Due Diligence: A Predictive Performance System

by Kirk Loury

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Wealth Planning Consulting, Inc. (WPC) is a retainer- and project-based consulting operation that has five particularly unique qualities important to its clients:

- Original investment research that demystifies investing.
- Using investment research as marketing tools to establish clear competitive differentiation.
- Integration of the investment solution with compelling sales and marketing messaging.
- Working with sales management to successfully execute the competitive messaging through relationship personnel in specific markets or territories.
- Addressing specific opportunities to win strategically important relationships necessary to shift the competitive balance.

WPC works with a wide variety of investment advisory organizations from private banks to broker/dealers to independent RIAs.

Due Diligence:
A Predictive Performance System

What you will learn:

1. Investment product due diligence is an essential component of competent investment solutions.
2. A process' highest value comes from qualitative analysis (evaluating the human dimension) and much less from quantitative analysis (reviewing data).
3. Qualitative analysis seeks to identify if a product's past performance is due to disciplined decision making or more by chance.
4. While future performance cannot be predicted, a product manager's decision-making rigor, and its role in producing the past performance, does tie together the likelihood that a performance pattern will continue (i.e. a pattern being excess return over a benchmark, tax efficiency, protecting when markets decline, etc.)

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 or another, but to point out that adding portfolio value begins and ends with the process' effectiveness. Either avoiding a performance pitfall or realizing extraordinary gains earns a lofty status.

Going beyond historical performance comparisons, standard-bearing due diligence processes investigate firm- and people-based strengths and weaknesses, recognizing that as much portfolio damage can occur with missteps in these areas as with poor product performance. And, the advisor suffers substantially greater reputation risk when a firm or its people fail compared to a product that underperforms its target.

The Investment Process: Giving Due Diligence its Purpose

For a due diligence process to have any value, it must be guided to find, evaluate, and rank hundreds of available data items. Portfolio construction explicitly identifies asset class factors that drive asset allocation according to an investor's circumstances, needs, anxieties and aspirations. Since investment products execute the asset allocation plan, due diligence that does not hold tightly to these same factors ends up as an unfulfilled promise.

The investment process defines for investment product due diligence these core relationships:

- Data items applied to any investment circumstance.
- Data items that are circumstance dependent.
- The relative value of one selected data item to another.
- The mixture of data elements that add value to portfolio construction.

Of the vast number of quantitative factors available through computer filters, a relatively few number have any practical value as it relates to portfolio construction. Presenting reams of due diligence data as proof of rigor either demonstrates: 1) a lack of confidence in developing evaluation systems or 2) intentional complexity to distract investors from an uncompetitive investment process.

Driving to a Destination		Making an Investment
• A Car	Is To	• An Investment Firm
• A Driver	Is To	• A Portfolio Manager
• A Destination	Is To	• An Investment Product

While due diligence is a discrete step in wealth management, if it exists as a standalone item and/or is a decoupled step to the investment process then planning compatibility is at risk.

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 investment products". 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 in a product, what is actually acquired? The first thing acquired is the investment firm.

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

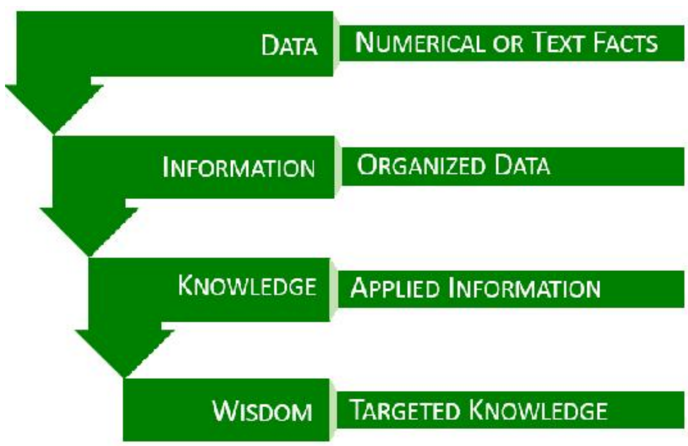
As a car cannot move on its own without a driver, the firm is an inanimate entity that can neither act nor think. Employees of the firm make investment decisions. Depending on the firm, the list of individuals involved with making investment decision will include: the chief investment officer, economist, portfolio managers, research analysts, and traders. Together, the collective choices made by the firm's people determine how products perform and the ultimate quality of the firm itself.

Two firms with a similar market stature and professional quality will have widely different products and results. Each investment decision made – buying, selling, or holding securities – is like making a series of turns in a car to get to a destination. How one driver gets to a destination will be different from another. 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 investment firm or the investment product's management team fail, the investment advisor 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 asset allocation 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 design alter the ability to seize value.

Regarding due diligence, any investor or advisor can gain access to data and information (as pointed out in "Basic Steps" following); it's simply a matter of subscribing to a product database. In the context of due diligence added value, this is nothing more than a commodity.

Due diligence knowledge attacks information with a clear understanding of how information interacts and the ability to filter out noise. For example, 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. How filtering criteria are applied to different mandates embodies the knowledge.

Wisdom adds a whole new dimension to due diligence. Factors are weighted to reflect relative importance. Questions are asked of the people to ascertain the reasons behind performance. Comparisons are made across managers, products, and vehicles. Experience and intelligence direct the process instead of reacting to results.

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 thousands of investment products, hundreds of benchmarks, and myriad risk factors and other statistics to search and sort. By and large, an advisor is neither advantaged nor disadvantaged with one filtering database or another.

2. **Product Rankings**
Using the database output, the advisor evaluates the results to identify those investment products that meet minimum criteria.

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 product 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 will override the fit given an investment firms better support, reputation, and the like.)

A Comprehensive Due Diligence Process: High-Value Elements

The best due diligence processes, as stated earlier, are much more about 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. A temptation is to use the information from investment product database providers as a primary source because it is pre-packaged and readily available. As it is with many things, the most valuable elements come through hard work.

   Typically, the conclusions arising from the manager interviews, document evaluations, and reference checks offer far more relative value compared to the quantitative set. Keep in mind that, while due diligence uses historical information, its orientation is to the future. The best place to judge the future comes from the insights gained from the qualitative 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 socially responsible investments; this isn't an everyday search, yet it 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 whether or not the manager was approved by the process or not. It may very well come to pass that a manager in a lower tier today will improve over time, and the advisor that willingly assists the manager to improve gains a preferred position.

    Further, 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 product's strategy, position, and prospects. 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 ticket 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 mishaps 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 that gives these signals is the ongoing due diligence process. 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.

From quantitative information gleaned from database filters, this predictive objective jumps to the more insightful realm of personal interviews, presentation evaluations, and communication capabilities.

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 Kirk Loury

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 two financial technology companies. As the founder of Wealth Planning Consulting, Inc. (WPC), he has developed two major, high-value components for financial and wealth management firms.

- The Balance Sheet Methodology (BSM) is a cloud-based financial planning, investment, portfolio, rebalancing, trading/execution, and monitoring platform with unprecedented integration and economic value. These qualities are noted in BSM's "no compromises functionality"™ and "5-pillar integration"™ market standards.

- Practice in Action! is a business coaching solution designed specifically for small- to mid-sized financial and wealth management firms seeking accelerated business performance. Using a unique combination of distance learning and the on-the-ground strength of Action! Groups (a pre-assigned accountability group of ten peer professionals), topics move quickly from concept to execution to results. Practice in Action! focuses its content on business planning, time budgeting, marketing, sales, service, and execution. The program spans twelve months and delivers a strong ROI arising from our extreme emphasis on execution.

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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