



Due Diligence from a Distance

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The Bernard Madoff scheme is widely recognized as revealing a failure of due diligence; the investors, intermediaries, and regulatory authorities who were burned did not spot red flags that others saw. Now, in the wake of the fraud, advisors and their clients are rethinking their processes and standards when it comes to researching all types of money managers.

In-depth due diligence is time consuming, expensive, and essential. Thankfully, advisors analyzing mutual funds and managed accounts generally have little trouble investigating operational issues, at least compared to those evaluating hedge funds, venture capital, and other alternative asset classes. Complacency is never warranted, of course, but for most firms used by advisors it is relatively easy to determine whether the basic structure of their operations meets appropriate standards. If not, caution is in order.

Once an operational review is complete, advisors must determine the likelihood that a particular manager will produce “good” performance going forward. (For the purposes of this article, we will set aside discussion of what constitutes “good” performance, since the principles addressed here apply regardless.) The rub for most advisors is that due diligence typically must be done “from a distance,” and is consequently less likely to add value than would be the case if greater access to the manager were possible.

In evaluating investment managers, consultants commonly look to the “The Four Ps”: philosophy, people, process, and performance. Unfortunately, throughout the industry past performance is weighted too heavily and is a more dominant factor in practice than industry participants admit. Advisors share this tendency with institutional and individual investors, but the lack of detailed information about other manager attributes compounds the problem, meaning they rely even more on past performance when making choices.

None of this is to say that performance history is not important, but evaluating performance well is a complex task, as other *Advisor Perspectives* articles have explored in great detail. [Ed. Note: For example, see [Mining for Factors that Predict Mutual Fund Success](#), [Collective Wisdom, Financial Markets, and Investment Lessons from Google™](#), and [Luck versus Skill in Active Mutual Funds](#).] Simple comparisons and measures often obscure important aspects of a manager’s performance, so the due diligence process must include a detailed deconstruction of returns and holdings and an interpretation of what any patterns



found indicate. Furthermore, given the wide range of fees charged on packaged products, an analysis of whether incremental costs are likely to yield extra returns on a sustainable basis is needed.

Analyses of active managers undertaken without the relative luxury of on-site visits should be aimed at estimating the probability that a manager will outperform an appropriately matched passive strategy. Given that key pieces of information may be lacking and that the chances of finding a manager that will consistently outperform an index are relatively low, the “hurdle rate” for choosing an active manager on the sole basis of analyzing returns should be high.

The real value of being able to quiz investment managers directly (more on that later) is to judge the interplay between performance and the other Ps – philosophy, people, and process. In the case of Madoff, neither his compound rate of return nor its volatility made sense given the stated strategy or the organization that was in place. Despite the unusual nature of this case, it illustrates that investors tend to prize repeatability and long-term performance without regard to the methods that produced it. With Madoff, even the incongruence of his steady performance and the changing market environment failed to give some investors pause.

Those that asked Madoff or his marketing

6 Questions to Start the Diligence Process

A thorough due diligence process includes many detailed questions about all aspects of an investment manager’s approach. However, some general inquiries can often open the door to important avenues for investigation. For example:

1. Under what circumstances do you expect your strategy to produce subpar relative (or significantly negative absolute) performance?
2. In your organization, are the attributes and risk profiles of portfolios actively monitored by a chief investment officer, or is the portfolio manager given free reign within their mandate and judged solely on performance after the fact?
3. What are the parameters of the bonus structure for portfolio managers, analysts, and leaders of the organization?
4. How do the members of the investment teams share information, including between specialists in different asset classes and strategies?
5. What are the structural changes occurring in the markets that may require you to modify your traditional approach?
6. What is your analytical advantage?

agents the hard questions about these discrepancies stayed away when they



couldn't be answered.

One advantage to visiting a management firm (unless you are there to sit through a carefully scripted dog-and-pony show, which is usually of no value) is that you get a feel for the organizational dynamics (a mix of philosophy, people, and processes, with a bit of culture thrown in) that will drive future investment performance. Often, the real insights into how a firm works come not from meetings with a portfolio manager or the chief investment officer, but from others that you have the chance to interview. The purpose is not to go for "gotcha" moments (although they sometimes happen); invariably the leaders of the best organizations can deal thoughtfully with whatever questions stem from the tidbits that you uncover. But the process of uncovering them yields more insight than all of the marketing presentations you could possibly attend.

While there are times when investors fall hopelessly in love with a management firm with a particularly hot group of investment vehicles, more often such affection is reserved for star portfolio managers, not their firms. Both must be assessed, but a detailed analysis of the firm will probably prove more productive. Its strengths and weaknesses, and those of its leaders, are likely to have a greater impact than most investors imagine. The incentives in place for members of the firm should mirror the needs of investors, potential conflicts of interest should be minimal and well understood, and the firm's decision-making processes and staffing model should work in a variety of market environments.

As for those star portfolio managers, advisors can easily fall into the trap of identifying too closely with them at the expense of objectivity. Opportunities to be on calls with managers or interact with them at conferences should be used to gather valuable insight about how they do what they do. Unfortunately, many of those interactions often amount to little more than a recitation of the current economic and investment ideas of the manager. The advisor gets the sense that he knows the manager better, but little of lasting value is learned. Instead, face time should be spent grilling the manager with hard questions about investment process.

Understanding is, after all, the goal of due diligence, which makes doing it from a distance so hard. At its core is a search for anomalies that need to be explained and questions that need to be asked. Having the opportunity to get those questions answered is an important part of gaining the comfort needed to say that a manager has a reasonable shot at producing the elusive alpha that an advisor wants to deliver to her clients.

Faced with the difficulty of analyzing managers themselves, advisors must decide whether to outsource that function by counting on intermediaries to analyze the managers under consideration. Relying on another firm to generate



the evaluations can provide needed leverage for advisors, especially sole proprietors, but countless examples point to the risks in such an approach. (Think of how the reliance on the credit rating agencies led to failed investment strategies throughout the industry.) At a minimum, advisors need to understand thoroughly what drives third-party evaluations and under what conditions their processes are likely to break down.

Ultimately, doing due diligence, whether in person or at a distance, is about knowing what you know and what you don't. Do you have enough information to properly appraise the chance of an investment manager filling its designated role? If not, continue the process or select a passive alternative for now. As in a game of cards, it only pays to play when you've identified a clear advantage.

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