

# Financial Services



## Achieving remarkable returns

Consider an investment in treasury management

by **Elliott Carpenter and Alan Fish**

What's the return on treasury? A large alternative investment manager obtained a partial answer while examining its cash management practices, including overnight investing. A few simple changes to its operating practices are now saving the company millions of dollars annually. And no, it isn't the installation of a whole new battery of processes, personnel or technology. Rather, it's the addition of a single, newly hired professional cash manager followed by an analysis and refinement of prior practices and procedures. Attention to a number of previously overlooked fundamentals can lead to significant returns and reduced risk for alternative investment managers.

### The business case for treasury

For many hedge fund and private equity (PE) fund managers, the treasury and cash management functions are often an afterthought. For example, a July 2008 Ernst & Young/Ipsos MORI survey<sup>1</sup> found that only 44% of hedge fund operations today have a treasurer or head of treasury. Had the survey been conducted two or three years earlier, this already low figure would most likely have been even lower.

By comparison, possibly by virtue of having been on the scene for a longer period of time, the majority of PE firms tend to have a more defined treasury function. Still, their focus tends toward rudimentary treasury activities such as cash management, while ignoring other high-value aspects of treasury. As these firms continue to grow or become more active in

overseas investing, their treasury challenges multiply. To capture more value from a sophisticated treasury operation, PE and hedge fund managers need to advance their capabilities in areas such as global cash management and foreign exchange management and to begin adding value to processes such as strategic planning and management reporting.

The reality is that alternative investment executives traditionally prefer spending their time focusing on what they do best, which is managing complex investments. Choose the right markets, the right strategies, the right investments, move swiftly and the profits will follow. That's a demanding business model. Up until the last twelve months, most firms felt little pressure to second guess any aspect of their operations. As long as the investor capital and profits were rolling in, why would management divert attention to something less strategic like the pursuit of improvement in cash or treasury operations?

For PE firms, the current economic environment is resulting in portfolio companies being held for longer periods of time than had been the case in the past causing the PE funds to make add on investments in the portfolio companies. These additional investments can strain cashflows and capital which elevates the importance of a well structured and proactive treasury.

Another reason many alternative investment managers have historically tended to focus less on treasury operations is the perception that any such overlay inhibits active trading. Capital markets favor the nimble. Accordingly, executives at hedge funds and at PE firms have long benefited from organizational structures that provide ample resources to evaluate markets and risks, along with enormous freedom to pursue the opportunities identified, but in many instances, neglect the treasury function.

## Pressing industry mandate

Today, there is the matter of the global financial crisis. Suddenly, cash flow, liquidity and counterparty risk have gained urgency and become a top priority. Perhaps if a firm pays more attention to its collateral management, it can obtain better terms or returns. Or perhaps it can negotiate lower banking or custodial fees. It certainly can reduce risks by more closely managing counterparties. These activities are specialties of treasury managers and can reduce costs, increase efficiency of operations and, in some cases, add basis points to the firm's total return.

And there are additional trends calling for more formalized and enhanced treasury management functions. Specifically, for many alternative investment managers, the underlying investor base has shifted. Two to three years ago, the lion's share of assets was being run by the funds' principals and limited partners and most often on behalf of individual investors or for the funds' own proprietary accounts.

Today, however, firms increasingly manage money from a diverse spectrum of investors and industries, including endowment funds, pension funds, sovereign wealth funds and other large institutions. Though they value the complementary nature of alternative investments within their portfolios, institutional investors are performing higher levels of due diligence and demanding more transparency with regard to the alternative investment manager's operating model and overall governance and risk management practices.

Similarly, they want greater insight relating to the composition of portfolios and the consistency of trading strategies. Institutional investors, boards of directors and regulators want assurance that investment managers have implemented an effective and well controlled operating model. Evidence of a

professionally managed treasury function is just one more way an alternative investment manager can demonstrate a commitment to a better operating model and an enhanced internal control environment.

Finally, pressure is coming from within the alternative investment industry itself. For example, anxious to address investor concerns as well as to avoid activist regulatory or legislative policy, the hedge fund industry is making greater efforts to police its own activities. For example, both the Hedge Fund Standards Board (HFSB) in the UK and the Asset Management Committee (AMC) in the US (part of the President's Working Group) have published best practice recommendations. Their recommendations touch on key areas such, as governance, disclosure, risk management, operations and valuation – nearly all of which are areas where a professionally managed treasury can add value.

To date, it is the hedge fund sector that seems to be taking the most visible steps toward self-regulation. But similar pressures and concerns are evident throughout the various segments of the alternative investment industry. Investors and regulators are demanding higher levels of assurance. So to attract and retain investors as well as to avoid potential regulation, it makes increasingly good business sense for firms to develop greater competence in treasury operations and related reporting.

## The rise of the treasury

An experienced treasurer or treasury manager can add significant value across a broad spectrum of activities. For example, a treasury manager can deliver improved financing terms or reduced transaction costs. Such benefits can accrue through consolidating activity into selected banks or perhaps simply through greater experience in negotiating with banks.

Also, a competent treasury professional can bring greater discipline to working capital as well as asset/liability management or, as in the opening case, to overnight investing. The fact is, minor adjustments to current practices can often result in enormous savings. Or it might be that a treasury executive can simply identify entirely new opportunities for cost savings or working capital reductions that others may have overlooked. Just as hedge fund, PE or other alternative investment managers know how to extract wealth from capital markets, treasury executives know how to make the most from cash and collateral operations.

Many hedge fund and PE managers have resisted change. For example, portfolio managers and operations managers often have significant back-office functionality responsibilities – treasury operations – embedded in their current processes and job descriptions. But as an organization grows, it begins to make sense to remove such legacy responsibilities and processes: these executives should focus on investment, not treasury.

Here, however, it will be important to try to anticipate and deflect resistance to change. For example, it is very likely that there will be a perception that a treasury manager is out to encroach on a portfolio manager's turf. Therefore, the concept and value of a professional treasury may need some advance marketing within the organization.

Moreover, any treasury manager charged with these tasks needs a clear mandate demonstrating unqualified senior management support. In a start-up treasury function, an important first step would be for the treasurer to identify and inventory all the various fragmented functions across the organization that will be defined as "treasury." This inventory will serve as the basis for those functions to be consolidated into a centralized treasury function. Even within an established treasury function, the

treasurer will come in regular contact with less than optimal legacy practices. In short, to succeed, a treasury executive needs sufficient clout and leadership sponsorship.

## Where's the return?

A well-organized and capably managed treasury function can deliver benefits across a range of activities. These include:

- ▶ **Cash management.** Centralizing cash management can provide a myriad of benefits. For one, the firm reduces the likelihood one fund or division will be borrowing short term on the same day another related entity is investing overnight, thus avoiding the cost of credit spreads. In addition, centralization consolidates volumes, yielding better returns and lower transaction costs. Given the low interest rate risk environment coupled with elevated levels of counter-party credit risk, effective cash management is a critical issue for management.
- ▶ **Liquidity risk analysis and planning.** The market crisis of recent months has highlighted the importance of robust liquidity risk analysis and planning. Regulatory agencies are placing greater focus on liquidity risk analysis and stress testing. The centralization of cash management combined with comprehensive liquidity risk analysis and planning can immediately reduce short term borrowing costs. The identification of liquidity stress scenarios and the establishment of "early warning" indicators and related monitoring procedures is a prudent management practice. In addition, better control and visibility into cash flow can help the firm make more accurate and efficient decisions relating to working capital. Further, less variability in cash flow – fewer surprises – can lead to an enhanced reputation with lenders and commensurately better terms.
- ▶ **Cash flow forecasting.** A well-structured forecasting methodology, supported by validated data sources, can improve accuracy and accelerate management's awareness related to fluctuations in cash levels as well as providing time to initiate changes that may better align actual and planned results to meet funding requirements.
- ▶ **Asset/liability management.** The market is increasingly intolerant of surprises related to investment performance returns. Inaccurate or insufficient asset/liability management (ALM) information can ultimately result in a negative impact on investment performance. A well-structured ALM process, integrated into the treasury function, can provide management with the ability to better anticipate investment volatility due to market risk. Additionally, recent market turbulence demonstrates that cash flow contingency planning is critical to success. Such a plan serves as the organization's "playbook" so that it can move fast should one of its investments encounter a liquidity crisis.
- ▶ **Foreign exchange.** Treasury managers are skilled in executing foreign exchange transactions and know how and when to execute trades to get the best rates. Moreover, with a centralized view of operations, the need for many such transactions can be reduced through netting of payments.

Similarly, with more and more alternative investment managers beginning to deal with multicurrency investments and investors, a competent treasury function can help lock in profits, protect gains and anticipate and optimize rates on upcoming conversions and remittances.

- ▶ **Banking relationship management.** A skilled treasury manager knows how to consolidate activity and negotiate the best terms for the business as a whole. A treasury professional speaks the language of bankers and knows how to network with

other treasury professionals to gain insight into current pricing conditions.

- ▶ **Governance, controls and investor relations.** For public companies, details relating to policies, procedures and reporting processes are required by the Sarbanes-Oxley Act. For most alternative investment managers, such details are not required by law, but nevertheless constitute a key component of governance. The appointment of a treasury professional will help firms gain better control of their operations.

This is particularly valuable as hedge fund and PE managers deal increasingly with institutional investors and anticipate increased regulatory scrutiny and change. The existence of strong treasury management can give greater confidence to investors, boards of directors and regulators.

- ▶ **Treasury technology.** The growing need for greater transparency of financial data to meet treasury's demands for comprehensive financial management has resulted in many companies consolidating legacy systems and spreadsheets to form an integrated treasury system solution or platform. The market today offers a range of different treasury solutions to meet most organizations' business requirements and budget parameters.

## Time to evolve

The time has come for alternative investment managers to enhance their treasury and cash management functions. Dispersal of treasury operations or failure to invest adequately in the infrastructure supporting

the treasury function, including people, process and technology, leads to increased costs and risks, as well as a missed revenue enhancement opportunity. Higher volumes of transactions accentuate both potential cost savings and potential risks. Meanwhile, investors, boards of directors and regulators are demanding more accountability and visibility, both of which are part and parcel of what an effective treasury function can deliver.

Current market conditions and increasing competition continue to challenge the asset management industry. The absence of a comprehensive treasury management function exposes alternative investment managers to higher levels of financial, operational and reputational risk. Increasingly, the industry itself is advocating an improvement in the quality of practices relating to governance, risk management, disclosure and operations. All of this comes on the heels of what many feel will be a future of increased regulation and intense scrutiny by investors, boards of directors and regulators.

Given these considerations, a final component of the business case for treasury is that of savings: the implementation of a comprehensive treasury function in an alternative investment environment can result in potential savings of millions of dollars. The question becomes, why would an alternative investment management firm resist? In today's conditions, we feel there are no good reasons for maintaining the status quo.

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