

Due Diligence in Manager Selection

A Practitioner's Perspective

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Agenda

- **Objective: Discuss a number of best practices for manager due diligence, from a practitioner's perspective**
 - Due Diligence Philosophy
 - Manager Selection
 - Investment Process: Return Generation and Risk Management
 - People, Culture and Business Structure
 - Operations, Back Office, and Fund Terms
 - Conclusion

Due Diligence Philosophy

- A definition from the Internet: “The process of investigation, performed by investors, into the details of a potential (*and ongoing*) investment, such as an examination of operations and management and the verification of material facts.”
 - Manager due diligence should be an evolving process
 - Cover a wide scope of operational details
 - Evolve over the course of time and experience
 - Keep track of conversations
 - Watch for patterns (both in performance and behavior)
 - Be intuitive, insightful, and self confirming
 - Set baseline for your expectations
 - Question what you don’t know
 - Use “triangulation”
 - Multiple unrelated pieces of information should all point in the same direction
 - Investment process, people, operations and the value proposition should match
 - Explore multiple resources (e.g., experts to run background checks)
 - What follows are a variety of areas to consider when performing due diligence
 - Applies to traditional and alternative strategies

Manager Selection

- **Manager Selection is a combination of art and science**
 - Approval process should pass all steps of due diligence
 - Be thorough and complete
 - Be aware of the need for diversification
 - But choose strategies which you are fully comfortable with
 - Observe past performance as an indicator of behavior
 - But rely on the state of the strategy and portfolio today to make a judgment on the future
 - Follow a set of basic principles for manager selection
 - Long-term practitioners of a well-articulated investment discipline
 - Solid business values
 - Staffed by experienced professionals
 - Performance providers, not asset gatherers
 - Narrow business focus / specialists
 - Masters of their own destiny
 - Complementary investment capabilities, delivering competitive performance
 - Provides diversification with style consistency and risk controls

Investment Process: Return Generation and Risk Management

- Return generation and risk management should focus on the processes and mechanics for how returns are made; Develop a solid understanding
 - Define strategy, its uniqueness, and the conditions in which it will out or underperform
 - Discuss process for generating investment ideas
 - Understand tail risks which could impact the strategy
 - Determine the approach to portfolio construction (position sizing, how investments come in or go out of the portfolio)
 - How is risk measured and monitored?
 - Is there independence in risk management oversight?
 - As it related to risk management, what transparency is provided to investors?

People, Culture and Business Structure

- **The organization behind a fund is critical to potential long-term success**
 - Review the academic training and background of key professionals verifying that this experience is relevant to the strategy
 - Determine how business decisions are made
 - Review compensation processes and look/verify alignment of interest
 - Discuss compliance processes with regard to personal trading
 - Perform thorough background and reference checks on the firm and senior management team. Question anything unusual
 - Review the legal entity of the management company
 - Determine and verify registration of the firm (SEC, NASD, NFA, FSA)

Operations, Back Office, Fund Terms

- **Operational strength should be a key part of the decision making process**
 - Determine who has responsibility for front and back office – meet with these individuals
 - Understand and be comfortable the fund’s service providers
 - Review trading and settlement processes along with cash controls
 - Look at pricing policies and systems used to determine valuation
 - Leverage experts (i.e., legal) to thoroughly review fund documents

 - Critique fund terms to see if they are reasonable in relation to the strategy (e.g., liquidity, fees)
 - Have there been any changes to terms and why?
 - Discuss any situations where the fund has had to adversely change liquidity

Conclusion

- To summarize, there are many ways to approach due diligence
- Important to be thorough and detailed
- I approach it as an iterative and evolving process which should be performed on a regular basis

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