

34<sup>th</sup> Annual Fiduciary Risk Management Conference

# BUILDING AN INVESTMENT DUE DILIGENCE PROGRAM

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PRESENTED BY

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# Discussion Topics—What We Will Cover Today

1. Why Establish a Formal Evaluation Process?
2. Best Practices for a Comprehensive Investment Manager Due Diligence Process...Search, Selection, Oversight and Other Considerations
3. Maintaining the Integrity of the Process
4. Quality vs. Quantity
5. M&A: Platform Integration Considerations
6. Lessons Learned
7. Key Takeaways

# Why Establish a Formal Evaluation Process?



# Why Establish a Formal Evaluation Process?

- Fiduciary duty
  - *“The standard of prudence is judged on whether the trustee followed appropriate procedures or processes for managing risk, diversifying assets, and balancing the financial needs of the beneficiaries. Neither the performance of an individual investment nor the overall performance of the portfolio is central to a legal determination of prudence. Prudence is demonstrated by the quality of risk management processes used to develop, implement, and monitor trust investment strategies.”* —Uniform Prudent Investor Act
  - Readily respond to questions about your firm’s oversight process during regulatory exams
- Part of firm’s approach to asset management
  - Extension of firm’s investment decision-making process and research
  - Facilitates more efficient and effective investment meetings:
    - Investment Committee
    - Prospect and client meetings
    - Investment manager meetings
- Risk mitigation
  - Establishes consistent approach to evaluating investment managers
  - Provides structure and discipline for not only hiring, but also firing managers, which is usually harder

# Best Practices for a Comprehensive Investment Manager Due Diligence Process



# Best Practices



## Key Attributes

- Separate Due diligence Committee
  - Sub-Committee of Investment or Allocation Committee
  - Appoint committee chair; reporting structure
    - Membership
    - Charter
    - Minutes
  
- Consistent and continuous oversight process
  - Search
    - Establish guidelines for considering a strategy/manager
    - Resources—people and budget
    - Tools—databases, ADVs, questionnaires, onsite visits, consultants
    - Quantitative vs. qualitative or both?
  - Selection
    - Operational due diligence—mutual funds vs. LPs
    - Mutual Funds—share class selection
    - SMAs—negotiate fees/minimums
    - Final evaluation and approval process

# Best Practices

## Key Attributes

- Consistent oversight process continued
  - Ongoing monitoring
    - Not done after initial due diligence—continuous
    - Establish assessment data points—returns, risk statistics, AUM (strategy and your clients' assets in strategy), formal review
    - Set frequency of reviews: weekly—quarterly—annually
      - Dollar thresholds?
      - Onsite visits?
    - Track interaction with managers
      - Create shared internal database for due diligence team
      - Document manager meetings
      - Save due diligence questionnaires, quarterly manager commentary
    - Create a “watch list”?
    - Set manager termination guidelines—how strict should they be?

# Best Practices

## Other Considerations

- What about due diligence on passive investments?
  - Okay to have a different process than for active managers
  - Be consistent in application
  - May just be quantitative review—AUM/your exposure, performance, tracking error, premium/discount to NAV, fees
  
- Use of a consultant
  - To what extent?
  - Due diligence considerations
  
- Annual assessment of platform
  - Gaps?
  - Too many managers?
  - Are there better alternatives?
  - Review of overall due diligence process



# Best Practices

## Reporting—Why Is It Important?

- Platform
- Analysis
- Regulatory
- Front office (Relationship Managers “RMs”)
- Communications—critical for buy-in

# Best Practices

## Communications With Front Office RMs

- Presentation describing due diligence process
- Education and updates on strategies
  - Webinars
  - Gatekeeper role
  - Updates with managers
  - Database
- Resource
  - Due diligence team email box
  - Provide talking points on manager performance
  - Participate in client meetings

# Maintaining the Integrity of the Process



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## Identifying and Addressing Conflicts of Interest

- Policy manual should include policies to address entertainment by investment managers
  - Covers Due Diligence/Investment Committees as well as RMs
  - If using consultant—what is their policy for entertainment?
- Proprietary strategies
  - Ensure permitted by law, disclosed, fees reasonable and in best interest of clients
  - Ideally, follow same due diligence process as third party managers
- Investment strategies run by clients of the bank that want to be on the platform
  - Providing LOC? Counterparty?
  - Extra hurdle for due diligence; disclosure to clients
  - May need to educate Senior Management about the risks and conflicts
  - Need to be able to fire the manager
- Head of Due Diligence—calls for a strong leader that is able to stand his/her ground
  - Needs support from Compliance, Risk Management, Senior Management

# Quality vs. Quantity



# Quality vs. Quantity

## Breadth of the Platform

- Diversification in terms of asset classes, styles (active, passive, concentrated, vehicles, fundamental, quantitative, etc.)
- Aligned with firm's AUM
- Manageable to oversee given needs and resources
- Sufficient assets to be a meaningful to manager and maintain good access to team

# M&A: Platform Integration Considerations



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## Mergers Present an Opportunity to Re-evaluate Platform

- Establish common due diligence process
- Create best-in-class platform by drawing best managers from each firm's platforms
- Best to rollout integrated platform to front office early in integration process to bring firm's closer together
- Create legacy hold list for strategies with low cost basis and/or significant client exposure
  - Need to continue to follow; may have a slightly different due diligence process for these managers
  - Terminate managers once assets and the number of clients invested become de minimis



# Lessons Learned



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- Passive or patient
- Chasing performance tends to lead to disappointment
- Black and white and grey; hesitating on terminating a manager
- Take the meeting
- First impressions really do matter
  - Selling or advising?
  - The dump
- Wash, rinse, repeat
- If you don't have a robust process, how can you properly judge a manager's process?

# Key Takeaways



# Key Takeaways

- Best Practices call for establishing a quasi-independent due diligence committee to oversee the platform; leadership should differ from approving committee
- Your process for selecting and overseeing managers should be consistently applied, supported by the organization and easy to articulate to managers, prospects and clients
- Be aware of conflicts; open to new strategies and ways to further enhance the platform and overall due diligence process
- **Helpful resource:** Comptroller's Handbook—Investment Management Services, which can be found on the OCC's website under Asset Management
  - **Appendix F: Guidelines for Selecting Investment Managers and Advisers**  
<https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/index-comptrollers-handbook.html>

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