

**Malaysian Association of Asset Managers  
20 or so Questions Clients should ask their Fund Manager**

The above article was a joint effort of the Malaysian Association of Asset Managers and Merican & Partners Asset Management Sdn Bhd

The Malaysian Association of Asset Managers (“MAAM”) has drawn-up the checklist below for the benefit of Boards of Directors, Investment Panel members, existing clients and would-be clients of fund managers, especially in the light of certain adverse developments in the fund management industry. With the dissemination of this checklist, it is hoped that the current issue over the safety of client monies, which has led to the debate of the merits for the appointment of bank-backed versus non-bank-backed fund managers, can be shifted to encompass other considerations that are just as important. MAAM highlights the points below.

**Regulatory and Industry resources**

- 1 Is your Fund Manager licensed by the Securities Commission?

Clients should periodically ensure that their managers’ licenses are renewed when their license dates fall due. The Securities Commission website publishes extensive resources on licensed intermediaries as well as their violations. These resources are available at [http://www.sc.com.my/html/enforcement/fr\\_enforce.html](http://www.sc.com.my/html/enforcement/fr_enforce.html).

- 2 Is your Fund Manager a Member of the Malaysian Association of Asset Managers?

Members of the Association are constantly informed of developments and impending changes to the industry’s best practices and contours that eventually benefit their clients. More information is available on the Association’s website [www.maam.org.my](http://www.maam.org.my) (launched in March 2002).

**Safety of Client Monies**

- 1 Is there an independent custodian or trustee for the funds?

Most institutions and clients require a fund manager to appoint an independent custodian or trustee, which is typically a rated banking institution. You may have consented to your fund manager being the custodian of your funds. If so, you may like to consider changing the arrangement to an independent custodian or trustee. It will reduce substantially or eliminate the risk of illegal or fraudulent transfer of funds. The additional costs incurred will be well worth it.

- 2 Are the stocks held in a separate CDS account?

Again, an independent custodian or trustee should hold all stock. Your CDS account will typically have a name as follows:

“ABC Trustee for XYZ Asset Management for the account of Client A”

Such arrangements are only prudent and will minimize the risk of misappropriation of stocks.

## Track Record

- 1 Is the track record independently verified?

Dependence on third party independent verifiers will lower the risk of fraudulent claims of performance. In Malaysia, two firms – Watson Wyatt Worldwide and William Mercer Zainal Fraser, typically do this. Fund managers submit their fund data to these firms on a monthly or quarterly basis. The rating firms calculate the performance and the results are ranked and published.

- 2 Interpreting track records

There are a number of things to consider when scrutinizing a track record. First, determine if the track record is that of a composite. (A composite is one figure that is an amalgamation of the performance of all funds for the specified period.) If it is a composite, then ask two questions:

- a) Does the style of the composite, correspond to the style that I have in mind?  
The composite has to be relevant.
- b) Has the firm included all funds of the same mandate in the composite? While this is difficult to determine for an outsider, it should be asked anyway.

If the track record is presented as a number of separate funds, note the dispersion of performance. If the performance varies from mediocre to spectacular out-performance, be extremely careful. It could mean that the fund manager does not have a uniform firm wide investment process. Alternatively, the fund manager could be favoring some portfolios over others by selective allocation of stocks.

## Fund Management Process

- 1 What is the role of the investment committee?

A fund manager should have an investment committee. Reporting to the committee will be the chief investment officer or fund manager. The principal function of the committee is to ensure that client funds are managed in accordance with mandates received and to review portfolio performance. Investment committees also approve asset allocations in some cases. But that may differ from company to company.

- 2 What is the fund manager's investment philosophy and style of management?

The fund manager must have an identifiable philosophy or style that he keeps to through market cycles. Switching philosophies and styles over time will result in inconsistent fund performance. Consistency is something to be valued in a fund manager.

- 3 What is the fund manager's view of the stock market?

A fund manager should be able to enunciate a consistent view of the market. Is he bearish or bullish? What are the reasons and assumptions for his view? What are the risks to his view?

- 4 What is the fund manager's asset allocation process?

A fund manager should have a model or method for stock allocation. The equity allocation should be consistent with his view of the market. If the fund manager is bearish, he should have a lower asset allocation under a Tactical Asset Allocation basis.

- 5 What is the fund manager's stock selection process?

The stock selection process is another aspect of portfolio management that differentiates fund managers. Typically, stocks are subject to a screening process before inclusion in portfolios. But screening is largely an art rather than a science. A stringent screening process may result on the manager missing out on opportunities. A proper balance must be struck between controlling risk and opportunity.

### **Risk management**

- 1 How does the fund manager monitor and measure risk of portfolios?

At the very minimum, a fund manager should monitor the Beta and the Tracking Error of his portfolios, and discuss what investment action should be taken in the event their portfolio's measures exceed tolerable limits. A simple Excel spreadsheet will suffice. More sophisticated systems such as BARRA are available but very much more expensive. Clients should be extremely wary of unexplained out performance as the manager might have taken risk beyond the tolerable limit of the client.

- 2 What are typical asset allocation guidelines?

It would be wise to ask this question to understand the range utilized by the fund manager. An aggressive market timer would vary equity allocation between 95% in bull markets and 0% in bear markets. Others may have a minimum asset allocation of 50% and may not time the market as aggressively. Others may remain invested across a market cycle and tend not to reduce asset allocation at all.

- 3 What are the guidelines for exposure to a single stock?

Group of companies?

Each fund manager should also have guidelines on exposure to each individual stock. For example, the Securities Commission's Guidelines on Unit Trust Funds sets the maximum exposure for an individual stock to 10%. The corresponding exposure to a group of companies e.g. the Lion Group is 20%. This limits the risk by preventing the concentration of the portfolio in any stock or Group of companies.

If at a later date, the fund manager violates any of these guidelines, there is good reason to question and perhaps terminate the management contract.

### Potential conflicts of interest

- 1 Does the fund manager engage in proprietary trading?

A fund manager has a fiduciary duty to act in the best interest of his client. When a fund manager engages in proprietary trading, the risk of breaches increases. There are rules that need to be followed. For example, the fund manager is not allowed to act as the principal in the sale to or purchase of securities from client funds. The proprietary trader should not be managing client funds at the same time. Further, priority should always be given to client funds in all transactions. Otherwise, profitable trades may end up in the proprietary fund and losing trades in the client portfolios. As a best practice, proprietary trading should be prohibited.

- 2 What are the rules and procedures for employee transactions?

Staff of the fund manager should give priority to all client transactions. Further, personal transactions must be executed only with after proper approval. This prevents front running of client portfolios.

- 3 What is the firm's compliance structure?

In order to achieve a strong compliance culture, the compliance officer would need to be independent and should not be reporting to the CEO but the Board of Directors. The Compliance Officer would typically also be enforcing the firm's Rules of Business Conduct, which should address such issues as:

- (1) How are their mandates being monitored? Does the Compliance Officer receive daily portfolio positions to ensure that mandates are not violated?
- (2) What are the manager's policies on broker rebates and soft commissions? Clients should discuss how rebates arise in an environment of negotiable commissions and what forms of soft commissions are received. Also note that broker rebates are strictly prohibited by the SC.

### Staff

- 1 What is the staff turnover for the last five years?

Huge staff turnover is an indication that not all is well. Fund management is still largely a people business. Frequent staff changes may affect performance and consistency. More damagingly, it may indicate the presence of unethical practices. Employees may choose to leave as a way out from participating in such practices.

### **Monitoring Performance Delivery**

- 1 Does the fund manager use derivatives for hedging?

In Malaysia, the Securities Commission allows the use of index futures to hedge portfolios but within limits. For unit trust funds, for example, the limit is 10% of net asset value. Hedging with index futures can be more efficient in the case of illiquid stocks or markets where stocks cannot be sold.

Clients should be aware of the investment characteristics of derivatives as well as how portfolio performance is modified by such derivatives. Clients should also enquire what are the risks of modifying portfolio performance when the horizons are mismatched. Equities as an asset class are included in portfolios for their long-term growth potential while futures modify portfolio performance for shorter horizons.

- 2 Does the fund manager employ leverage?

Besides hedging, index futures can also be used to leverage a portfolio. However, with leverage, the upside and downside are accentuated. It is therefore very important to clarify the relevant regulations on the use of such strategies and if this kind of trade is allowed.

- 3 Does the manager guarantee performance?

The manager should discuss and disclose the derivation of any guarantee and the risks pertaining to that guarantee. The discussion and disclosure should address such issues as:

- i) A dilution of performance due to the guarantee structure;
- ii) Credit risk of the guarantor and the issuers of the underlying investments;
- iii) Liquidity risk of the underlying investments;
- iv) Conflicts of interest that may arise amongst different operating parties;
- v) The requirement to hold to some specified date with concomitant uncertainty in the intervening period

- 4 What are the manager's valuation policies, particular with respect to debt securities?

The manager should maintain a consistent methodology for valuing financial assets. Currently, the MASB is receiving comments on the Recognition and Measurement of Financial Instruments (MASB exposure draft 35) while MAAM has promulgated the adoption of its “Guidelines for the Portfolio Valuation of Debt Securities” which promulgates the mark to market methodology.

### **Others**

- 1 What are the fund manager’s sources of information & research?

The fund manager should have a data and information feed such as a Bernama screen.

A fund manager should ideally generate research reports and rely only partially on brokers. If a fund manager relies completely on brokers, performance can only be as good as those research reports. So, it is important to ask which brokers the fund manager trades with.

- 2 Is there a process of allocation of trades to brokers?

A fund manager should have a system of allocation of trades to brokers. Brokers should be ranked, for example, on a quarterly basis and trades allocated in accordance of ranking. More highly ranked brokers should be allocated a larger value of trades. A client should ask a fund manager the ranking of his brokers and the information should be checked against the actual trades in the monthly valuation report.