

Assessing investment managers' business, operational and compliance risks

Evolving due diligence to focus on non-investment risks

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Dianna Zentner,
Director, Global
Manager Oversight &
Due Diligence

Investors are very familiar with research and due diligence focused on money managers' *investment* people, portfolios, performance and processes. But what about managers' *non-investment* risks? This paper describes the due diligence processes that can be applied to non-investment risks. It also outlines governance practices for investors aiming to bring both aspects of due diligence together to make well-informed investment decisions.

Defining non-investment due diligence

Non-investment due diligence focuses on understanding the non-investment risks and controls of a money manager's business, including:

- Business structure and activities,
- Operations, and
- Compliance.

Understanding managers' business, operational and compliance risks

NON-INVESTMENT RISKS CAN IMPACT A MANAGER'S ABILITY TO DELIVER ON ITS INVESTMENT PROPOSITION.

While manager research may identify firms with excellent investment people, portfolios, performance and processes, the non-investment aspects of those firms may have a significant impact on the firm's ability to deliver results. For example, a weak trade order management system or failure to achieve timely execution can mean that managers fail to realize the full return potential of their investment process.

THESE RISKS CAN IMPACT INVESTORS' REPUTATIONS.

The reputation of an organization is tied to its investment program and to the managers who invest money on an investor's behalf—just ask any organization that invested assets with Bernie Madoff. Quality research can provide investors with in-depth information to make more informed decisions to minimize unintentional risk exposure. Investment research can protect organizations from some reputational risks, but a deeper understanding of managers' non-investment risks is also important.

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REGULATORS ARE CONCERNED ABOUT THESE RISKS, TOO.

Recent media articles have highlighted regulators' focus on manager due diligence.¹ Regulators will likely expect more information than what is typically provided through investment research. The Great Recession has made it clear that risk is not static—investors cannot simply rely on the stability of a management firm's reputation or operating history.

AN UNDERSTANDING OF MANAGERS' NON-INVESTMENT RISKS IS PART OF TRUSTEES' FIDUCIARY RESPONSIBILITY.

When you look up the word "fiduciary" in the dictionary, words like "trust" and "confidence" appear. Fiduciaries are entrusted with a great responsibility—the financial security of others rests (at least partly) on their shoulders. Plan participants, retirees and/or fund beneficiaries expect trustees to make prudent investment decisions. In addition to investment research, increased knowledge about managers' non-investment risks may help inform those decisions.

Separating investment and non-investment risk assessments

Assessing the business, compliance and operational risks of an investment firm is a different challenge than assessing the investment process. The two are best carried out independently. Reasons for this include:

- **Resource conservation**

Particularly in a market environment where expense controls are tight, resource conservation is a great benefit of a tiered due diligence approach. With a tiered approach, investment research can be performed first, with compliance and operational due diligence conducted separately after a manager's investment merits are validated. This method can save thousands of hours for staff and management and/or external vendor costs by focusing compliance and operations due diligence only on investment-qualified managers, rather than on hundreds of managers that may never meet the necessary investment criteria.

- **Different skill-set requirements for investment and non-investment due diligence**

Particularly for larger or complex investment programs, there is a wide range of knowledge required to perform investment and non-investment due diligence—it is rare to find a single person who is highly skilled in both kinds of expertise. With a tiered approach, the work is separated, so that individuals can focus on either investment or non-investment research. A tiered approach also minimizes the risk of any one individual failing to perform the proper scope of work.

- **Independent viewpoints**

Tiered approaches also allow viewpoints from non-investment and investment-related research to be objectively considered by a governing body. Separating these two types of manager due diligence can neutralize the risk of a biased perspective.

¹ For several examples, see "Managers enter a new era of due diligence" (*FundFire*, March 31, 2010) and "S.E.C. enforcers focus on avoiding a Madoff repeat" (*NY Times*, February 8, 2010).

Governance practices: Bringing together manager research and due diligence that's not investment-related

In a recent Russell Research paper², author Don Ezra described governance this way:

It is not management. Management is about running an enterprise.
Governance is about seeing that it is run well. So management is judged by results; in contrast, governance is about process.

Bringing together investment research and due diligence about managers' non-investment risks requires the basic governance principles outlined in Ezra's paper.

ASSESS THE REQUIREMENTS

Arguably, the requirements for researching money managers' investment capabilities and assessing managers' non-investment risks are different. Investment research typically requires people with investment expertise and a background in business and economics. In contrast, assessing money managers' business, compliance and operational risks requires knowledge of regulatory requirements, risk management, operations, and complex business models.

To determine who is best suited to conduct the different types of manager research, due diligence and oversight, we can look to best practices for governance. Don Ezra's research paper recommends that for each decision, trustees should ask three key questions:

1. What are the knowledge requirements?
2. What are the time requirements?

In turn, the time requirements are of two types:

- How much time is required?
- Can this decision be made in calendar time, or is it a real-time decision? (In other words, does it require instant action, or can it be deferred until the next scheduled meeting of the decision makers?)

3. Do we have someone, or a group, that meets these qualifications?

If not, depending on the culture of the enterprise, filling each role offers a further choice:

- Should we hire someone?
- Should we outsource the function?

KNOW WHO "INPUTS", "DECIDES" AND "OVERSEES" THE VARIOUS ASPECTS OF MANAGER RESEARCH, SELECTION AND MONITORING

It may sound simplistic, but knowing who is responsible for the various tasks associated with manager research, selection and monitoring can help trustees clarify roles and identify gaps and/or overlap. Don Ezra's paper outlines the importance of a governance matrix that includes responsibilities, clearly illustrating who needs to oversee, manage or conduct various elements of an investment program. The idea of a governance matrix applies within a manager oversight program, too. It is important to know who is responsible for conducting each of the due diligence exercises that are required.

² Ezra, Don. "Investment governance: A pragmatic update." Russell Research ViewPoint. January 2010.

AIM FOR OBJECTIVITY

With an approach to due diligence that separates investment and non-investment risk assessments, the investment professionals responsible for manager research are not the same people assigned to assess managers' non-investment risks. Similarly, those who ultimately decide whether or not to hire or terminate managers do not personally conduct either type of research. The separation of these functions is intentional: It's designed to provide equal weighting to the different aspects of manager research and due diligence.

If investment professionals researched and became biased towards a manager's compelling investment proposition, they might overlook huge compliance risks. Similarly, compliance and operations due diligence analysts focused on non-investment risks could focus too much on a specific, manageable risk that it could cause them to miss out on a significant investment opportunity. Instead, based on input from these two respective groups, an objective governance body, such as an investment committee, either decides to hire/terminate managers or endorses the decisions related to such activity.

SUMMARY: MANAGER RESEARCH AND DUE DILIGENCE REQUIRES THOROUGH UNDERSTANDING AND GOVERNANCE PROCESSES.

Institutional investing requires in-depth understanding of money managers—including both investment research and due diligence about managers' non-investment risks. We believe that while both types of research are important, sound governance processes can help investors to make objective and better informed decisions.

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