Due Diligence
Investment Manager Checklist

By Judy Benson

The goal of this article is to provide a checklist for analyzing investment managers in a search environment. In conducting the research for this article, we relied on various sources and compiled the information in an aggregated, unattributed manner.

Our research demonstrated (and it will be no surprise to readers) that due diligence should not be a one-time, up-front event. Rather, there must be periodic investment manager relationship check-ups. As a result, we provide some insights on these factors as well.

Key Takeaways

1. A successful manager search cannot be conducted solely as a quantitative process. The qualitative factors play an equal—if not more critical—role.

2. Due diligence does not solely involve investment processes; there must be significant scrutiny on non-investment factors. ('We refer to operational due diligence as “non-investment manager” due diligence throughout this article.) Business risk factors can directly affect a manager’s ability to deliver on its investment approach.

3. There is not an inverse relationship between the size of the investment manager (as measured by assets under management/advice) and the amount of due diligence conducted. Large investment managers have their own unique risks, and size does not and should not lead to an erroneous conclusion of reduced risk.

4. All managers in a particular portfolio must be analyzed under a holistic approach. A consistent—and consistently applied—due diligence program can help protect fiduciaries.¹

The term “qualitative analysis” often connotes qualitative investment manager analysis. Our research showed that this term also is used within the context of non-investment manager analysis. In this article we try to separate these two factors, but we caution that it was not always possible.

Preliminary Steps

There is a run-up to the implementation of the quantitative and qualitative due diligence process. We start with an identification of the desired exposure (or role) being sought for the portfolio (e.g., a particular investment style). Its fit in the portfolio asset allocation strategy must be confirmed.

Quantitative Analysis

Analysis of investment manager databases, application software, industry contacts, etc. is a logical first step in the due diligence process. The costs of manager search and selection software are relatively low, and the data are likely to be GIPS compliant and easy to compare across vehicles. But the data are quantitative, may not account for the sources of return, may not represent the entire industry, and may have survivorship bias. Further, manager classifications have changed from pure capitalization and style classifications that today are broad-based and may not have commonality among consultants. An asset class group may have multiple strategies and styles within a seemingly common framework. This means that, for example, the statistical metrics alone may not communicate the different risk exposures taken to achieve the return stream.

1. Define the potential universe of managers for the specific opportunity by using the selected database(s).¹ That database is screened using factors vital to the fiduciary (e.g., assets under management, availability of capacity in the style).

2. Conduct a quantitative analysis of measures such as (but not limited to) risk-return measures and risk-adjusted return analysis (e.g., Sharpe, alpha, information ratio), absolute performance, performance versus benchmark, style index/universe comparisons, consistency/reliability of returns, and tracking error. (The full panoply of measures may instead be performed after the qualitative steps have been completed.) Stress testing also is a must.

3. The result of the quantitative analysis is a manageable list of investment managers on which in-depth qualitative research can then be conducted.

Qualitative Analysis

An overarching view of the qualitative analysis portion of due diligence—both investment manager and non-investment manager—would include analyses of personnel, investment process and process implementation, research capabilities, investment philosophy, and investment strategy. Details about some of these crucial factors include the following:

Philosophy. Does the investment manager’s philosophy make sense? Has it been tested/changed? What is the value add?

People. Organizational structure and ownership, resource allocation, financial statements, turnover. To whom does the chief compliance officer report?

Plans. Internal business structure, strategic business plans, and client composition.
**Product.** This step in the due diligence process is geared to product structure and its appropriateness for the implementation of the firm’s investment philosophy.

**Process.** Sufficiency of trading and portfolio accounting systems, adequacy of backup procedures, and conflicts of interest, along with the investment management decision-making process, and buy-sell disciplines. Idea generation, portfolio construction methodology, and risk management guidelines also fall into this bucket. What are the drivers of performance and sustainability of the process? Are environmental, social, and governance (ESG) and socially responsible investing (SRI) considerations evaluated or omitted in the decision-making process of securities?

**Research capabilities.** Depth of the research team, expertise, and number of companies covered.

**Progress.** Does the investment philosophy need to evolve? Are models and technology updated periodically and thoroughly vetted?

**Price.** This runs the gamut from key person compensation to alpha generation.

On the non-investment manager side of the ledger is the broad area of business operations. This might include the firm’s reputation in the industry, assets under management and number of accounts managed, and proven administrative capabilities in areas such as trading, client communications, reporting, and registration compliance. Additional factors such as the present employment of those involved in creating the firm’s track record and turnover may round out the analysis.

**Non-Investment Due Diligence**

All too often we assume that the fiduciary’s due diligence responsibility begins and ends on the investment side of the business. Yet this is not the case, because a deep understanding of non-investment risks is integral to the overall decision-making process.

The key attributes of a successful non-investment due diligence process include the following elements:

1. It should be conducted independent of the investment due diligence process.
2. Before conducting non-investment due diligence, the investment due diligence should have narrowed the list of potential candidates to validate the merits of the investment proposition. This suggests a multi-pronged funnel of quantitative due diligence followed by investment manager due diligence. Only at this point should non-investment due diligence be conducted. Whether the non-investment due diligence is conducted internally or externally, it will involve substantial time and soft or hard dollar costs (if a third-party vendor is utilized). If the proposed manager does not satisfy the investment criteria, conducting non-investment due diligence arguably would represent a needless expenditure of time and money.
3. There should be separate teams for the investment and non-investment due diligence, because these involve different types of expertise. The non-investment due diligence team should have demonstrable expertise in regulatory requirements, risk management, operations, and complex business models. These factors will help guide the decision of whether non-investment due diligence should be outsourced.

A non-investment due diligence checklist might include the following:

- Oversight/supervision/management
- Effective governance
- Conflicts of interest (internal and external)
- Ownership
- Privacy
- Practices/people implementation
- Culture and organizational changes
- Compliance/ethical culture
- Frequency of changes in personnel, processes and policies

**Non-Investment Due Diligence for Larger Investment Managers**

Non-investment due diligence should not be light-handed on the big guys—the larger investment managers. They are not necessarily less risky, and fiduciaries need the same due diligence protections. Even when budget priorities must be established in the due diligence process, we caution that reputational/headline, financial, regulatory, and legal risks are “equal opportunity” and do not respect size. All managers must be evaluated in a systematic manner.

Even so, larger managers require the following additional due diligence cautions:

1. Due diligence protocols must include the means to assess whether investment managers have addressed the potential impacts from outside disruptions, such as a cyber attack.
2. Size creates complexity. Even though a larger manager has greater resources (personnel and otherwise) under its umbrella, it is likely to be far more complex. By dint of size (and potentially reporting layers), larger firms may be slower to identify or react to issues. Oversight, supervision, and effective communication are vital within large or complex organizations.
3. A well-established manager is just as vulnerable to infrastructure and organizational risks. Staff turnover in mission-critical areas such as compliance, operations, and control functions is just as important as turnover among investment professionals. (In fact, we would argue that the impact of turnover is just as critical for smaller, boutique, or new managers.) The due diligence process should inform the causes of the turnover, potential solutions, and any residual effects of the turnover itself. Larger firms tend to utilize proprietary systems, so information technology turnover could have a crippling effect. The due diligence process must address structure, func-
The due diligence also must examine the governance body, which includes the decision-makers or fiduciaries.

Performance concerns. Agreed-upon benchmarks and other key ratios over designated periods must be established up-front in order to monitor performance.

Violation of guidelines. The manager is deviating from stated style/investment strategy.

Staff. Significant changes/turnover.

Assets under management. Substantial asset growth or erosion each should be treated as cautions.

Business plan. Be on the alert for significant changes in the business plan.

Business risk. Have the operational resources or controls become inadequate?

Law/regulations. Have litigation or regulatory problems surfaced?

Event risk. Has there been an extraordinary event that may interfere with the manager’s ability to fulfill its portfolio role in the future?

Termination
The ongoing monitoring and evaluation may expose qualitative changes to the organization that may warrant terminating the manager. In addition to the foregoing checklists, the due diligence process should identify other issues such as the departure of a key portfolio manager, periods of unexplained under-performance, changes in philosophy or investment process, and demonstration that the investment thesis under which the manager was hired has changed or no longer is viable.

One final word on performance: It has been suggested that there is a natural period for a manager’s skill to start being demonstrated. This natural period is defined as the inverse of the turnover ratio. For example, a manager with a two-year turnover ratio will turn over more than one-half the portfolio annually, so that the entire portfolio is turned in two years. Over many two-year periods, stock selection skills should become apparent.

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Endnotes

1. Our sources included Raymond James Manager Search and Due Diligence; “Manager Search and Selection” presentation of Scott Thayer, Graystone Consulting, for The University of Chicago Booth School of Business CIMA Certification course; and articles from Russell Investments, including “Assessing investment managers’ business, operational and compliance risks,” by Dianna Zentner (August 2010), “Managing risk investing with larger, brand-name investment managers,” by Dianna Zentner (February 2012), and “Insights for evaluating active management,” by Don Ezra (December 2011).

2. The word “fiduciary” is applied broadly to any individual or group that has a fiduciary oversight responsibility.

3. Other sources to complement the database(s) might be industry sources or other networks.

4. Sufficiency of trading and portfolio accounting systems could be categorized in either the investment or non-investment areas.

5. Another view holds that the due diligence personnel who are familiar with the quantitative aspects also should be involved with the qualitative assessment. A lack of familiarity with the quantitative (or vice versa) might lead to an inappropriate recommendation.

6. The same thinking detailed in the previous endnote also would hold true here; i.e., such a division of responsibilities may lead to poorly informed opinions. To reiterate, these three distinct roles are equally critical in the ongoing due diligence and hiring/firing processes.

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