CAP GEN

Practical Capital

Safeguarding and futureproofing your family office

2023

Welcome to Practical Capital, our guide for family office executives.

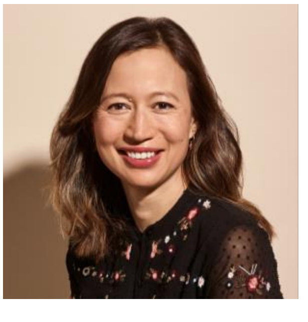
As any insurance broker will tell you, people often only think about paying the right price for protection once the risks of a problem have increased. The rest of the time, when the environment is benign, the last thing we might expect to spend time and money on is planning for disaster scenarios. But while we at CapGen may be natural optimists, we are also – crucially – pragmatic about the responsibility of managing other people's money, and the various ways in which we need to protect their interests. Some of them are obvious, but others less so. We all know about the importance of fund fees for example, but our legal team will also negotiate side letters about what fees would be payable in the event of a fund wind-up. On the investment side, we all know that global diversification is important, but if you don't make sure that your fund managers are sourced from all over the world as well (as we do) then you can end up with a globally diversified pool of managers who all went to the same London business school. Risk is a surprisingly mercurial concept, and its rarely the obvious ones that cause the most trouble.

What's more, the banking crises we saw in early 2023 may not mark the end of the risks to the banking system. We've seen further noise from a UK bank in recent weeks, and the prospect of structurally higher interest rates and tightening liquidity mean that those risks are likely to remain elevated. That's why in this issue, we've looked at everything from operational due diligence in banking and portfolio management, through to step-by-step guides to follow in the event of a liquidity crunch.

This issue of Practical Capital is all about futureproofing and safeguarding your operations; from the basics, right through to the nitty gritty of how and why problems can occur, and what you can do about them. These are the kind of structures that can give you the freedom to work in the knowledge that you have done everything in your power to protect your family office from the major risks out there today.

As ever, we hope you find this guide interesting, engaging and above all, useful.

Richard Adams
Partner, COO & Compliance Officer



Hiroko Atherton
Partner, General Council

Banking: Knowing your risks and how to manage them

The banking crises of early 2023 have reminded everyone that the unthinkable can happen – major banks can (and do) fail. So what happens when the mainstay of your financial infrastructure looks vulnerable, and what can you do to protect your assets? Here, we explore these questions and more.

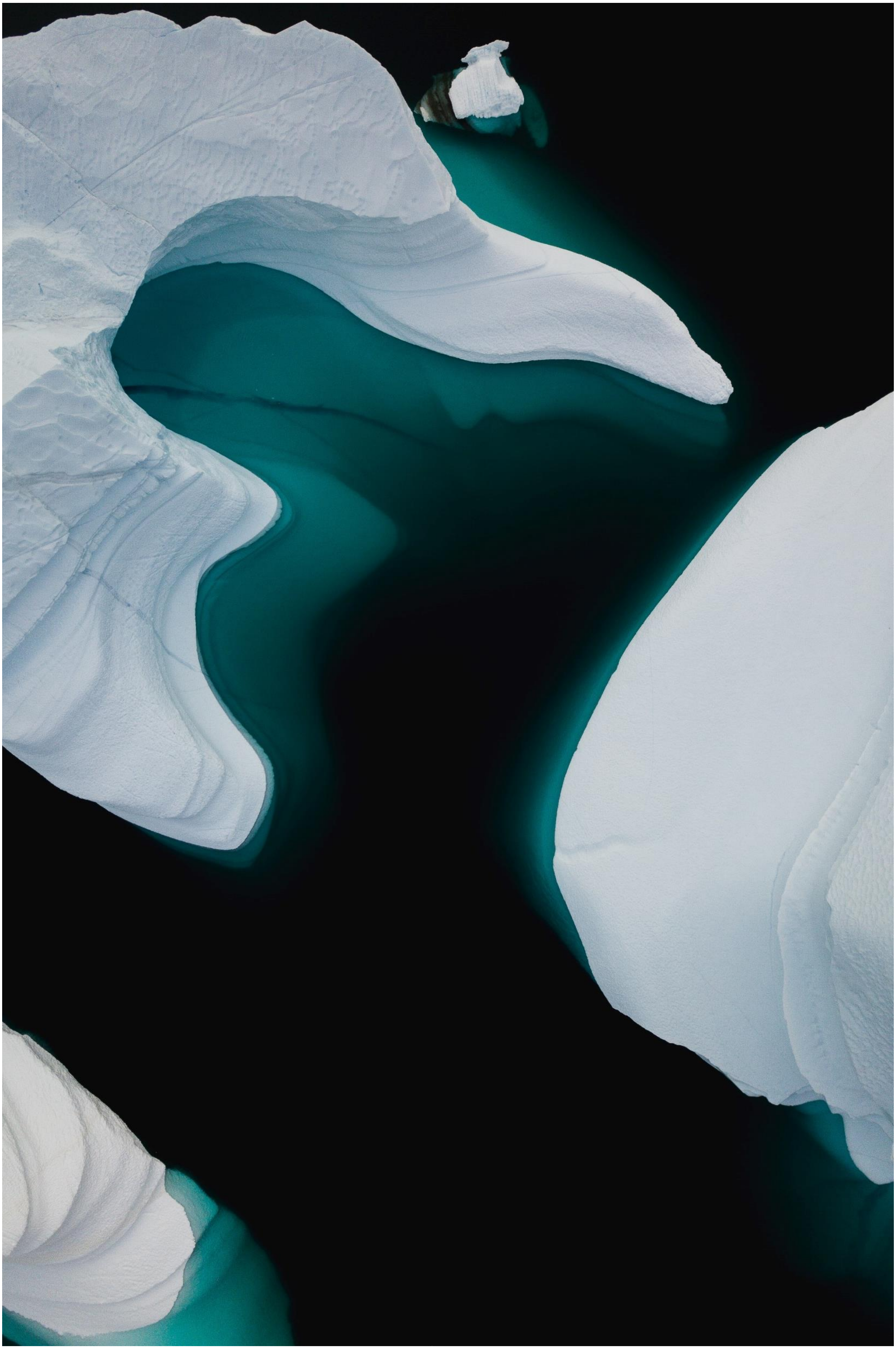
The first difficulty you have when finding a banking partner, is that there isn't really much choice. Custody and banking as a service can look very similar across all major providers, barring the often surprising differences in underlying costs. The second problem, is that custody and banking is low margin business, and that means that banks need to find other ways to make money out of you. Even more so since capital and regulatory burdens have increased the cost of doing business. If you don't give your bank enough revenue – through FX business, cash deposits or credit lines – or if you're simply a higher-cost client to serve, then it's not unheard of to have your credit line removed, or to simply find your bank unresponsive to your service. When it comes to banking, that can mean you have to strike a balance between diversity of exposure and having enough capital with each bank to maintain a meaningful relationship, not to mention making sure that you have the time and bandwidth to work with more than one bank – which can be time intensive.

Top Tip

If a bank says they need to manage all your assets in order to offer you or your client the best deal, it is often worth looking elsewhere. We have often found that deeper levels of due diligence show that an attractive-seeming initial fee will be clawed back elsewhere through hidden costs.

Paying up for protection

So we know that in most cases, you're going to have to select one custody partner to work with for operational ease and in order to be able to negotiate the best fee terms. That means that the pressure is on to get it right when it comes to due diligence. While price doesn't always determine quality, one thing that we found in our own search for a banking partner when setting up our discretionary platform, was that some of the banks with higher upfront custody costs offered better levels of protection against potential losses and other risks. For example, more client favourable indemnity language in client contracts, deeper pockets/higher indemnity caps in the event of a claim and better segregation of client cash and assets from other clients and the custodian's own assets in the event of the bankruptcy of the custodian. The more competitive deals often had low indemnity caps combined with client cash and assets being held in pooled accounts. Price may not always determine quality, but the reality with banking is that your custodian and bank is a business just like any other, that needs to make margins in order to stay afloat. In a nutshell, they will be making money off you somewhere, so sometimes it's better to pay that money up front in the knowledge that you're getting a fair fee for a fair service.



Doing due diligence on existing relationships

While due diligence on a new banking relationship is critical, we also know – given the ways that the risk landscape is constantly evolving – how important it can be to conduct due diligence on your existing relationships. This extends not only to your primary provider, but also to any banking relationship that could cause you risk. Here are some of our top tips for looking under the hood of your banks:

01 Look at your exposure to different banks; do you know what you're invested in, does your portfolio look balanced from an operational/counterparty risk perspective (as well as an investment point of view of course), do all your funds use the same custodian? What are the risks and the subsequent action points?

02 Understand the differences between when your cash is being held under regulatory client assets rules and when they are on deposits on a bank's balance sheet.

03 Understand and make a note of when deposit protection schemes apply and when they don't, including who's eligible and who isn't.

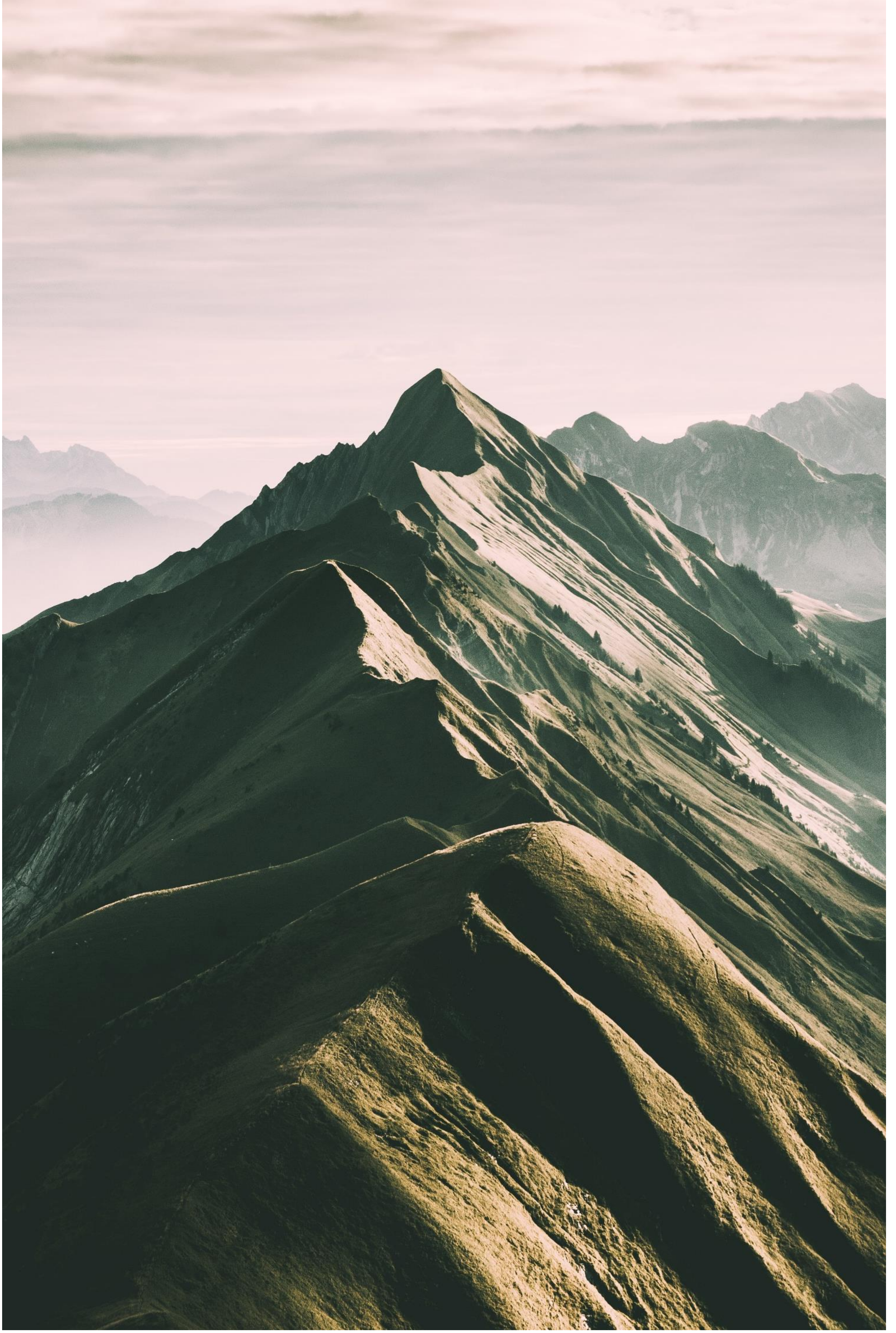
04 Look at the protection of cash assets – how and when banks and/or custodians are required to ringfence under client money rules.

05 A good resource to look through is the ISAE3402 international standards report – which highlights that the bank has fit and proper processes.

Banking in an investment management context

Equity markets might be largely flat (barring the initial success of the AI mega-cap stocks) so far this year, but the environment is far from benign. Liquidity is tightening, rates and inflation are structurally higher and geopolitical risk remains elevated, all of which means that it's an important time to keep an eye on portfolio risk. Often, investment managers will focus on macroeconomic risks in this kind of environment – we do as well – but this piece is about the structural and operational risks that are posed by tougher environments, and what you can do about them. Here, we've covered a long list of questions to ask when you're doing a risk assessment of the structure of your portfolio holdings.

More specifically, we're focusing on banking relationships, not simply in the context of direct holdings of cash, custody, FX and lending - which tend to come to mind first - but in the context of indirect exposure to banks and the banking and custody system through funds and other investment products. In practice, this is an area of risk in which the underlying investor has little control; it is up to the fund or product manager to determine how they work with their own counterparties. Nevertheless, our view is that a known risk – even one that is beyond your control – is better than an unknown one. A known risk is one that can be monitored and pre-emptive protective action taken where possible and appropriate.



Here, from our perspective, are a few of the ways in which risk-savvy investors can think about banking in a portfolio context:

01

Look at your portfolio as a whole

As tempting as it is to look at fund holdings on a line-by-line basis, in order to determine where are you exposed to particular banks, it pays to look through to the underlying banking providers. For example, do the majority of your funds bank with the same provider? If so, there is a potential risk there and it is particularly important to drill down into what their client protection terms are.

02

What is negotiable

When looking at fund terms (bearing in mind what's negotiable and what's not) it's worth pausing to consider what you can unintentionally opt into for a better rate. For example, are more favourable economic but less liquid terms actually worth the risk in the context of a fund structure that does not offer decent terms on protection of fund assets and cash? Do you shore yourself up for an unlikely Armageddon event or do you go for the higher returns? We consider specific legal protections to try and negotiate separately below.

03

Dig deep

It may seem obvious, but your operations due diligence should cover more than just who the banking and custody service providers are and whether they are reputable. How do your managers look at cash in their funds, what is its role and to what extent given the investment strategy of the fund? For example, is it in money market funds or are they lending against it? It's important to do this so that you can get an accurate sense of your real liquidity and whether something is a technical or real risk.

04

Learn to live with the risk

Everything in your portfolio has a banking risk, they underpin everything, in the end when FTX goes bust it does so in the same way as a bank. Knowing the risks you're exposed to includes knowing what your liquidity rights are on these investments and how they work in detail, gates, distributions in specie, partial distributions. There is a multitude of factors that determine how quickly you can redeem; notice periods to meet a trade date, redemptions over multiple NAV points, gates or holdbacks. These can leave you exposed to the asset (and its counterparties) for many months after you choose to redeem, so it's important to be comfortable with those risks from the outset. Once you have done your due diligence and negotiated the best terms you can, the next steps are monitoring and having a plan.

05 Have a plan

Where are the pinch points in your portfolio due to certain funds being more exposed to the custody and banking sector in the event of a downturn than others? If there was a market meltdown affecting a broad range of asset classes, have a priority list of what would be most likely to become illiquid or otherwise lose value and who would you talk to first. Managing the risks is an ongoing process of due diligence on investment, quantifying the risks, obtaining transparent reporting, monitoring on an ongoing basis and being prepared to take swift but considered action in the event of market or product difficulty.

06 Manage liquidity ahead of a crisis

Managing liquidity so that your investment portfolio has the ability to weather a crisis is key. It's important to know how much you need and for what purposes, and where this is going to come from if your assumed liquidity events from other fund assets do not happen or are (more likely) delayed. You may have private equity commitments to meet, you might want to deploy capital at attractive prices when markets tank, or you also might know that in the event of a crisis you'll simply want the emotional security of having capital that is less affected by market turbulence. It's important to try and avoid being a forced seller of any asset, particularly in a falling market. If you have capital calls to fund in the future, for example, it can be worth putting redemption orders in early in order to have the capital ready at hand when you'll need it and being mindful of which funds in your portfolio have the ability to limit liquidity unexpectedly. This is something that we recommend doing on an ongoing basis as the market changes over time.

07 Cash is [not] king

Furthermore, when the market looks risky there's often a temptation to see for cash as a simple safe haven, but in terms of both investment and structural risk, that's not always the right thing to do.

- Money market funds have taken in huge flows in 2023 under the guise of safety, but breaking the buck can happen, they were all triple AAA rated when that last happened. There is around $7trillion in money market funds at the moment, but half of them are b rated corporate paper.

- Our view is that short-dated government paper is more efficient, but it takes more due diligence, time and expertise to manage.

Legal protections for product holders

The more sophisticated the investment strategies that you invest in, the more complicated the underlying legal structures can be. Our legal team has spent decades analysing fund structures and the ways in which investors can protect themselves against undue risk. Here, we have put together a brief guide into the nuts and bolts of legal risk in fund products.

The first question to ask is, do you know what you actually hold, have you looked under the bonnet? Then there are obvious things like investor protections, looking for concrete limits on investment scope, concentration and borrowing and checking service providers, but this is only skin deep. Let's take a hedge fund for example, it may be based in Cayman and structured as a limited liability company. Typically, it will offer minimal investor voting rights, a very high leverage cap only if caught by AIFMD and no concentration limits or binding investment scope. This is market standard, and to some extent arguably required to allow hedge funds to invest in the way they need to generate the expected levels of returns. These are known risk that can be mitigated by monitoring them over the life of your investment.

What is less obvious is the nuts and bolts, which can have wider repercussions if things go wrong.

Here is a non-exhaustive list of things to look out for:

01 Not only who the custodians are but how they hold fund assets. How does the fund hold cash, does it sweep it across to a separate account overnight, can it use the cash as security in respect of other activities?

02 Which counterparties are you exposed to? Prime brokers, banks, custodians, over-the-counter derivatives? Are you invested in multiple hedge funds that use the same counterparties, thus giving you a larger indirect risk than your line-by-line breakdown would suggest?

03 Operational due diligence; assess the internal risk monitoring, oversight, reporting and expertise of the team. Is decision making concentrated or are there lots of checks and balances? Is there significant key person risk? In essence, do you have a good enough idea of how the fund works on the inside and what drives its decision making and risk processes.

04 What does a fund actually hold? Complexity increases the potential number of counterparties you're exposed to, particularly if the product has derivatives, swaps etc. These relationships may not always be referenced in the fund documents, and it pays to look at investor reports before investing and negotiate more transparency to enable you to look through if required. In many cases, it is a case of knowing what you don't know. For example, a hedge fund holds [x], what is the percentage of this, is the fund reporting sufficiently transparent to show this and can it be monitored on an ongoing basis so unusual activity is spotted immediately.

The role of tech – get your data right

By Tom Williams | CEO, Point Group

> **"By failing to prepare, you are preparing to fail."**
>
> **Benjamin Franklin**

Crises are inevitable. We all face them. Regardless of whether they affect us as individuals, the organisations we work with and for, or society as a whole.

The ability for anyone to respond adequately to any crisis comes down to several factors, but creating the 'space' to think, and then respond quickly and decisively to events is key. The creation of this 'space' is why organisations whose sole aim is to deal with effectively with crises, such as the military, emergency organisations and (some) governments, devote so much effort to: one, gathering as much information as possible, and two, distilling that information into digestible and communicable formats. All with the aim of reducing the potential to make poor choices by increasing time available to think and plan, and speeding up decision-making cycles.

Technology plays an increasingly important role in supporting effective crisis management across all sectors, predominantly by supporting the collection of information, and by providing the tools to turn that information into actionable intelligence.

In the world of investment management, the approach to dealing with crises is no different. We need the right information and the best tools available to give us the space to react and respond both to daily operational demands, and to unforeseen 'crises':

- Silicon Valley Bank has gone bust, are we exposed either directly, or via a third-party?
- Russia has prevented Ukraine grain exports, what is the likely impact on commodity prices and my portfolio?
- My CIO has been taken ill/retired how do I ensure continuity when so much knowledge is in their head?
- We are facing disagreements with stakeholders over succession-planning, generational wealth transfer planning and future investment strategies, how do I ensure we can correctly plan and communicate?

Data-first investment management

In the context of investment management, and working with firms like CapGen, we believe that by taking a 'data-first' approach businesses can build the operating platform needed to support both day-to-day activities, and crisis management responses. This focuses on 'getting the data right' as a non-negotiable first step, before deciding which analytical tools we need to deploy against the data to answer questions as they arise.

The foundational element comprises a complete, accurate and updated record of all investments across all asset classes, geographies and sectors, regardless of custodian, investment manager or platform. This independent Investment Book of Record (IBOR) provides us with the single source of investment data truth we need to then analyse by utilising the correct set of tools to suit our specific needs.

If data is not properly collected, organised and secured, the performance of any technological 'tool kit' and ultimately the family office will be restricted. This is particularly true of investment data, where data feeds from multiple custodians, investment managers, direct investments, platforms and alternative asset classes must be considered in the round. The challenge of creating a reliable 'single source of investment truth' is significant; it takes time, effort and a great deal of expertise to complete to a high standard. But once achieved, the consolidated data set can be exploited through reporting, investment decision-making and risk analysis tools with confidence.

Building a future-proofed investment operating platform

The data-first approach supports the design of flexible and agile investment operating platforms. The needs of any family office are likely to change over time, whether suddenly in response to a crisis, or more gradually as new generations assume greater responsibilities or new activities are pursued. Changing needs, must be met by changing technological capabilities and it is rare that a single provider will meet all the needs of a single-family office in all scenarios. By establishing a data foundation, offices can create integrated modular operating platforms, comprising a changing mix of technological tools from different providers over time including the application of new technologies such as AI and machine learning.

By way of summary, if you can understand any situation clearly and accurately, you are likely to respond more effectively to that situation regardless of whether you are seizing an opportunity or mitigating a risk. Understanding comes from knowledge, and knowledge requires intelligence. In the world of investments this intelligence is derived from data, get this right and the rest becomes far easier.

Point Group is a London-based fintech firm that CapGen has worked with over the past four years to design and build a powerful, data-centric and agile investment operating platform consisting of proprietary and 3rd party solutions. The CapGen platform aggregates, analyses and visualises data from multi-asset, multi-custodial investment portfolios, empowers decision-making and delivers accurate and timely investment reporting.

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