The Keys to Effective Operational Due Diligence

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Investment Risk vs. Operational Risk

Investment risk

- Risk that the actual return on an investment will be lower than the investor’s expectations.
- Inherent to a manager’s investment strategy.
- Plans manage investment risk by focusing on several key factors, including:
  - Risk balance
  - Tactical allocation
  - Investment structures

Investment Risk vs. Operational Risk (cont.)

Operational risk

- Includes many qualitative elements (e.g. an investment manager's internal controls, design and implementation of systems, oversight of employees).
- Taking on additional operational risk is never expected to improve returns.
- For this reason, operational risk is an uncompensated business risk.

Investment Risk vs. Operational Risk (cont.)

Operational risk, continued

- It is difficult to anticipate seemingly unknowable risks.
- Week controls or sloppy systems are difficult to price into the risk calculation, because human error is unpredictable.
- An investor, therefore, must assume that human error will be prevented by tight controls in the manager’s systems, in order to rationalize using a manager.

What Makes an Investor Nervous?

- Investment managers operating outside mandates
- Ineffective transaction controls
- Weak reconciliation procedures
- Concentration of authority in one or a few individuals
- Inappropriate attitudes toward risk management
- Lack of checks and balances

Causes of Investment Mandate Violations and Increased Risk

1. An investment manager does not fully recognize or understand its investment mandate or internal controls, and may unwittingly be increasing operational risk.
2. An investment manager is fully cognizant and supportive of its investment mandate, but a breakdown of internal systems and controls, and/or human misunderstanding or error may have created transactions that unwittingly are outside of the investment mandate and contribute to increased operational risk.
3. An investment manager chooses to circumvent its investment mandate or internal controls for "the better interests" of the client, and is making no effort to "cover up" their lack of compliance with the mandate or override of controls.
4. An Investment Manager chooses to circumvent its investment mandate or internal controls as a means of improving their relative performance, and is making a conscious effort to hide this circumvention from their clients.*

**Difficult to detect until performance falls out of line with expectations or the investment manager makes a mistake in covering the trail. Rarely resolved without substantial financial loss.*

Objectives of Operational Due Diligence

1. **For all** - Reaffirm the details of investment mandates to the investment managers' teams, the necessity for adhering to them, and the Plan's desire to minimize operational risks.
2. **For those with less sophisticated internal support** - Create an opportunity for strengthening internal systems, procedures, and safeguards that preserve the investment mandate and minimize operational risks.
3. **For those who operate outside of their investment mandate in a transparent manner or have systems and processes that expose the Plan to unnecessary risks -** Create an opportunity for constructive redirection of any internal systems, procedures, and personnel.
4. **For those who are covering up an overt disregard of their investment mandate or an overt disregard for systems and processes to reduce risk -** Create a potential deterrent, as the process increases their risk of being discovered.
5. **For the Plan's Staff/Board -** Provide feedback to the Plan's Staff and Board that strengthens its understanding of operational risks associated with individual investment managers, and provides assurance of increased manager accountability for maintaining the investment mandate and reducing operational risks.

Operational Due Diligence Process

1. **The Process** – The process is customizable and should be tailored to a plan's specific needs and budget. Elements of the process may include:
    1. Manager visits
    2. Pre-hire visits
    3. Repeat visits
    4. Remotely applied procedures
    5. Other procedures (addressing fee calculation or valuation concerns)

Operational Due Diligence Process

1. **New (initial) manager visits** – Assess operational risks relating to the Plan's existing investment managers. Begins with a discussion with the portfolio manager to understand the strategy, then an understanding of processes and systems. Concludes with a wrap-up meeting to discuss findings and recommendations.

- Traditional Managers (such as equity and fixed income)
  - Attempting to bypass system controls (such as entering inappropriate trades into the portfolio system)
  - A day in the life of a trade

- Non-Traditional Managers (such as real estate, PE, FOFs)
  - Focus on Manager's due diligence for accepted investments
    - How does this manager screen potential investments?
    - Due diligence binders
    - Ongoing monitoring
  - What investments were rejected because of the manager's due diligence process?

Operational Due Diligence Process (cont.)

2. **Pre-hire visits** – Assess operational risks before the Plan has committed any capital to the investment manager. Similar in scope to the new manager visit.
3. **Repeat visits**
   - Repeat visits in response to issues noted in new manager visits.
   - Normal repeat visits based on a rotational basis.
4. **Remotely applied procedures** – Provide ongoing monitoring of managers and potential risks, recalculate investment management and performance fees, serve as an indicator of changes in operational risk, and focus on minimizing operational risks.
5. **Reporting process**
   - Manager flash report
   - Executive summary of findings
   - Site visit reporting

Key Elements of a Strong Due Diligence Process: Moving Beyond the Rubber Stamp

- **Field work** – A short meeting is not enough.
- **Targeted** – Right areas; your account.
- **Actual testing** – More than just listening to a well-rehearsed story by a polished investment professional.
- **Deep industry knowledge** – Should be conducted by senior individuals who know the inner workings of investment managers.
- **Collaboration** – Should work with manager to discuss observations, ways to improve systems and controls, and items for follow-up.
- **Closing loops** – Visits, calls, or remote update procedures to follow up on points raised in closing meetings.
- **Meaningful feedback** – Reporting should be transparent and provide a broad overview as well as sufficient detail.
- **Independence** – No conflicts of interest.

What about SSAE 16s (SAS70s)?

What is it?

Pros:

- Standard report that people are familiar with
- Manager pays
- Heavy/thick reports

Cons:

- Manager controls process
- Manager hires and pays
- Sometimes not focused properly
- Might not address Plan's product
- Probably does not address Plan's account

Sample Reporting – Manager Flash Report

- Quick overview of most important findings
- Action items, resolutions, key observations
- Establishes risks by category
    - *Category 1 risks*: Follow-up on-site visit recommended to address issues noted during the engagement.
    - *Category 2 risks*: Remote (rather than on-site) follow-up recommended to address issues noted during the engagement.
    - *Category 3 risks*: No items noted for follow-up. Managers should be subject to normal rotating site visits and recurring remote procedures.

Sample Reporting – Site Visit Reporting

- Detailed procedures and observations from the due diligence engagement.
- Typically accompanied by a transmittal letter which highlights key items, items for follow-up, and manager responses.

Core Areas of Focus - Customizable

- Identification and understanding of systems, controls, and resources impacting portfolio management
- Assessment of compliance with the investment mandate and effective portfolio risk management
- Understanding of investment manager's trade execution, trade allocation, soft dollar, and directed brokerage policies and the related impact
- Valuation and counterparty risk
- Performance measurement and review
- Effective and timely trade reconciliation procedures with the custodian
- Performance reporting

Core Areas of Focus (cont.)

- Effective and timely controls over income recording
- Timely response to notification of corporate actions
- Effective procedures to maintain confidentiality of transactions and portfolio details
- Appropriately skilled personnel with relevant training and development programs
- Effective and independent compliance functions ensuring, in particular, compliance with relevant regulatory requirements
- Adequate financial strength and insurance arrangements of investment manager
- SEC search / background checks
- Effective disaster recovery and continuity procedures

Other Areas of Focus

- Manager and custodian fee recalculations – Challenges to the fee recalculation process include:
  - Changing agreements
  - Differing formulas
  - Complex formulas for investment fees
  - Differing investment vehicle structures
  - Differing custodians and administrators
  - Lags in market values
  - Complex hurdle calculations
  - Complex waterfall structures, some requiring deal-by-deal analysis

- Fee recalculation engagements can identify and recover overcharges.
- This could be separate from operational due diligence.

Other Areas of Focus (cont.)

- Valuation procedures
  - Valuation of a Plan's investments can be challenging, especially for alternate asset classes (e.g. private equity, real estate, hedge funds).
  - Valuation procedures can vet values provided to a Plan by its investment managers.
  - Can be focused where the Plan believes the most valuation risk exists.
  - Often result in material changes to the fair values utilized by Plans.

Managing the Budget

- Operational due diligence does not need to be an all or none decision.
- Consider prioritizing risks. Address higher risks sooner.
- Spread out costs.
  - Don’t need to do everything in one year. Consider a multi-year cycle.
- Customize the process to meet the Plan’s needs. Eliminate steps that aren’t meaningful.

Considerations for Prioritizing Operational Due Diligence Visits

1. Consider the following when prioritizing investment managers for operational due diligence visits:
    a. Visit new investment managers, prior to funding
    b. Any investment managers that Trustees or Plan staff have specific concerns about
    c. Custody of assets, are the investments in a liquid portfolio, where the Plan is able to halt trading?
    d. What is the age of the investment? Are the investment managers in the investing stage or the harvesting of investments?

Considerations for Prioritizing Operational Due Diligence Visits, continued

1. Consider the following when prioritizing investment managers for operational due diligence visits, continued:
   e. What are the lock-up provisions? Is there an exit for an investment?
   f. Consider the overall relationship with the manager. It might not be worth performing ODD on a manager the Plan is phasing out.
   g. Consider performing remote procedures on all of the investment managers that are not visited. This would help to further prioritize the remaining investment managers, and identify any changes in risk levels.

Sample of Past Findings in Assessing Operational Risk of Investment Managers

1. Inappropriate levels of authority or lack of segregation of duties:
    - Client service director had authority to place trades.
    - A list of authorized traders was initially distributed to the firm’s counterparties and was never updated for personnel turnover.
    - Traders, who should generally only have authority to execute trades already entered into the trading system by portfolio managers (after clearing compliance screening), could also enter trades into the trading system and then execute them – thereby bypassing authorization and compliance controls.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

1. Inappropriate levels of authority or lack of segregation of duties (cont.):
   - Traders had the authority to add, delete, modify, and override compliance guidelines without any secondary approval or review.
   - Traders had the authority to add, delete, and modify the security master file without any secondary approval or review (or audit trail).
   - Portfolio managers had the authority to add, delete, modify, and override compliance guidelines without any secondary approval or review.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

2. Differing interpretations of investment guidelines:
   - How “leverage” is defined. Is a futures contract with 5% down “leverage”? Is an option “leverage”? Is external leverage different from contract-internal leverage?
   - When assessing the percentage limitations within a portfolio, is an option considered at its contract value or its net cash value? Same for futures.
   - Is a dollar-denominated ADR of a foreign company a “Non-US Investment”?

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

3. Poorly designed compliance systems that were ineffective in blocking trades that would violate the investment guidelines:
   - Often when multiple guidelines are violated, the correction of only one of the violations allows the trade to be processed.
   - Guideline violations can be overwritten or modified without appropriate oversight.
   - The latest version of the guidelines is not input into the compliance system, or guidelines are missing from the compliance system.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

4. When evaluating non-traditional managers, we observe that many well-run fund of funds managers have a three pronged approach to evaluating underlying hedge funds:
    - Manager research – Focusing on evaluating the investment strategy of the fund.
    - Quantitative analysis – Focusing on correlation and other statistical measures to evaluate whether funds would be an uncorrelated fit for the fund of funds.
    - Operational due diligence – Focusing on the operational and business risks inherent in the underlying fund managers' operations. The Operational Due Diligence group should have veto power over any existing or potential investment in an underlying fund.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

4. (cont.) Some non-traditional fund of fund managers either did not provide the operational due diligence group veto power, did little or no actual operational due diligence, or excluded key components such as the following:
    - Obtaining an understanding of key internal controls surrounding trading, reconciling, cash receipts and disbursements, accounting, compliance, valuation, and performance measurement functions.
    - Requesting information on any current or prior litigation.
    - Requesting correspondence resulting from regulatory reviews, such as SEC examinations.
    - Requesting personal trading policies and obtain an understanding of how the underlying manager monitors these policies.
    - Obtaining an understanding of managers' hiring practices, including compensation structure for key personnel, and turn-over.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

5. Poor documentation of due diligence conducted on the underlying investments. The investment manager indicated that elements were included in its due diligence process, however, the due diligence information maintained by the investment manager did not support the claim.
6. Inadequate assessment of fair values, including assessment of risks inherent in the lack of transparency.
7. Improper segregation of duties surrounding the cash disbursement process.
8. The investment manager did not adequately monitor compliance with the provisions of the side letter.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

9. Manager fees calculated using a soft, as opposed to hard, performance hurdle resulting in overcharges.
10. Logic errors in the formulas used to calculate custodial fees were noted, resulting in triple-charging for a certain class of investments.

Sample of Past Findings in Assessing Operational Risk of Investment Managers (cont.)

11. Manager fees did not incorporate side letter provisions.
12. Manager overcalled commitments, holds onto for three years, and only credited the Plan for the net amount invested. This resulted in an understated hurdle, which caused the manager to overcharge.

Contact Us For More Information

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