multiplicitygovernance

Insights- Advisory

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Fund governance – independence is not enough

At Multiplicity Partners, we have observed many investments funds that failed. Funds that failed to deliver the liquidity promised to investors, failed to properly value their assets, failed to manage leverage appropriately or even cases of fraud and embezzlement. In this article, we share our view on where fund governance can be improved. In particular we advocate that fund boards should be composed of professionals with complementary experience to provide truly holistic oversight.

Failed governance is certainly not only apparent in many investment funds. Of much greater economic, even systemic, relevance was the lack of proper board oversight in the banking sector during the financial crisis of 2008. The prototype of failed governance was arguably the board of directors at Lehman Brothers; out of ten external directors...

- only two having experience in banking
- one theater producer
- one former admiral of the US navy
- four were older than 75 years
- nine were retired.

As we all know by now Richard Fuld, CEO and Chairman of Lehman, has handpicked these individuals to make sure that the board lacks the competencies to challenge him in any way on the relevant topics. Meaningful risk oversight on critical and highly technical issues such as steering of leverage and liquidity assessments of structured credit books is simply not possible without hands-on experience in financial markets.

What happened in the wake of the Lehman bankruptcy had to have consequences in the regulators approach to governing bodies of financial institutions. First regulator had to focus on the systemically relevant “too big too fail” banks, before they could tackle smaller banks and investment funds.

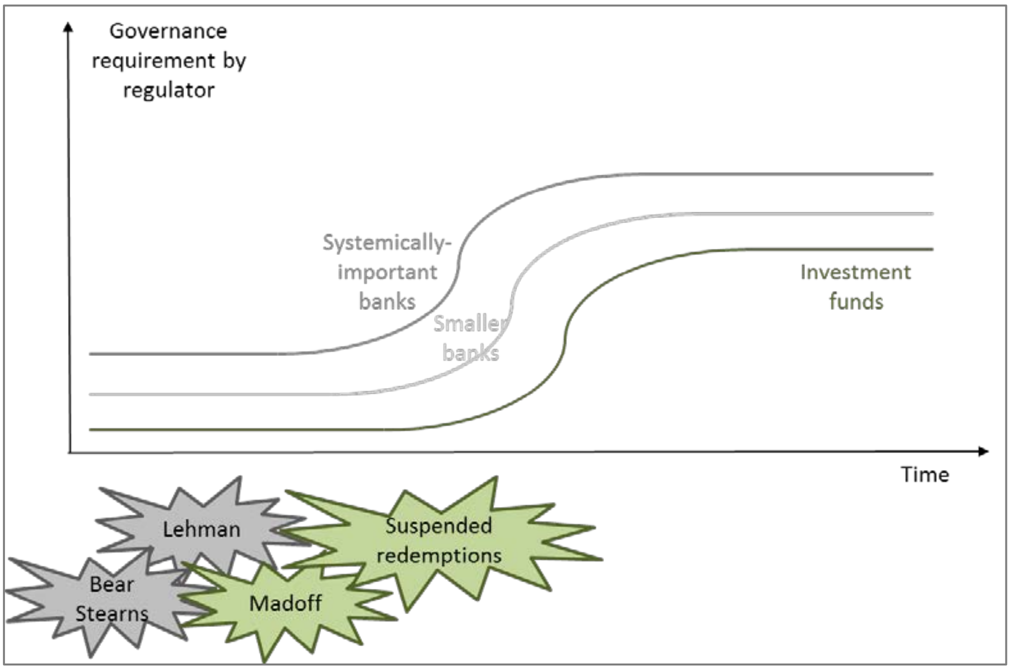

Figure 1: Schematic illustration of increased regulatory pressures on financial institutions

One of the areas where we expect increased scrutiny from the regulators is the lack of investment and risk management competency on fund boards today. In particular last year's Consultation Paper 86 by the Central Bank of Ireland is clearly addressing the scarcity of investment and risk knowhow on fund boards.

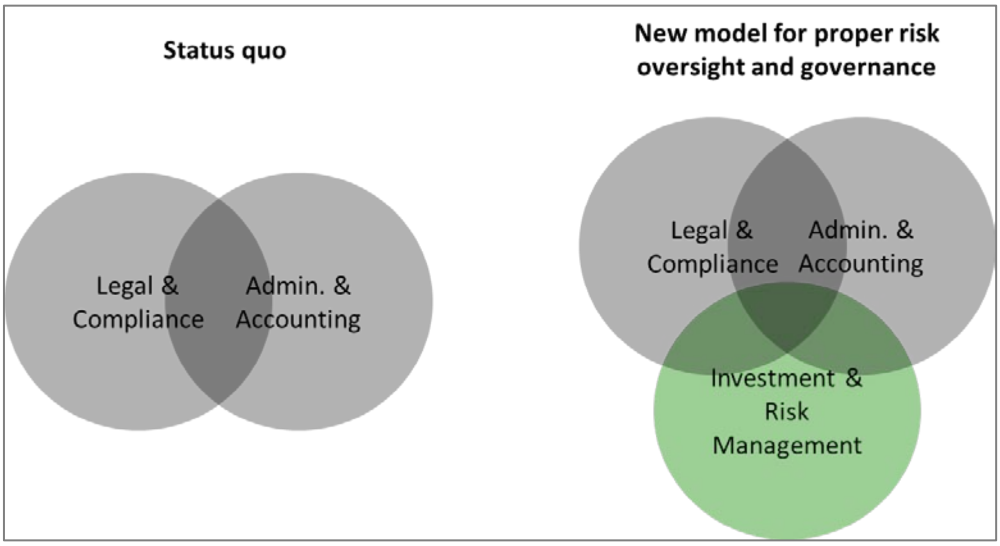

Figure 2: Skillset and experience on fund boards

Let's now look at what failures in governance we observed in the investment fund industry. In particular the hundreds of funds that suspended redemptions, the creation of "side pockets" and the massive fraud of Madoff seriously shattered investors' trust in the fund industry. As our team has been advising investors on the restructuring and selling of impaired and illiquid funds since 2010, Multiplicity Partners has built up a database of such "failed" funds and has performed a review of board composition.

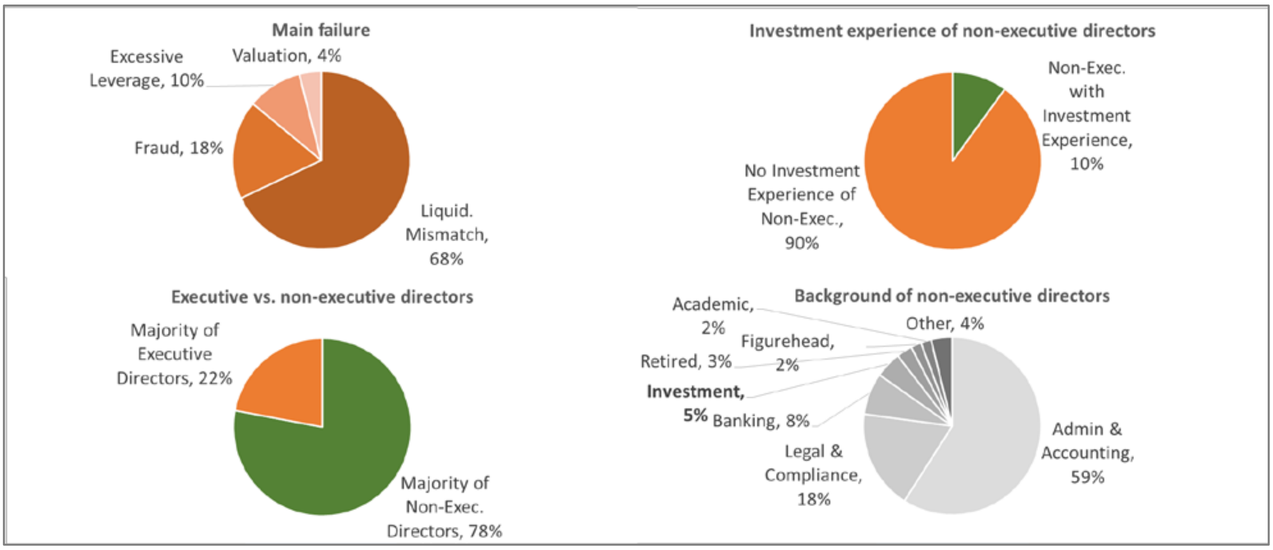

Figure 3: Statistics on failed funds and their board of directors' composition

There above statistics are based on a non-representative samples of 52 investment funds which include hedge funds, real estate, credit, emerging markets, shipping, credit funds as well as fund-of-funds. According to our data set we see mismatches between the liquidity of the underlying investments and the terms offered to investors as the main reason why funds seriously fail to meet investors' expectation, other than simple underperformance.

When we analyzed the background of the individual non-executive fund directors we found that only 10% of the funds had one or more directors with documented investment background. Not a single (!) director with any risk management background could be found on these funds. The most prevalent professional background is fund administration and accountancy. It comes as little surprise that these boards could not perform sufficient risk oversight on the often highly complex investment strategies employed.

Interestingly, the vast majority of these fund boards were dominated by non-executive directors which per se is a good sign.

In conclusion we can argue that it is not the lack of independent directors, but the lack of diverse and relevant skills and experience that lead to some of the biggest failures in the fund industry.

Please do not hesitate to contact us to discuss your governance requirements.

Roger Rüegg is a founding partner of Multiplicity Partners. He is responsible for the firm's advisory business and has more than 17 years of experience in the alternative investments and banking industry. Prior to founding Multiplicity Partners, he held several roles at Horizon21, Bank Julius Baer and McKinsey & Company. Roger holds a MA HSG, University of St. Gallen, Switzerland, is a Certified Financial Risk Manager (FRM) and received the accreditation of Certified Investment Fund Director (CIFD).

About Multiplicity Partners

Multiplicity Partners is an investment boutique specialised in providing liquidity solutions to holders of private market funds and distressed assets. The firm also offers a range of advisory and governance services across alternative assets.

As part of its governance business, partners of Multiplicity act as independent directors of investment funds, investment management companies and special purpose vehicles in all recognized fund jurisdictions.

It is our mission to truly represent investors' interests and to add real value on boards by bringing in complementary skills in investment and risk management.

Contact information

Multiplicity Partners AG
Bodmerstrasse 5
CH-8002 Zürich
E info@mpag.com
T +41 44 500 4550
www.mpag.com

For enquiries:
Roger Rüegg, Partner
E rr@mpag.com
T +41 44 500 4550