to my conversation with Josh. And do check back to a future episode of the PODfolio podcast. In the meantime, do you take care of yourselves. Thank you.

[MUSIC PLAYING]

SPEAKER 2: You've been listening to a Willis Towers Watson podcast. For more information, visit WillisTowersWatson.com.

[MUSIC PLAYING]