

POTENTIAL RISKS OF CUSTODY “INSOURCING” FOR NONPROFITS

As a leader of a nonprofit organization, your responsibilities are substantial, your time is limited, and the decisions you make have long-lasting implications for your organization and those that it serves. More recently, the prudent management of expenses has been a consistent theme throughout the boards of endowments, foundations, and operating nonprofits alike. While the goal to minimize expenses is certainly important, decisions made solely on the basis of cost may actually create additional challenges for the organization as a whole.

This piece examines investment committees who rely on advice from external investment consultants for portfolio management expertise, but choose to “insource” the operational and custodial duties of their portfolios as opposed to utilizing the services of a professional custodian. While initial cost savings may be realized, a more holistic analysis reveals the potential for higher incremental costs associated with operational needs, compliance, performance reporting and fraud prevention that must be assumed by staff. As a result of our findings, we hope to provide a framework for committees deciding whether or not to delegate asset servicing responsibilities to a third-party custodian.

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OPERATIONAL EFFICIENCIES

We have observed that while investment management tends to garner most of the attention of investment committees, the administrative and operational responsibilities consume substantial time for staff of the organization. Money movement, tax reporting, and the day-to-day servicing of the portfolio often adds considerable stress on a nonprofit’s staff, which can potentially detract from tasks more closely associated with the mission of the organization.

Organizations that perform operations internally spend considerably more time collecting and consolidating reports for tax purposes as well as navigating multiple managers when cash needs arise. Nonprofits utilizing an external custodian eliminate the need to collect documents from a number of different providers and reporting for tax purposes flows through one platform. Cash movement is almost effortless.

Concerns related to investment operations often arise due to lack of experience by the staff that is performing a particular function. Take trading, for example. While nonprofits who custody their own assets have the capability to make trades, it is likely not a function that they are accustomed to performing on a regular basis. As a result, trade execution may be affected and the likelihood of errors increases considerably.

EXAMPLE

A nonprofit arts organization currently administers its own portfolio. When this self-managed portfolio needs to be rebalanced, the CFO is required to contact each product provider (mutual fund, ETF custodian, etc.) to make buy and sell requests. Because there are different settlement times for different security types, this introduces the risk of cash shortages within the account.

The use of a single custodian can mitigate these challenges through efficient, single-point trade execution, allowing changes to the portfolio to be more accurate and less burdensome.

Finally, as the portfolio construction becomes more sophisticated — as is often the case with the inclusion of private equity and other illiquid vehicles — the need for centralized insight into the portfolio is essential. An outsourced custodian can seamlessly coordinate capital calls and other cash deployments, taking the responsibility out of the hands of an organization’s staff.

CONSOLIDATED PERFORMANCE REPORTING

One of the pitfalls of having multiple investment managers, each with their own separate custodian, is the administrative burden of decentralized reporting (needing to aggregate performance

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reporting from each manager). A centralized custodian consolidates performance reporting and permits managers and asset allocation strategies to be properly evaluated against peers using appropriate benchmarks in a consistent and timely manner.

Additionally, consolidating assets under the same custodian allows the organization to see the complete picture of their investment program. This consolidation engenders more effective trade coordination and rebalancing as well as reduces the possibility of investment overlap or gaps in asset allocation which can lead to sub-optimal decision making. Occasionally there are situations — particularly in regards to legacy private equity positions — where assets need to be held externally. In these instances, a dedicated custodian can aggregate these assets with the remainder of the portfolio holdings into one consolidated report that feeds into overall performance analysis.

By utilizing a professional custodian with consolidated reporting capabilities, investment committees are equipped with enhanced insights into the performance and structure of their portfolios. We have observed that investment committees with this level of detail are better positioned to make informed decisions regarding their investment program.

COMPLIANCE MONITORING

Over time, custodians have evolved from being simply record-keepers and asset holders to sophisticated technology providers. As clients’ needs have shifted with changes in technology, custodians have augmented their services in order to provide risk management analytics as well as compliance testing and portfolio transparency.

As the regulatory environment has become more stringent, greater scrutiny has been placed on an organization’s ability to effectively keep up with risk and compliance standards. This type of monitoring could result in a need to increase dedicated risk and compliance staff or legal personnel required to navigate the evolving regulatory landscape. A professional custodian eases this burden through employing the most contemporary risk management solutions to ensure that organizations are kept in compliance.

CYBERCRIME PREVENTION

While not normally considered by investment committees, fraud prevention is a significant risk to any organization and must be an important part of the governance model. With cybercrime at an all-time high — particularly among nonprofits — having an additional “set of eyes” reviewing every transaction and cash movement request is crucial. When organizations choose to custody their investments internally, appropriate fraud prevention measures must be in place; otherwise they may be exposing themselves to undue risk.

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An organization chooses to utilize the services of a third-party custodian with best-in-class technology — as well as a dedicated client service team — to monitor transactions that identify suspicious activity, and to protect assets from those seeking to do harm.

DECISION FRAMEWORK

Staff	What capabilities do we currently have within our staff for compiling and analyzing performance? If asked to perform these functions, how might this affect their other duties?
Reporting Needs	How detailed do we need our performance reporting to be? Do we have the tools available for audit requirements?
Investments	Does our portfolio have complex structures (private equity) or a large number of investments?
Risk/ Compliance	Do we have sufficient policies and systems in place to mitigate theft and cybercrime?

CONCLUSION

Thankfully, for boards and investment committees, the decision to outsource the custody of their portfolios and managing costs are no longer mutually exclusive. When viewed against the costs of additional staff, potential investment opportunities lost and the risk of fraud, using a third-party custodian can be a tremendous way to achieve your cost saving targets while also protecting your organization.

Finally, and potentially most important, outsourcing to a dedicated custodian frees up staff and the board to focus on your most important asset...your mission.

Learn More

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