Rethinking Due Diligence and Manager Selection

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Due diligence in manager selection has become too much of a standardized documentation process. It should be an investigative discovery process. Rather than focusing on past performance of individual managers, the focus in due diligence should be on the defining characteristics of the investment management organizations where the managers work. In the long run, organizational structure, not past performance, is likely to drive future performance.

Due diligence is an important function performed by investment professionals. It has its roots in the obligation to meet a standard of care for clients—a responsibility to investigate and rigorously pursue information about the investments that are chosen on their behalf. That obligation naturally leads to a process of documentation that supports those choices. Unfortunately, the industry has developed such a culture of documentation that when people talk about due diligence in manager selection, they are often talking about collecting the available information to make a decision. The most important part of due diligence—*discovery*, which is what due diligence should primarily be about—may be overlooked.

Due diligence is an investigative process of trying to ferret out new information. In that regard, the process of performing due diligence associated with manager selection is woefully out of balance in practice. And it is out of balance across the spectrum of allocators and investors—from institutions to individuals.

Investment professionals interested in due diligence should watch *All the President's Men* or *Spotlight*. The reporters in those films are models for people charged with researching asset managers; a focus on in-depth investigations is needed.

Due diligence is not a one-size-fits-all effort; the approach should be different in each specific situation. In each case (as with other investment processes), the due diligence process should address the following three questions:

- What am I trying to do?
- Why am I doing it?
- How am I going to do it?

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The first two questions are about beliefs. I deal with all kinds of organizations, and my place is not to tell them what their beliefs ought to be but to help them think about execution based upon those beliefs. The third question is about the specific process of performing the necessary due diligence. The answers to these questions vary according to the type and size of a particular organization.

Challenges in Performing Proper Due Diligence

Consider a small, sole-proprietor Registered Investment Advisor (RIA). The defining feature for sole proprietors is that they are very stretched in terms of resources and time. Relative to larger firms, they have fewer analytical tools and less access to managers. Those constraints place limits on the depth of due diligence they can perform.

A billion-dollar RIA will obviously have more resources. Interestingly, I find that the investment function is often understaffed at those firms. In addition, differences of opinion about investment choices may occur among advisers and a firm may or may not have an investment committee. Even if an investment committee exists, it may not be effective. In some cases, the DNA of these organizations, particularly those put together by mergers, can be all over the place in terms of beliefs. Consequently, the organizations have difficulty acting together in a coherent manner when it comes to selecting managers.

The mega-RIA firms and broker/dealers, although operating under different standards of care for their clients, share some traits. Given their large size, they have dedicated resources for due diligence. But the quality of that due diligence varies considerably. In addition, issues about the use of proprietary products need to be to addressed, and individual advisers and brokers face "cleared by due diligence" risks if they use a product on an approved list that really is not appropriate for a client and has not been properly vetted.

Of course, the questions to ask in the due diligence process depend on investment strategy. With so-called passive investing, the due diligence requirements are fairly modest. But no strategy is truly passive, so there are questions to be answered about the degree and nature of active decisions to be made and specific implementation choices, including how to deal with known index weaknesses.

In factor investing, now the hottest trend, questions arise about which factors to emphasize, how they can be isolated, and whether they will prove to be robust in various market and economic environments. On the surface, factor investing gives the impression of using quasi-passive vehicles, but the degree of turnover within them varies dramatically. In terms of investor behavior, the evidence is that factor investing looks much like traditional active investing, with investors moving from factor strategy to factor strategy, depending on the environment and, of course, performance.

Finally, active management is essentially home base for the discussion of due diligence and manager selection. In general, due diligence in this category is dominated by performance evaluations, and most investor discussions revolve around it. Although a tremendous amount of information is available on active managers, getting useful, differentiated information is difficult, time-consuming, and expensive.

Think about the situation of the small RIA engaged in active management. Clearly, the firm has a real problem with due diligence; it has a shortage of time and lots of in-depth work that needs to be done. In fact, this problem is present for all organizations selecting active managers, regardless of organization size.

Investment professionals commonly say, "We believe in active management." In most organizations, I do not see the necessary resources, or the proper organization of resources, to act on that belief. A complicating factor is that active management is sexy; most clients are attracted to it and want to believe that their advisory firm can find the best managers that are available. But finding those managers is not easy, and organizations that claim to be able to do it without having the means to do so are not living up to their duty to their clients.

Making Decisions

Numbers and stories are at the core of how people make decisions. Both numbers and stories have traps, so how people process them is critical to decision making. With numbers, we tend to rely on history. We cannot predict the future.

But consider the analysis of "what works" in scholarly journals and mainstream financial publications. The answers are based upon history. Historical data are often presented as "proof"—I call this the allure of proof—but history is not really proof, just "proofiness." Paul Samuelson is credited with saying, "We have only one history of modern capitalism. Inferences based on a sample of one must never be accorded sure-thing interpretations."[1]

Essentially, Samuelson is saying that we have only lived one path, but most people like to extrapolate from it to make decisions. The truth is that we should not make grand conclusions based on that one path.

Furthermore, we have an even narrower time frame than the existence of modern capitalism; most analyses and tools are limited to a historical period of 30 years or less. For example, many finance practitioners pay $2,000 a month for a Bloomberg Terminal that provides, for many important data series, data that are only 10–15 years old. Only a few series go back 25 years or more.

That constraint makes analysis more difficult than we admit. My entire career has been during one economic regime: globalization, disinflation, and declining interest rates. In addition, over the past 30-plus years, everything has changed about the investment business and the markets. When we get out of this regime, we are set up to make a lot of errors by basing our expectations on our limited historical experience. For example, how well are we prepared to deal with the negative interest rates that are becoming increasingly common around the world? Are we really ready to deal with a high-inflation environment when it comes around again?

Everything changes—and we cannot get trapped in the frame that we are used to. Many investment variables change over time—returns, factors, correlations, styles, volatilities, asset classes—but our models to deal with them are built on stasis. The models do not properly account for the movements of those variables. Consequently, we can get pulled astray by the models.

With respect to active management, another important issue is manager and organizational behavior, which also is in flux as the environment changes, although that fact is little appreciated.

We have to try to figure out how to deal with these changes in the proper context. Unfortunately, our tools get in the way. For example, the Sharpe ratio can be helpful, but it is misused and overused. It is the key indicator used by many decision makers, yet

[1]David A. Levine, "How Much of Your Nest Egg to Put into Stocks? All of It," *New York Times* (12 February 2016): www.nytimes.com/2016/02/13/your-money/how-much-of-your-nest-egg-to-put-into-stocks-all-of-it.html.

you never hear them discuss the problems with it as an indicator or present the caveats about how it should be used. We have taken this particular tool way beyond its capabilities.

Returns-based style analysis is nowhere near as popular as the Sharpe ratio, but it is another great example of a misused tool. Consider a chemist with a beaker full of something; she can go through the various chemical processes to isolate the components of the beaker. We expect returns-based style analysis to do the same for us. Consequently, we try to justify nonsensical results from such analyses, which can be caused by the migration of those investment variables I mentioned earlier. Returns-based style analysis can be of value, but it must be used carefully.

The most common error regarding historical information is performance chasing. No one admits to performance chasing, but it is prevalent in investment organizations large and small—despite the fact that the evidence shows that it does not work. Why do we do it? A main reason is that we have designed performance chasing into our decision processes.

Why can't we stop? Consider these questions posed by Jason Hsu:

> Would a consultant or financial advisor recommend a shortlist of managers with poor recent performance? Would the pension CIO and his staff choose a manager with a negative trailing three-year alpha to present to their layman board? Given a keen understanding of investors' buying behavior, would salespeople and marketers educate client prospects on products that have recently underperformed?[2]

Well, most people do not recommend lists of managers that have underperformed. Rather than take the time to educate clients on managers that have underperformed and explain to them that the underperformers may offer a great investment opportunity, most advisers simply do not mention the underperformers. We are conditioned not to consider managers that do not have good performance over the past few years, mostly because of concerns relating to career risk and business risk. It basically comes down to market conventions and fear trumping best practice.

But, as Howard Marks put it, to achieve better results,

> you have to invest differently than the average investor. To do that, you have to think differently than the average investor. And to do that, you have to consider different inputs than the average investor, or consider inputs differently.[3]

A key way performance chasing is designed into decision making is through the routine use of screening against a database of asset managers. Investment people love to use screens. What do those screens always contain? Performance. Most screens contain some criteria that are highly correlated with past performance and specifically include performance-based criteria, such as having returns above the fund's benchmark. Although the screen nominally includes other factors, the presence of performance hurdles means that past performance drives the results by definition.

Narrative-Creation Machines

Due diligence should start by studying asset management organizations and how they work. Qualitative judgments of organizations have taken a backseat to detailed quantitative reviews. Future performance comes from today's organization, yet the "real" organization may be hidden behind its marketing narrative.

A lot of information about the asset management industry is freely available. Consulting firms large and small publish insightful commentary about the workings of asset management firms in blog postings and white papers that can be found online. Another worthwhile resource is *The Industrial Organization of the Global Asset Management Business*, which is available from the CFA Institute Research Foundation.[4]

In evaluating a particular firm, the focus of analysis should not be limited to its investment function; a holistic evaluation is necessary. Standard qualitative evaluations usually cover three key issues: philosophy, process, and people. But where does that information come from? The managers themselves.

Asset management firms have become narrative-creation machines. The narratives are necessary—when I work with asset managers, I want them to create the best narratives they possibly can. But the problem for the allocators of capital is that those narratives go uncontested by those doing due diligence. The analyst's job is to crack the narrative of a manager to find what is really there. The narrative used in decision making has to be the *analyst's*, not the asset manager's. Too often, I see a report on a manager from an institutional consultant or third-party

[2]Jason Hsu, "If Factor Returns Are Predictable, Why Is There an Investor Return Gap?," *Fundamentals* (November 2015): www.researchaffiliates.com/Our%20Ideas/Insights/Fundamentals/Pages/488_If_Factor_Returns_Are_Predictable_Why_Is_There_an_Investor_Return_Gap.aspx.

[3]Letter from Howard Marks to Oaktree Clients, "What Does the Market Know?" (2016): www.oaktreecapital.com/docs/default-source/memos/what-does-the-market-know.pdf.

[4]Ingo Walter, *The Industrial Organization of the Global Asset Management Business* (Charlottesville, VA: CFA Institute Research Foundation, 2015): www.cfapubs.org/toc/rf/2015/2015/5.

research firm that includes descriptions of a manager that are almost a cut-and-paste lifting from the asset manager's own materials. The narrative has simply been passed on by the analyst.

This narrative-creation machine has two parts. The first is simply the asset manager talking about what is happening in the investment world—ideas, strategies, portfolios, and so forth. Which is more valuable for an investment adviser: the investment value of that narrative or the communications value of it? I think it is the communications value because the stories deal with important investment ideas and are told by really smart people. We can take what they have to say and use it to enrich our client communications.

While tempting, it is dangerous to get hung up on the specific points of view from an investment standpoint because managers get hot and they get cold; their perceived wisdom ebbs and flows. Trying to keep track of who has been hottest of late distracts from the main purpose of due diligence, which is to understand the organization and how it makes decisions.

There is an interesting debate about how promotional asset managers should be regarding their point of view. If they are open about their ideas and their positions ("talking their portfolios"), they put stakes in the ground regarding their views that can be hard to pull up. They can avoid making the investment decisions that they should because their own public statements are factored in instead of just the merits of the situation at hand.

The second part of the narrative machine is providing descriptions of the organization, which are used in due diligence questionnaires, requests for proposals, presentations, and other materials. They provide standardized, stylized answers, but they do not encompass the range of issues that analysts should be worried about. Consequently, the asset management firms end up anchoring analysts where they want them to be anchored—what I call "analyst capture."

For example, if I ask someone what he likes about a particular investment manager, the response often is, "Its process." When I ask the person to tell me about the process, I usually get back the marketing version of the process, which is, of course, not the real process. In general, if you do not understand anything beyond the marketing version of the process, you do not know the process well enough to invest with the manager.

The manager narratives often include expected outcomes—such as targeted volatility, targeted alpha, or targeted risk—which are also there to anchor analysts. In a sense, those targets are helpful because analysts can work against them during the questioning process, but too often, they are taken as attainable rather than questionable.

Many asset managers' narratives include the phrase "consistent and repeatable," which to me is a hollow marketing construct. When I ask for in-depth information about what is consistent and repeatable, there is often not much there. We often see relatively consistent performance and infer the investment process must be consistent too. Continuous improvement ranks far above consistency; continuous improvement is the critical thing to focus on when looking at organizations. Apparent consistency can be a trap.

Enablers of the narrative-creation machines of asset managers include the financial press, investment conferences, and various platforms and third-party research firms. Investment conferences provide a venue where we can listen to portfolio managers talk about their investment ideas. They almost never talk about *how* they do what they do, which is of more lasting value. Similarly, investment platforms and third-party research firms often pass along and reinforce a manager's narrative when they should be deconstructing it.

Evaluating the Organization

Every organization is messy to some degree. The purpose of due diligence is to find the messiness in an organization, and the purpose of manager selection is to value it clearly in the context of everything else. People are not, generally, inclined to do so. Reports recommending a manager often include no mention of any problems or shortcomings; it is as if they do not even admit such imperfections are possible. The bedrock of the due diligence process is skepticism, but it is often in short supply.

On the soft side of organizational evaluations, I closely examine what I call their "ecosystems and egosystems." We have to remember that investment professionals are people. They make decisions just like the rest of us do, and we should turn to psychology and behavioral finance for insights in understanding them. Similarly, investment organizations are like all other organizations. For those who think investment organizations are full of rational automatons, I encourage a reading of the CFA Institute Research Foundation monograph titled *Fund Management: An Emotional Finance Perspective*.[5] It provides a completely different and realistic view of things. We often are tripped up in our analysis because we spend all our time looking at investment considerations when what really is important is how the organization works and how the people in it behave.

[5]David Tuckett and Richard J. Taffler, *Fund Management: An Emotional Finance Perspective* (Charlottesville, VA: CFA Institute Research Foundation, 2012): www.cfapubs.org/toc/rf/2012/2012/2.

The typical anthropologist off the street could go into a firm and do a better job of due diligence than most investment analysts. The reason is that the anthropologist would look at how the organization is put together—the connective tissue—and would not go to the chief to ask about the tribe. The anthropologist talks to the members of the tribe in great depth.

The best due diligence is field work. Large organizations should absolutely be doing onsite research. It has to be well designed, and it needs to differentiate and identify the aspects that are critical for future success. Field work calls for different skills from the skills a typical investment analyst has. Indeed, few people are actually trained in due diligence. No wonder we do not do it as well as we should—nobody has ever trained us to do it!

Most firms cannot send someone out to see every manager, and small ones do not visit managers at all, so we also have to think about carrying out due diligence from a distance. Doing so requires a narrow focus—targeting fewer managers and asking the kinds of questions that are uncommon. You should avoid getting hung up on investment predictions (yours or the manager's) that are fleeting in their importance. It is beneficial to break out of the normal channels and talk to individuals in different parts of an organization. Although in-person due diligence is best, talking on the phone can be useful. Just as Woodward and Bernstein got some key information about the Watergate scandal from working the phones, we can too.

Analysts should focus on methodology—focus on the *how*, not the *what*. Most investment people love to talk about the what, typical investment talk. To do effective due diligence, we need to ask important questions that focus on how the organization works, such as how decisions are made and what sources of outside information are used. So, we need to take the conversation back to the *how* at every opportunity. And we need to remember that everything is connected—the smallest piece of information is important in the mosaic.

Some tips when doing due diligence: Remember, it is your agenda, not the manager's. You need to be in control. Do not listen to presentations or pitches; get them in advance and spend the time asking good questions. Have a plan for what you want to cover, but follow the evidence where it leads you. (The goal is not to fill out a due diligence report but to discover new information.) Learn about the whole organization, and talk to many people individually from various parts of it, triangulating on the question of whether it is likely to excel going forward.

For those who are outsourcing due diligence to others, evaluation of the providers is critical in discovering whether they can really add value. Such evaluation is difficult for those who are not used to doing it. In some cases, the providers send out junior people for site visits, and in other cases, due diligence methods may be sloppy. A former student of mine, who works for an asset management firm, told me that even the institutional consultants who come to visit ask easy questions. So, whether outsourcing is providing what you need is difficult to know without analyzing the providers' methodologies. As a first step, I suggest tracking the provider's decisions. When they recommend managers, what does the performance profile look like leading up to that decision? When they recommend firing managers, what is the performance profile leading up to that decision? In essence, try to see whether performance is the defining factor. Anyone can make decisions on that basis.

We know from the available evidence that investment fund flows occur in response to performance. We also know that most of the time, performance is pretty much statistical noise. People want to say otherwise, but in the short term, it is mostly noise. And flows amplify performance, resulting in virtuous cycles and vicious cycles. The stereotypical example is Janus during the dot-com era. Janus started buying the high-flying stocks. Performance was great, and the money kept pouring in. Janus continued to put the money to work in the same names that it had always favored, and the cycle was just glorious—until it was not, at which time the whole thing shifted into reverse.

Crowded investments are riskier than sparse ones. That is true for stocks, and it is also true for investment managers. Once the poor performance starts, it is hard to stop because of the outflows that force managers to sell down their positions. In addition, the managers tend to take more risk when they are under pressure, to try to recoup losses. Organizational stresses are revealed, some of which may have been able to be anticipated by means of thorough onsite due diligence.

Roland Meerdter defined the concept of "auto-flow" into crowded investment strategies: "the stage at which the money into an investment product decreases in terms of quality while its volume increases. A fund in auto-flow often has become the 'default' for a specific asset class. Once auto-flow is disrupted, the imbalance causes cascading outflows."[6]

Funds that stumble after being in an auto-flow situation can come unwound in a big way. Recent examples include the PIMCO Total Return Fund, the MainStay Marketfield Fund, and the Growth Fund of America—all different kinds of funds with different catalysts, but the same results.

[6]"King Gross—An Unintentional Abdication," *Propinquity* (2016): http://propinquityadvisors.com/king-gross-an-unintentional-abdication/.

So, focus on the impact of flows. Popularity is a hindrance; the crowd can control manager behavior at critical times. You must be ready to move early when such a situation presents itself, rather than fight the unwinding of a popular idea.

Capacity considerations are also important. Do not go by what a firm says a product's capacity is. The firm is self-interested in managing perceptions about capacity. Examine a strategy in all its permutations; it could have been marketed in separate accounts, mutual funds, variable annuities, wrap products, a subadvised portion of another mutual fund, and on and on. In addition, try to find out what other kinds of products the managers are using the same securities in—and the actions of competitors that are doing the same thing. And remember that during times of financial stress, previous estimates of effective capacity become irrelevant.

Most importantly, evaluate the manager's actions and previous statements. Some organizations are good at closing funds at appropriate times and do so in an investor-friendly manner. But you also should watch what they say; estimates of capacity have a way of creeping up over time as assets grow. A few years ago, Jeff Gundlach, the founder of Doubleline Capital, said, "It's fun to manage $5 billion. If you manage $70 billion, you're going to have to say 'yes' to the marginal securities."[7] Now that he *is* managing that sort of money, I wonder if he is accepting marginal securities.

Organizational Characteristics

All organizations have defining characteristics, such as their ownership structure, business model, client base, organizational design, incentives, staffing philosophy and training, and information architecture. In addition, many have a language of their own. Those characteristics are critical in understanding how the organization operates. Staffing philosophy and training are two particular areas where investment management firms tend to struggle, which is hard to believe because the lifeblood of the firms is their human capital.

Structure drives process, and it is critical to carefully examine structure versus process when carrying out due diligence. How does the structure of the entire organization relate to the firm's strategy, particularly if the firm has a single strategy? Sometimes, you can see a problem by simply looking at the organization chart and a description of the investment process. In addition, incentives are important, and diversity is finally starting to get the attention it deserves.

"Information architecture" is a term that describes how firms organize, array, and use their information. It is critical. It is an area of emphasis for me in doing due diligence. As an example, I was once part of a group that was proposing to do some work on information systems for a well-known asset manager. I was there for a couple of hours, only talking with information technology people (no investment professionals), but I walked out knowing the structure and priorities of the organization. I knew much more than I expected to know about the culture of the organization, and I could see what I thought were definite weaknesses in the organization—all from two hours of work focusing only on the technology infrastructure.

Conclusion

Qualitative judgments need to have a larger role than at present in the manager selection process. When I ask allocators how they factor the qualitative side of things versus performance, they generally tell me that performance is only about 20%–25% of the decision process. But that is just not the case. In many organizations, they comb through tens of pages of different ratios and performance plotted in myriad ways—that is a sign of quantitative results driving everything. The qualitative factors are looked at very superficially. From the moment the process starts with a screen, performance drives the decision-making process. That should not be the case. We need to design out performance chasing, just as we have designed it in.

We need to change our approach to due diligence and manager selection. We need to favor qualitative information over quantitative measures. Reputation is a lagging factor, and the real organization is hidden from us. We must uncover it—that is what due diligence is all about. I suggest grading organizations ex-performance. We should buy and sell against the popularity cycle by basing decisions on the quality of the organization, not what its recent performance has been, and analysts should act as if they have 10-year investment horizons.

To add value on behalf of clients, we have to change the way we are making decisions. The focus should be on the organization and how decisions are made. We should be looking for organizational alpha, not portfolio alpha.

CE Qualified Activity CFA Institute 0.5 CE credit

[7]Randy Diamond, "Doubleline's Gundlach Bouncing Back," Franklin Square Investment Partners *Investment News* (4 October 2010): www.investmentnews.com/article/20101004/FREE/101009981/doublelines-gundlach-bouncing-back.

Question and Answer Session

Tom Brakke, CFA

Question: Based on your experience, is there one characteristic that has the most impact on a person becoming a high-quality manager? If so, is it education, credentials, age, gender, experience, or something else?

Brakke: I do not want a hired asset management firm to be one dimensional at all, so the diversity element comes into play. I want cognitive diversity, not just social diversity. Many management firms, especially small firms with managers who have gone out on their own from a successful organization, are too monolithic in terms of how they think about the world. They might do okay for a while, but they are going to have trouble in a variety of different environments.

I recently asked a number of investment firms about their training processes, and you might be surprised that 90%–95% of them said they essentially have no training and development plans for senior investment staff. Apparently, portfolio managers come fully formed! They do not have anything they need to work on.

Question: If you could pose only one question to an asset manager, what would it be?

Brakke: My first question would be, What are your weaknesses? I really want to understand what managers have identified as areas in which they have to improve for the organization to be successful. I know from experience that all I am going to hear back are positives, strengths. Most managers will squirm if they are asked that question because they do not want to talk about weaknesses. They do not want to admit that there is something that they are not as good at as others.

Girard Miller, who is the chief investment officer for the Orange County Employees Retirement System, recently created a very interesting request for proposal. He provided seven characteristics that a firm ought to have, and he told candidates to list them one through seven in terms of how good they were at each—a forced ranking. Of course, they could still claim they were good at all of them, but he forced them to rank each.

I want the candidates to tell me what they need to work on and how they are going to improve.

Question: Given the work involved in doing proper due diligence, and given the underperformance of active managers, is it better just to throw in the towel and go passive?

Brakke: I do not know if I would say "throw in the towel," but I think it is better in many cases to at least have part of your exposure be to passive investing, if only to be able to get the exposure to beta. Passive management has problems just as every other approach has. That said, in terms of weighing one against the other, organizations have to be honest with themselves about whether they are going to add value. The evidence is all clear: The beneficiaries of active management are the active management firms themselves. They really do add value before fees, but not after fees. Then, you add to that a layer of advisory fees, and the client is not served at all.

The question of active versus passive is worth asking. If you can improve your client's situation by using some passive strategies and concentrate your active strategies into areas in which you actually know something more than other people—that is a pretty powerful combination.

Question: Is the process more difficult for certain asset classes? Are there due diligence analysts that have certain characteristics; maybe they specialize in a certain class?

Brakke: Much research is devoted to what is commonly called "operational due diligence" for hedge funds and the like. I think some of that same intensity ought to be brought to analyzing long-only managers. Many managers of alternative investments are quite opaque, even in the liquid alternatives space. So, you have to ask questions about levers needed to operate in a particular strategy.

Alternatives have become very popular, but the knowledge base is lagging pretty dramatically. If I gave a test to most advisers about what is in those products and how the products should be expected to perform over time, my guess is that most would fail. As a wealth management organization, if you are using alternative products, I recommend you pay a lot of attention to them and make sure, from an education standpoint and from a due diligence standpoint, that you are prepared to make good decisions on behalf of your clients.

Question: One way to select managers is to use pre-vetted managers and products on custody platforms. Are these platforms performing the same level of due diligence when they accept a manager on their platforms?

Brakke: Most are doing some due diligence, but from what I have seen, it has not been thorough. In many cases, the effort is much more oriented to getting good performing managers into the system than understanding the managers in depth.