Due Diligence:
A Predictive Performance System

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What you will learn:

1. Investment due diligence is an essential component of competent investment execution.
2. Quantitative analysis discovers only those investment candidates mapping to both necessary and desirable Factors while excluding all others.
3. Investments with an historical pattern of producing targeted Factors are more likely to continue this pattern in the future; "luck" is unlikely to be repeated consistently.
4. Once an investment is deemed a worthy candidate, the sponsoring firm must be assessed; investors "hire" firms and not investments.
5. Investments likely to hold the past's investment record in the future show disciplined decision making.
6. Due diligence must separate from preferences and be decidedly objective.

Due diligence is an activity that all investment advisors purport to do and do well; for one to say otherwise would be professional suicide. The point here is not to stand in judgment of one due diligence process over another, but to point out that adding portfolio value begins and ends with the process' effectiveness. Either avoiding a pitfall or realizing extraordinary gains earns a lofty status.

Going beyond historical performance comparisons, standard-bearing due diligence processes identify sustained delivery of target investment factor characteristics ("Factors") while equally investigating firm- and people-based operations. Consistency is the opposite of luck and arises from disciplined and repeatable decision-making methods.

A Wealth Plan: Giving Due Diligence its Investment Purpose

A wealth plan is an inventory of an individual investor's circumstances, needs, anxieties and aspirations and their respective funding requirements (institutions call this inventory, liabilities).

An investment plan must deliver the funding necessary to fulfill the wealth plan's objectives. A truism holds: a wealth plan without investment execution is fruitless; investment execution without a wealth plan is aimless.

The wealth plan structures the investment execution by organizing the

funding inventory into time horizons—short-term; mid-term; long-term—with each horizon having its own investment objective.

Generally, the short-term seeks low volatility so when bills come due, the money's available. The long-term seeks growth necessary to overcome inflationary erosion and, most important, to build a cushion accounting for forecasting errors in valuing future funding needs. The mid-term represents an efficient bridge as long-term investments transition to cash-producing resources.

Portfolio construction explicitly identifies investment Factors to meet each horizon's objective. Since investments execute the wealth plan, due diligence that does not hold tightly to these same Factors ends up as an unfulfilled promise.

There's a practical order to due diligence centered on efficiency. The investment discovery process eliminates those investments unlikely to achieve what the plan requires. For example, if a wealth plan dictates low volatility or defensiveness as a guiding sentiment for the short-term horizon, conducting due diligence on investments ill-fitted to these requirements wastes time and resources.

Today, reams of data exist that describe investments, but standard-bearing analytical tools push out data noise to focus on the critical Factors necessary for the investment plan to effectively execute the wealth plan's definitions.

Firms, People, and Products

Ask an investment advisor what due diligence is and an answer will likely reflect the sentiment that "it is an evaluation of the relative merits of one investment compared to another". True enough, although the due diligence eye has a vastly wider field of vision.

A person driving a car to a destination is analogous to the elements investigated in due diligence. When money is invested, what is actually acquired? The first thing acquired is the investment firm.

The firm contains all the fiduciary, compliance, organizational, and market characteristics; it is the entity through which investing takes place. To wit, as the car allows motorized mobility so does the investment firm allow investing.

A car cannot move on its own without a driver, the firm is an inanimate entity that can neither act nor think. Employees of the firm make investment decisions. Depending on the firm, the list of individuals involved with investment decision making will include: the chief investment officer, economist, portfolio managers, research analysts, and traders. Together, the collective choices made by the firm's people determine which investments are bought and which are sold. The sum of these choices determines the firm's ultimate quality.

Two firms of similar size will have different investment results. Each investment decision is like making a series of turns in a car to arrive at a destination. Drivers will have quite differ-

ent experiences. One will arrive more quickly, another will incur more expense, and yet another will encounter traffic. So it is with comparing investment products, investment performance represents the cumulative investment decisions (i.e. "turns") made by the investment team.

The investment marketplace, it can be said, commits nearly all its attention to investment performance. Lacking a deep appreciation of the firm-people-product linkage will curtail the impact due diligence can have in mitigating this truism: if either the firm or the portfolio management team fails, the investment fails.

Data, Information, Knowledge, and Wisdom

While any due diligence process will include the basic steps listed above, it is certainly not suggested that the manner in which those steps are carried out, process to process, is the same. Most Requests for Proposals (RFP) ask about due diligence as a check-off item: Do you do it? How do you do it?

Interestingly, few RFPs ask how the due diligence process adds value to investment selection and portfolio construction or ascertains whether an advisor considers his or her process to be a competitive advantage.

This is more than a nuance. A doctor that asks a patient the wrong questions has done a patient evaluation. A doctor that asks the right questions, but does not listen to the patient's answers has done a patient evaluation. A doctor that asks the right questions, listens, but is not current in treatment options has done a patient evaluation. None of these scenarios leads to an acceptable practice standard. So it is with due diligence processes.

Consider this progression to understand how differences in due diligence process designs alter the ability to seize value.

Due diligence for a core fixed income product will be very different from a large cap growth equity product, and this will be very different from a market neutral hedge fund-of-funds evaluation. Knowledge shapes information by adding purpose and rids the process of noise and distractions.

Wisdom adds a whole new dimension to due diligence. While Factors are weighted to reflect relative importance, answers gained from insightful questions account for how disciplined decisions produced the performance record.

Comparisons are made across managers, products, and vehicles. Experience and intelligence direct the process but wisdom uncovers the applied knowledge.

A Comprehensive Due Diligence Process: Basic Steps

Regardless of the advisor, any due diligence process will have the following fundamental steps.

1. Database Analysis

At the outset, due diligence draws upon computer-based programs and databases for high powered filtering. The databases will have tens of thousands of

investment products, hundreds of benchmarks, and myriad risk Factors and other statistics to search and sort. A tool's merit is derived from its ability to combine multiple factors and time periods into a structured result that accurately reflects various investment environments.

2. Product Rankings

Using the database output, the advisor evaluates the results to identify those best fitting the required Factors the wealth plan defines.

3. Investment Firm Participation

The fact that an investment product has all the features an advisor wants is irrelevant unless the investment firm is willing to give the advisor authority and access to actually use the investment product (i.e. these are contractual agreements).

Some investment firms will seek to work with as many investment advisors as possible while others are far more selective, catering only to the largest institutions or wealthiest families.

4. Negotiation

Investment firms that agree to work with a manager will do so only if it is economically feasible.

Feasibility is more than the advisory fees charged to the investor to use the product, but also includes the wholesale, back office, and technical resources required to support and connect to the advisor's platform.

Investment advisors with large distribution possibilities will be viewed more favorably than those with limited potential.

5. Positioning

Most advisors will have several investment choices for a given strategy and may include different investment vehicles as well.

The task is to associate properly a product's characteristics best fitting the client's situation. (Noting here that some advisors may override at their peril the best fit for an investment firms brand reputation and/or cache.)

A Comprehensive Due Diligence Process: High-Value Elements

The best due diligence processes, as stated earlier, are much more than having tools and commitment.

Investment advisors must not only aspire to achieve insightful analysis, but also to catalog ongoing learning so the knowledge and wisdom elements come alive. Superior due diligence is built upon the foundation of the characteristics reviewed below.

6. Follow-up Questions

An advisor armed with a list of interview questions that dutifully follows the order gains little in establishing an insightful understanding of the likelihood that a manager's process will sustain past performance in the future.

Each initial question in the list sets in motion a discovery methodology derived from other questions in response to each answer a product manager gives.

Yes, this is first an exercise in active listening, but, second, the advisor's experience must guide the dynamic framing of the follow-up questions.

Subsequent questions uncover the relative solidity of the manager's processes, thinking, rigor, and commitment; all the elements that make every manager interview unique. This is a direct application of wisdom and where the treasure in due diligence lies.

7. Relative Value

A due diligence process will produce volumes of quantitative and qualitative information.

Typically, the conclusions arising from the manager interviews, document evaluations, and reference checks buttress what was learned in the quantitative investment discovery. Keep in mind that, while due diligence uses historical information, its orientation is to the future. The place to judge the future comes from confirming or disputing the pattern suggested by the quantitative evaluation.

The advisor's due diligence process must properly weight components to allow the most important insights to rise to the top of the decision matrix; elements must not be treated equally.

8. Consistent Application

A process is a process only if it is applied consistently.

For due diligence, this retraces the portfolio team's historical decisions made in reaction to market events and circumstances occurring at a point in time. The beauty of consistency comes into play when, over time, value clearly shows. This value creation from previous decisions illustrates an advisor's competitive advantage and leverage.

9. Evolutionary Refinement

Consistency is a cousin of rigor, but this rigor must not rise as a dictator to the process.

Investment advisors deliver value by applying wisdom and thereby see areas to refine and improve. Making changes to a process is a sign of strength not weakness. Indeed, process changes serve the advisor well in proving that due diligence is an active, live component to investment planning.

10. Situational Freedom

Part of an effective due diligence process is exception handling.

Exceptions, guided by structure, allow the advisor to adapt to situations and circumstances without enslavement to the process. For example, identifying capable managers in less common geographical regions in order to better serve a client's desire for face-to-face contact adds value to the relationship as long as the required compromises meeting this need are well documented and understood.

11. The Client's Value System

Investment advisory is foremost a relationship business.

A client's values may not be explicitly designed into the due diligence process but, in the process' scope, can be accommodated. This affords the advisor

an opportunity to set a customized investment plan in motion, while providing a context for enhancing the relationship. An example is a client desiring an impact investing tilt; this can certainly be addressed without detracting from the process' overall value.

12. Manager Relationships

High performing managers usually have many asset gathering sources and can pick and choose its investment advisory relationships.

An advisor lacking preparedness, discipline, sophistication, and professionalism will not gain access to the best managers and products.

Without being belligerent or arrogant, the advisor must ask penetrating questions and give insightful feedback. As well, the advisor must be true to the due diligence process and own the agenda to prevent a prominent, name-brand manager from merely presenting his or her standard marketing pitch.

13. Organizational Priority

Any repeated process becomes tedious and the temptation is to delegate responsibility to less experienced personnel.

While delegating a portion of the process offers an ideal professional developmental opportunity, the advisor must still own the entire process, and most important, conduct the qualitative assessments.

Gaining insights, cataloging wisdom, and making process refinements occur only when the advisor places due diligence accountability high up in the organization.

14. Coaching

Effective due diligence generates an evaluation and relative position of a firm, its people and products.

The advisor can enhance his or her relationship with the manager by giving improvement suggestions to the investment presentation and discussion.

Moreover, separate account managers will be called upon to meet personally or electronically with a client. To the client, the manager is an extension of the investment advisor. An advisor's stature increases when the manager capably and professionally articulates the investment's strategy, position, and expectations. It is in the advisor's own self-interest to coach the manager before any presentation to ensure that the most effective meeting will occur.

15. Walking Away

Prior to launching an investment product, the business relationship between the manager, the advisor, and the client must be solidified.

For investment vehicles other than mutual funds, the advisor and manager will negotiate fees, services, and reporting expectations. The advisor must be willing to walk away from a manager if minimum relationship standards are not agreed upon.

16. Always On

There are "seasons" to the due diligence process involving performance updates.

The monitoring process uses these intervals to reevaluate existing managers and update watch lists (i.e. possible investment products). Even with an investment product approved as a platform offering, the manager actually receives a "round trip ticket" wherein the return is used when a firm, its people, and/or its products fail to maintain the required standards at some point in the future.

Managers are terminated and this reflects a healthy due diligence process.

17. Dispassionate

As a professional services business, investment advisory revolves around relationships. Naturally, advisors that frequently engage managers in client portfolios will not only deepen the business relationship but the personal one as well.

The challenge is to keep sufficient distance between the due diligence process and these relationships in order to eliminate favoritism that may cause a manager to overlook danger signals arising from the ongoing due diligence process. Friends are one thing, however, the advisor must remain more committed to his or her fiduciary responsibility.

18. Anticipation

Due diligence expects to minimize performance, people, and firm surprises.

Monitoring strives to identify potential failures and to alert clients when any mishap appears on the horizon. It is far better to let the client know that corrective action was taken and the threat is no longer active, than to let a problem fester and have it hit the client relationship with blunt force.

The engine within the monitoring function to uncover these signals is the same due diligence process applied anew during periodic review. The advisor always takes aim, to the degree possible, at directing activities and responses instead of reacting.

Predictor of Future Performance

Effective due diligence processes draw a trend line derived from the past and extrapolates it as a predictor of future characteristics.

While this runs counter to the compliance caveat, "Past performance is not a predictor of future performance", it must be clear that due diligence's domain is the future; again, clients don't buy past performance but they invest in hoped-for future gains.

Far more scientific than artistic, leading due diligence processes identify the elements found in the firm-people-product data pool that are replicable and likely to maintain the past's trend line.

Just as an investment product's performance is derived from people's decisions, so is the success of predictive performance a function of the people that design, manage, and refine the due diligence process.

About the Authors

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A thirty-year investment advisory, financial services, and technology veteran, Kirk Loury has worked across the industry as a chief investment officer (alternative and traditional investment firms), strategic consultant, chief marketing officer (mutual funds and venture capital), and the founder of multiple financial technology companies. Loury earned his B.S. in marketing from the University of Colorado, Boulder and his M.B.A. from the Harvard Business School.

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