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Improving Investment Management Operations: What does it mean for a record to be fully reconciled?

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As the asset management industry continues its move into a new era of increased competition and margin compression, investment management middle and back offices are burdened to supply an operating platform that supports complex and global assets, simply and inexpensively.

Increasing the complexity of operations is the number of parties that may be participating in account recordkeeping. Custodians, fund accountants, and - of course - the investment management firms - have recordkeeping responsibilities, each with different purposes. So, a basic question regarding any investment management operating platform is: “What does it mean for a record to be considered fully reconciled?”

First, a brief discussion of the varied parties’ purposes in recordkeeping. IBOR, or Investment Books of Record, refers to investment data used to supply accurate information to the front office in support of an investment management process. This includes what a manager may trade, such as intraday share positions and pending transactions. IBOR is distinguished from data used in support of back-office operations, commonly known as Accounting Book of Records (ABOR). ABOR supports back-office business functions and includes data for such needs as daily NAVs, regulatory reporting, fund administration, and transfer agency services. Managers must reconcile to a custodian’s records, but most do not need the fund administration information found in ABOR. Archer recently coined the term Custodian Books of Record (CBOR), representing the data being provided to the IRS by the custodian. This includes income, as well as realized gains and losses.

At its most basic, reconciliation will account for discrepancies between two sets of records. For investment managers, this typically means reconciling a custodian’s records to the manager’s IBOR. Investment managers maintain records for performance measurement and trade order management purposes, as well as client support. It cannot be assumed that one set of records is “correct” and the other “incorrect” because the veracity of each is determined by their underlying purpose. A custodian’s records are dominated by their need to account for accurate cash and settlement of securities. An investment manager’s records must focus on accurate trading and performance measurement. In effect, both are correct when viewed individually, but can conflict when compared one to the other because they often have separate, competing goals. A custodian’s records often reflect settlement date, whereas a manager’s must have a trade-date focus.

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Further complications are added with the presence of a fund accountant, whose ABOR must be adequate to strike an NAV; investment managers often desire to reasonability test the fund accountant’s ABOR against the investment management firm’s IBOR.

In reconciliation, assuming that “the custodian is always right” does not always fit with an investment manager’s needs. Instead, an investment manager may consider its accounts fully reconciled only when all differences between its records and other parties’ have been identified and adjusted on the manager’s IBOR and performance measurement systems.

Simply matching IBOR to portions of CBOR, or conducting a reasonability test of ABOR, does not ensure compliance with current standards. Because of both the importance of accurate performance presentation and regulatory scrutiny, it is not an exaggeration to say that reconciliation is the foundation of a manager's data integrity.

While computers have sped the process of comparing records to identify differences, it has been up to the processor to note the "whys" for the breaks, and to manually adjust their records as necessary; often twice, once when the break occurs and again when it is "fixed." This is further complicated when considering that different parties often treat similar transactions differently. The back office platform must be able to easily assimilate all of these differences onto one common record, and it must do so in an environment of tightening resources.

For example, here is a brief survey of how some major custodians handle transactions and cash:

	Transaction Booking	Cash Booking
Custodian #1:	Settlement Date	Settlement Date
Custodian #2:	Settlement Date	Trade Date
Custodian #3:	Trade Date	Trade Date
Custodian #4:	Trade Date	Settlement Date

When reasonability testing of ABOR is needed, data points in addition to positions, transactions and cash are required. These include:

- Local Pricing of Global Securities
- Local Market Value of Global Securities
- Local Accrued Income of Global Securities

As there are an abundance of pricing and local value sources, and given the absence of a global 'market close,' the investment industry has not yet established a standard for fair value NAV pricing, which poses a challenge for Investment managers attempting to reasonability test fund accountants whose 'best efforts' practices differ.

Technology is available to significantly automate the reconciliation and reasonability test processes. At a minimum, there are at least two requirements for this automation: an accounting system that corrects errors through the automatic reprocessing of all relevant transactions, and highly customizable data exchanges with custodians and fund accountants. These capabilities allow processors to focus on true discrepancies, like position breaks, and to ignore the "false" breaks caused by accounting and / or policy differences. Additionally, the reconciliation process can be further simplified when the IBOR system is able to intelligently apply reconciliation adjustments at a global level.

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Here are some examples of how an investment manager can simultaneously account and adjust for problematic breaks. These include missed corporate action transactions, cash withdrawals, and unmanaged assets.

Corporate actions are troublesome when one system misses a scheduled action, causing a break until it has been caught and fixed. Global processing can account for the problem should the investment manager miss a corporate action. However, when a custodian misses a corporate action, the discrepancies are often "noted" by the manager, with accounts effectively remaining discrepant until the custodian processes the action. This can lead to delays in finalizing performance or in trading accounts. A system that adjusts for the difference by automatically entering an entry on the side that is missing the corporate action allows the manager to present its performance and trade with confidence.

On the surface, a simple transaction such as a withdrawal request does not seem to be one that would prove difficult to account for. However, when taking the view from an investment manager's perspective, it can effectively highlight the advantages of adjusting for differences rather than merely noting them.

For an investment manager, when a client requests a cash withdrawal from an actively managed account, any amount raised to comply with the request can be considered to be non-discretionary – an account's percentage of cash was not increased because of a strategic decision by the investment manager – yet it is often reflected as part of a portfolio's assets until the cash has been removed from the custodian's records. This can be particularly troublesome during periods of volatile markets. Instead, if an investment manager removes the cash from its portfolios on the requested date, and then automatically adjusts for it until it is removed from the custodian's records, false breaks are eliminated and the performance record will accurately reflect investment expertise.

Archer outpaces custodians in its ability to make predictive calculations of cash availability and trading positions. Knowledgeable of custodial processing standards and abilities, Archer anticipates and rejects false positives in breaks with custodians, significantly reducing the need for manual reconciliation of accounts.

Archer data is validated and reasonability-tested throughout each trading day. A full reconciliation of Archer data is completed daily, comparing the quantity of securities and the value of cash in each account to the custodian records of these values for each account. Well over 1 million positions and tens of thousands of transactions are compared across nearly fifty custodians every trading day.

In less than 1% of the accounts compared, a reconciliation "break" will be discovered.

Lastly, with unmanaged assets, the custodian shows the asset belonging to the investor, however, the investment manager does not want to reflect it as part of a portfolio for trading, performance and account billing reasons. An automated process, once programmed, will recognize the asset as unmanaged and adjust for the difference between records automatically. Thus, it is not reflected in the investment manager's records, nor does it cause a "break" between the records because it is actively being accounted for.

Because of the increased complexity of fund accountant reasonability testing, one might expect an increased need to adjust records. However, an IBOR platform capable of highly customized interfaces that simulate - but do not match - fund accountants' records provide for a best-efforts check on fund accountant data. Comparison of shares and cash at the account level, rolled up to the portfolio level, is essentially the same for reconciling to custodian and comparing to fund accountants. Calculating and comparing pricing and accrual information at the portfolio level, and subscriptions and redemptions at the account and the portfolio level, however, requires a complete understanding of the fund accountant's practices in this area. Once understood, the comparisons can be automated, false breaks can be identified, and reasonability testing can occur in advance of settlement.

In essence, being "fully reconciled" for successful investment managers means that their records reflect their needs by accurately accounting and adjusting for differences with custodians and / or fund accountants. With flexible technology and customized interfaces, this can be achieved on a daily basis through a highly automated process, placing less strain on human resources while providing other benefits, including:

Trade Error Reduction: Because all positions in all accounts are fully reconciled and trade issues identified prior to settlement, portfolio managers can confidently trade from correct positions.

Accurate, daily performance: Since flows are properly recognized on the day they occur, performance calculations are the most accurate possible.

Increased client responsiveness: All positions in all accounts are fully reconciled. Therefore, current performance can be calculated, and clients can be provided with the most accurate daily reports.

Simplified regulatory compliance: Accurate, timely data makes it easier to respond to regulatory discovery requests.

Lower Cost: The high level of automation described herein will lower labor costs while increasing data accuracy.

When a highly automated reconciliation process is driven by an intuitive user interface, the result is an intelligent work flow that supports data integrity simply and efficiently. While data accuracy is a paramount concern, the timeliness and accessibility of the data across a firm is of equal importance for both cost efficiency and customer support. Given the ever-increasing compliance and regulatory demands the investment management industry faces, timely, accurate, and accessible data will continue to be a hallmark of successful firms.

As an added value service, Archer has the ability to reconcile a single investment account against multiple sources, in an automated fashion. Investment managers can reconcile cash, positions, and accruals, as well as compare against fair market value pricing, to reconcile IBOR and to exercise proper oversight and controls on ABOR service providers.