



Scrutinizing Your Fund Managers: 5 Best-Practice Steps for Conducting Due Diligence and Evaluating Fund Managers

SEVERAL EPISODES OF RECENT INVESTMENT FRAUD POINT TO THE NEED FOR FIDUCIARIES to conduct extensive due diligence when selecting investment managers. The most publicized case has been that of Bernie Madoff, the founder and chairman of the eponymous New York hedge fund Bernard L. Madoff Investment Securities LLC, one-time Chairman of the NASDAQ stock exchange, and former National Treasurer of the American Jewish Congress.

In March 2009, Mr. Madoff plead guilty to defrauding his clients of an estimated \$20-65 billion. His clients included wealthy individuals, retirement trusts, banks, charities, hedge funds of funds, and other domestic and international investment entities. Although it appears likely to enter history as the largest “Ponzi Scheme” ever perpetrated, it is not the only investment fraud that has been exposed since the markets contracted sharply in 2008; the FBI website reports that it is actively investigating over a dozen cases of such high-profile fraud, albeit on a much smaller scale.

Regardless of recent headline scandals, the vast majority of investment managers serving qualified retirement plans are legitimate. Yet, even legitimate managers leave a plan sponsor and its fiduciaries liable for certain activities. Consequently it is incumbent on the plan sponsor fiduciaries to incorporate a comprehensive due diligence review process when selecting an investment manager.

The goal of this report is to provide the plan sponsor and their fiduciaries with an outline of the best practices that should be employed during the investment manager selection process.

Best practices approach to hiring investment managers

Every plan sponsor must make decisions concerning the evaluation, hiring and occasional firing of investment managers. These decisions demand prudent fiduciary judgment, and the exercise of skill and caution, tempered by experience. When evaluating potential investment managers, decision makers should, at a minimum:

- a. Construct a complete profile of an investment firm’s investment and business approaches Professional resources
- b. Financial strength
- c. Historical performance
- d. Regulatory history
- e. Personnel, fees
- f. Other appropriate factors.

Appropriate due diligence should not only help plan fiduciaries avoid fraud, but provide practitioners with greater long-term satisfaction with their choice of investment managers. The result should be both reduced manager turnover as well as stronger long term investment performance.



Set clear and reasonable objectives for the manager.

There are two inevitable truths that fiduciaries must acknowledge regarding the manager selection process:

- a. Recent performance is a poor predictor of future performance, and current trends are unlikely to persist.
- b. Every manager will inescapably enter a time period when their particular strategy is out of favor.

If a committee's objective in hiring a fund manager were to preserve wealth in down markets, then denigrating such a fund when it does not "shoot out the lights" in a bull market is less than productive. Nonetheless, every manager must be held accountable for their performance relative to their affirmed strategy.

Delegate responsibility and accountability to investment professionals.

A typical investment committee is composed of busy professionals of varied expertise with a variety of other business duties to juggle. Why wouldn't they leverage the experience, resources and established due diligence processes of a dedicated investment professional? An appropriate advisor will not only share in the fiduciary responsibility of the plan, but will already have first hand experience with an array of effective managers and practices. Of course, the independence of such an advisor must be sharply considered; too many still receive undisclosed or inordinate fees for steering fiduciaries to a particular manager. Be forewarned: all investment professionals are not created equal. The advice a committee receives from their advisor can only be trusted when that advisor has no conflicts of interest. Only advisors who prove to be 100% independent from the managers they recommend should be relied upon by plan fiduciaries.

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Use initial screens that do not emphasize performance, but focus on search objectives.

In searching for a competent manager with a 'wealth preservation' mandate, the following three criteria can begin to narrow the search:

- a. Manager tenure – The committee will want to know that the fund's current manager "owns" that fund's track record (i.e., has himself or herself actually directed investments of that fund, as opposed to merely replacing someone else in the manager's seat). A reasonable minimum tenure may be five years or more for the fund's lead manager(s).

- b. Concentration of holdings – Lower concentration of holdings leads to greater diversification of assets.

This diminishes the potential negative impact that the failure of a single holding or small group of holdings can have on the fund's overall performance. Depending on its objectives, the committee may set an initial screen to exclude funds with fewer than 60 holdings.

- c. Volatility – In financial theory, higher volatility, as measured by standard deviation of returns, is associated with higher risk. In searching for a fund manager appropriate for wealth preservation, the committee may screen to eliminate funds exhibiting high standard deviation.

Perform strong due diligence:

Evaluate the 4 P's "People, Philosophy, Process and Performance".

- I. **People:** Carefully consider the stability of an organization and its personnel. Questions the committee should answer include: Are firm characteristics favorable, and likely to remain so? Are the organization's personnel trustworthy and capable? Specifically, are there past



judgments against the firm or its employees, current litigation, or ongoing regulatory scrutiny? Is there a structure of sufficient openness and oversight that any questionable actions or considerations will be quickly noted and stopped – ideally before they are even taken? When evaluating potential fund managers, Benjamin N. Alpert, CFA, notes the following Fraud Warning Signs in his recent Morningstar article *Madoff Reminds Investors (Painfully) to Do Their Homework*:

- a. Unusual structure or complexity
- b. Related brokerage and custody
- c. Unknown or related auditor
- d. Self administration

The common thread in these signs is obscurity and obfuscation, and particularly a lack of objective, third-party oversight. A legitimate fund manager generally has nothing to fear from openness.

II. *Philosophy*: A manager's philosophy should describe in broad terms how investment returns will be generated for its clients. Committees then must judge whether or not the investment philosophy is consistent with the asset class objectives stated in the IPS. Additionally, the committee should determine whether the manager's actions may have diverged excessively from its stated philosophy at any point, to ensure that the fund will consistently fulfill its intended role in the portfolio.

III. *Process*: Focus on how managers put their investment philosophy into practice. Obtain sufficiently detailed descriptions of portfolio construction methodologies, screening processes, and buy and sell discipline, and address any apparent contradictions or perceived inconsistencies. Further, discover whether individuals or teams manage the portfolio, if leverage or derivatives are used, and how risk is managed. Finally, evaluate whether the stated and observed practices are in line with the desired objective.

IV. *Performance*: Evaluate the fund's historical returns to answer the following two questions: 1) Has the manager demonstrated an ability to add value in a manner that is consistent with the committee's original

search objective? 2) How well and consistently has the manager executed their strategy? Judge to what degree the fund's results are the outcome of the manager's skill and actions, and to what degree the factors that contributed to the results will continue in the future.

Conclusion

Investment fraud is a relatively rare – though a real – danger. The more common potential liability for plan fiduciaries is an inadequate evaluation of the plan's fund managers. Both dangers can be mitigated and pitfalls avoided via a thorough and objective manager evaluation process such as that described herein. Following this five step approach should generate a strong conviction among committee members that the managers they select (1) are legitimate and capable, (2) will meet the plan's long-term needs, and (3) can be effectively monitored over time. This conviction will enable plan fiduciaries to turn their attention to and better address their other responsibilities, leading to greater organizational effectiveness and reduced cost of oversight.

For completely independent assistance in evaluating fund managers, please contact Bidart & Ross, Inc. Our investment professionals have 20 years of experience selecting and monitoring fund managers on behalf of plan sponsors and fiduciaries. We would be pleased to help you address your Plan's investment selection and monitoring needs.