

# The Art of Due Diligence

Exploring the Qualitative Aspects of Manager Research

**Mark S. Rzepczynski, PhD**

Founding Partner and CEO, *AMPHI Research and Trading*

**Keith Black, PhD, CFA, CAIA, FDP**

Managing Director of Content Strategy, *CAIA Association*

**Aaron Filbeck, CFA, CAIA, CIPM**

Associate Director of Content Development, *CAIA Association*



# 2021 CAIA Level II Curriculum

## Topic 8: Due Diligence & Selecting Managers

- Active Management and New Investments
- Selection of a Fund Manager
- Investment Process Due Diligence
- Operational Due Diligence
- Due Diligence of Terms and Business Activities



# Motivation

Manager selection and the due diligence process is a complex process which includes both quantitative and qualitative analysis that has not been adequately explored.

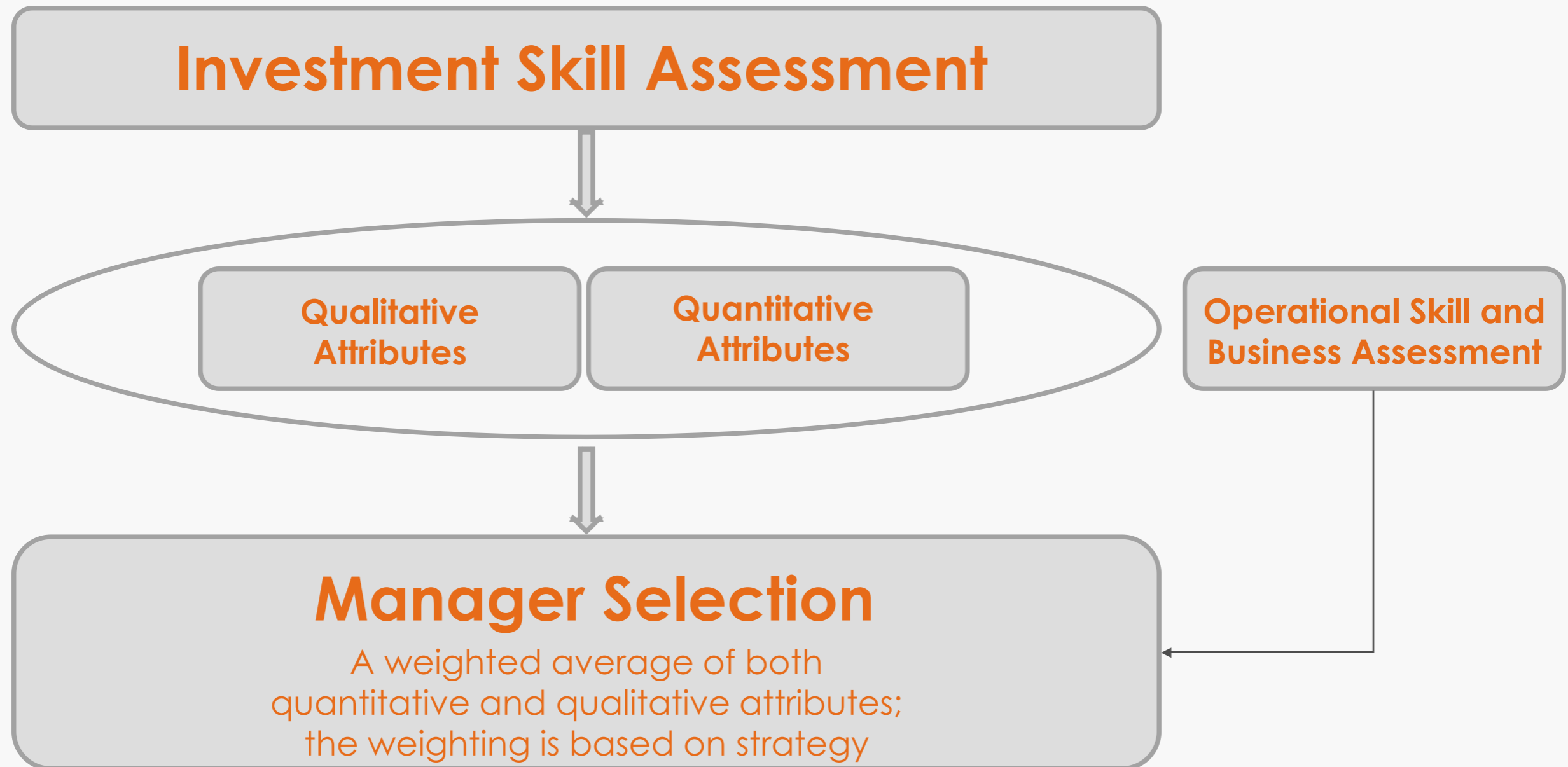
Using the global CAIA membership, we conducted a survey of both investors and managers involved with the selection of alternative investment managers to generate insights on the decision process.

This survey will help direct research and education on how manager selections can be made more efficient and investors can better separate the skill from luck with alternative investments.

# Executive Summary

- **Alternative investment manager selection is a complex process** that relies on both quantitative and qualitative analysis that cannot be captured through specific empirical measures of skill.
- **Manager skill assessment for alternative investment is much more difficult than selecting traditional investment managers** and requires greater analysis of the philosophy, culture, and processes of the manager.
- **Qualitative factors for alternative manager skill assessment are as important or more important than the quantitative assessment** for alternative managers assessment.
- **The operational due diligence of manager business risk can dominate or override assessment of investment skill** and is critical to the manager selection process.
- **The manager selection process is tailored to the strategy being reviewed.** Thus, the issues or factors involved with choosing a private equity manager are very different from factors associated with a systematic hedge fund manager.

# An Overview of the Due Diligence Process

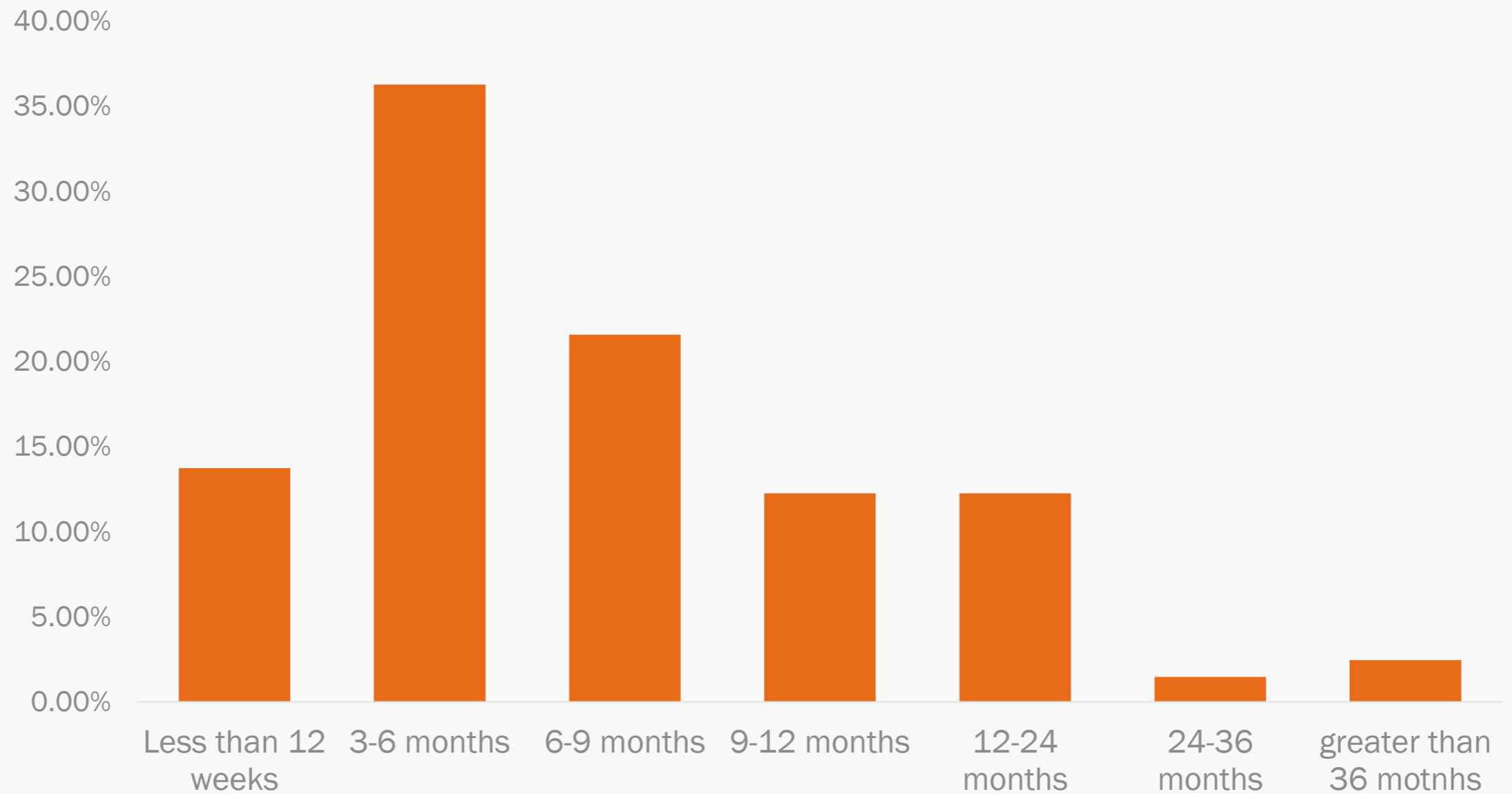


# Survey Participants

- A total survey response (N=344) is divided between 233 investors and 111 managers across a broad range of geographies, job descriptions, titles, firm types, and sizes.
- Just over 50 percent of investor participants are located in the US with approximately 20 percent in Europe. The remainder of investors are in Asia and Latin America. The majority of these participants (70%) are very or extremely involved with due diligence and manager selection and do not just have an interest in the subject.
- 50 percent of the investor respondents are associated with firms over \$10 billion in assets under management and one third representing over \$100 billion in assets under management. Small firms under \$500 million in AUM represent about 25% of the investors.
- Most of these investor participants have significant exposure in alternative investments. 70 percent have 10 percent or more of the total assets under management in alternative and more than 15 percent are holding 50 percent or more in alternatives.
- 45 percent of the respondents have 10 plus years of experience in manager selection and due diligence and over 40 percent have both CAIA and CFA designations.
- About 1/3<sup>rd</sup> of the respondents review 25 or more managers each year. This number does not include meetings or conversations which do not lead to a complete due diligence.

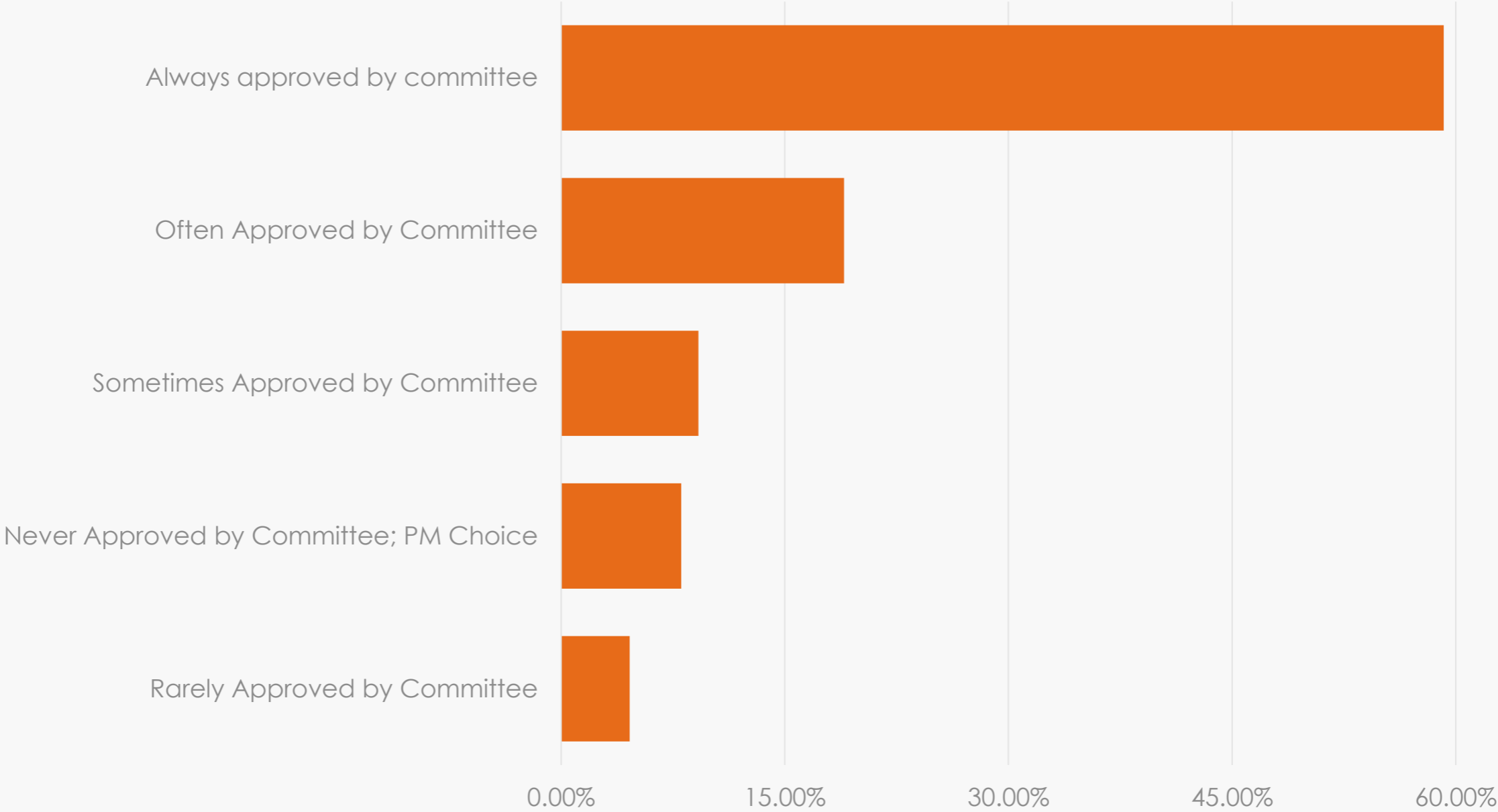
# AN OVERVIEW OF THE MANAGER SELECTION PROCESS

# How Long Does the Manager Selection Process Take?

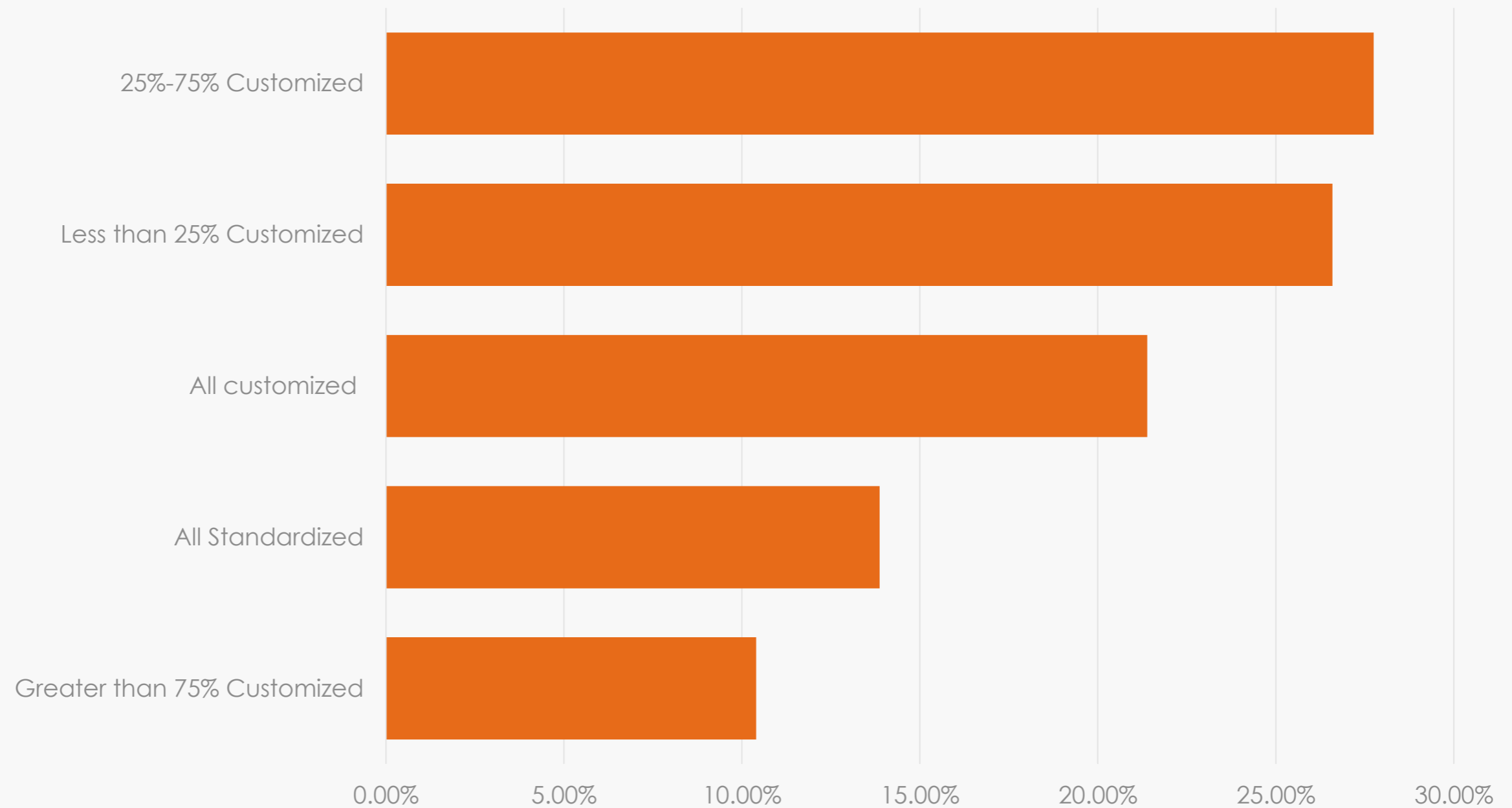




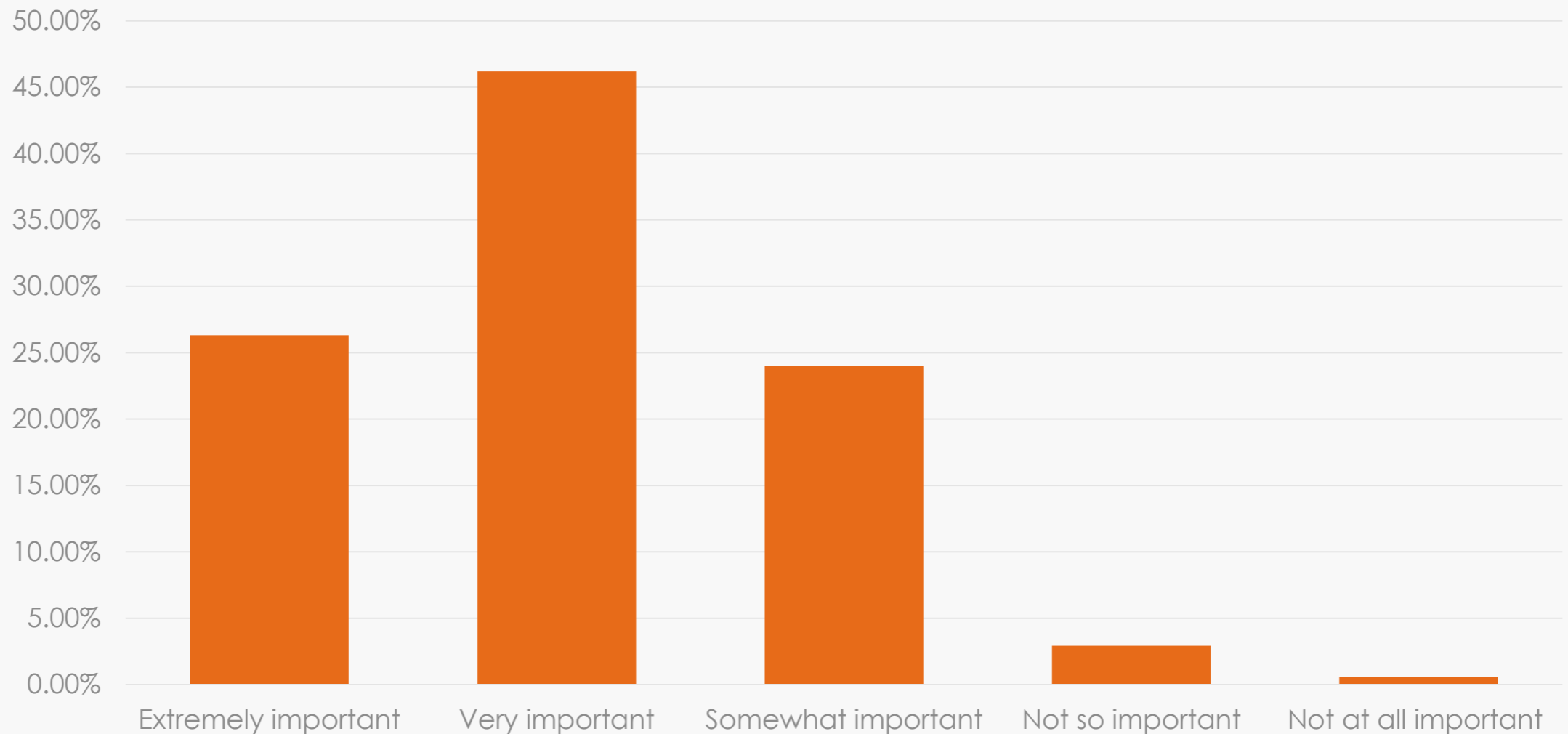
# Who Approves a New Manager?



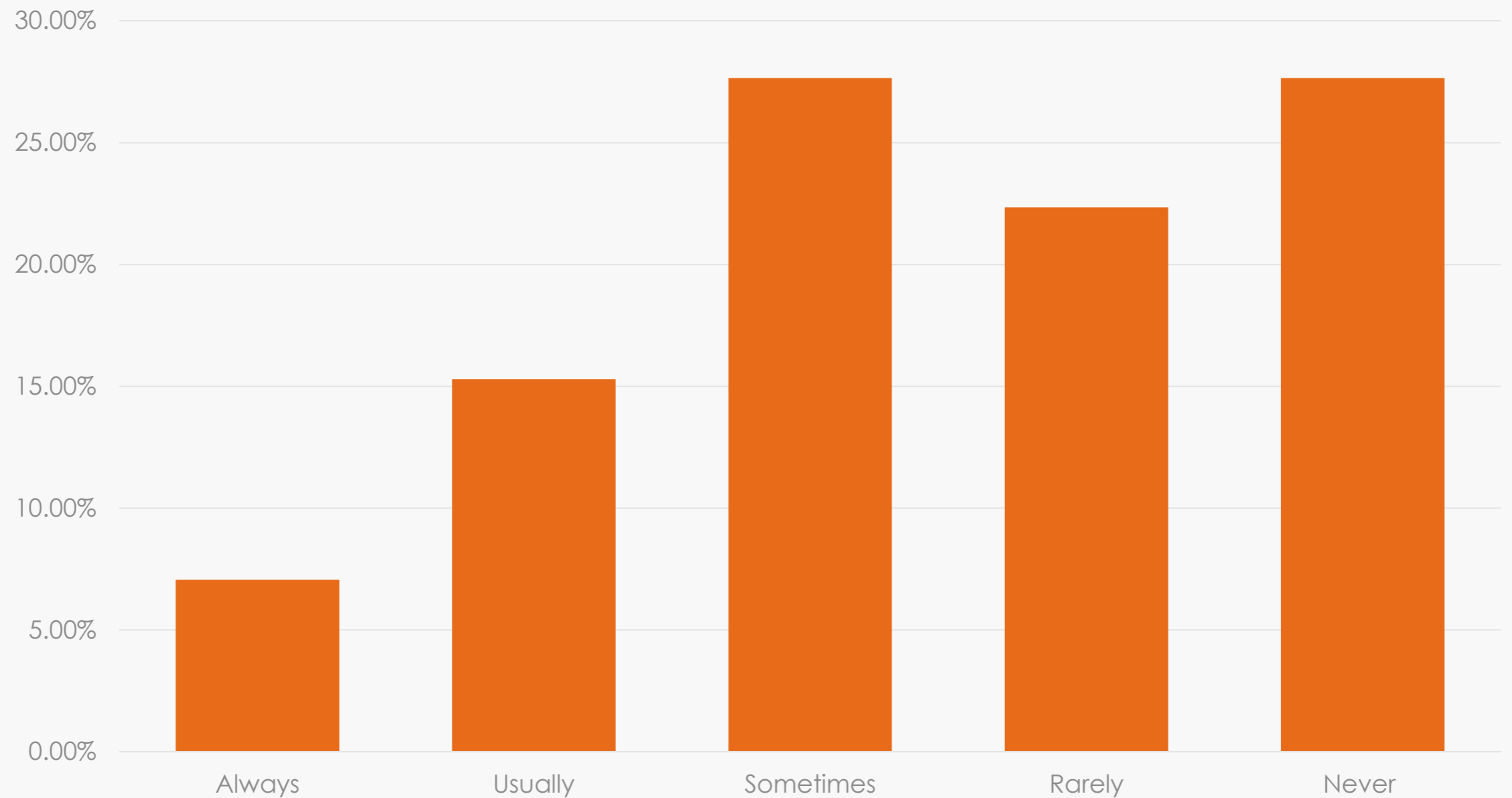
# How Standardized Is the Due Diligence Questionnaire Process?



# How Important Is the Quality of Answers to a Due Diligence Questionnaire?

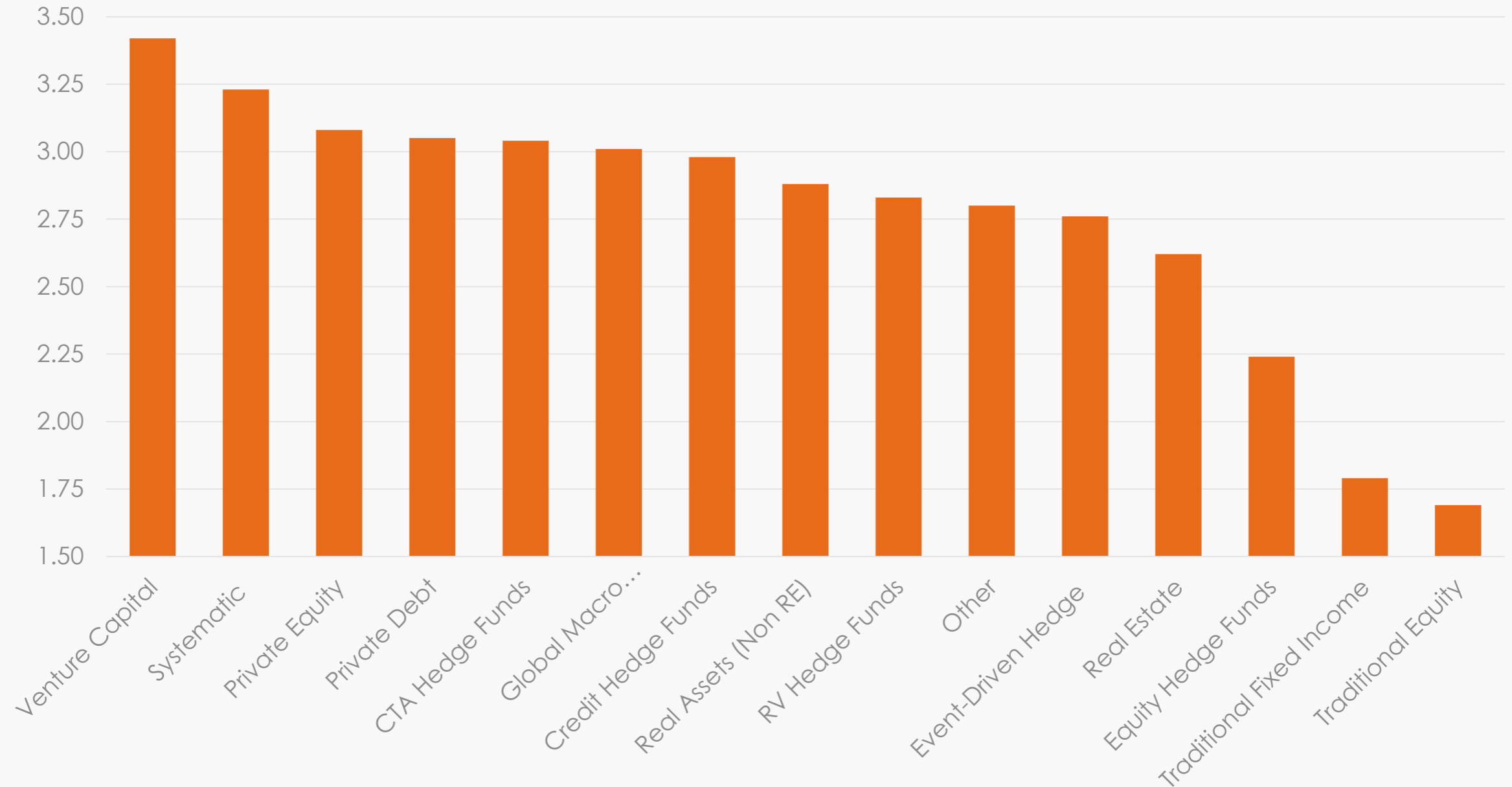


# Do Consultants Have an Impact on the Manager Selection Process?



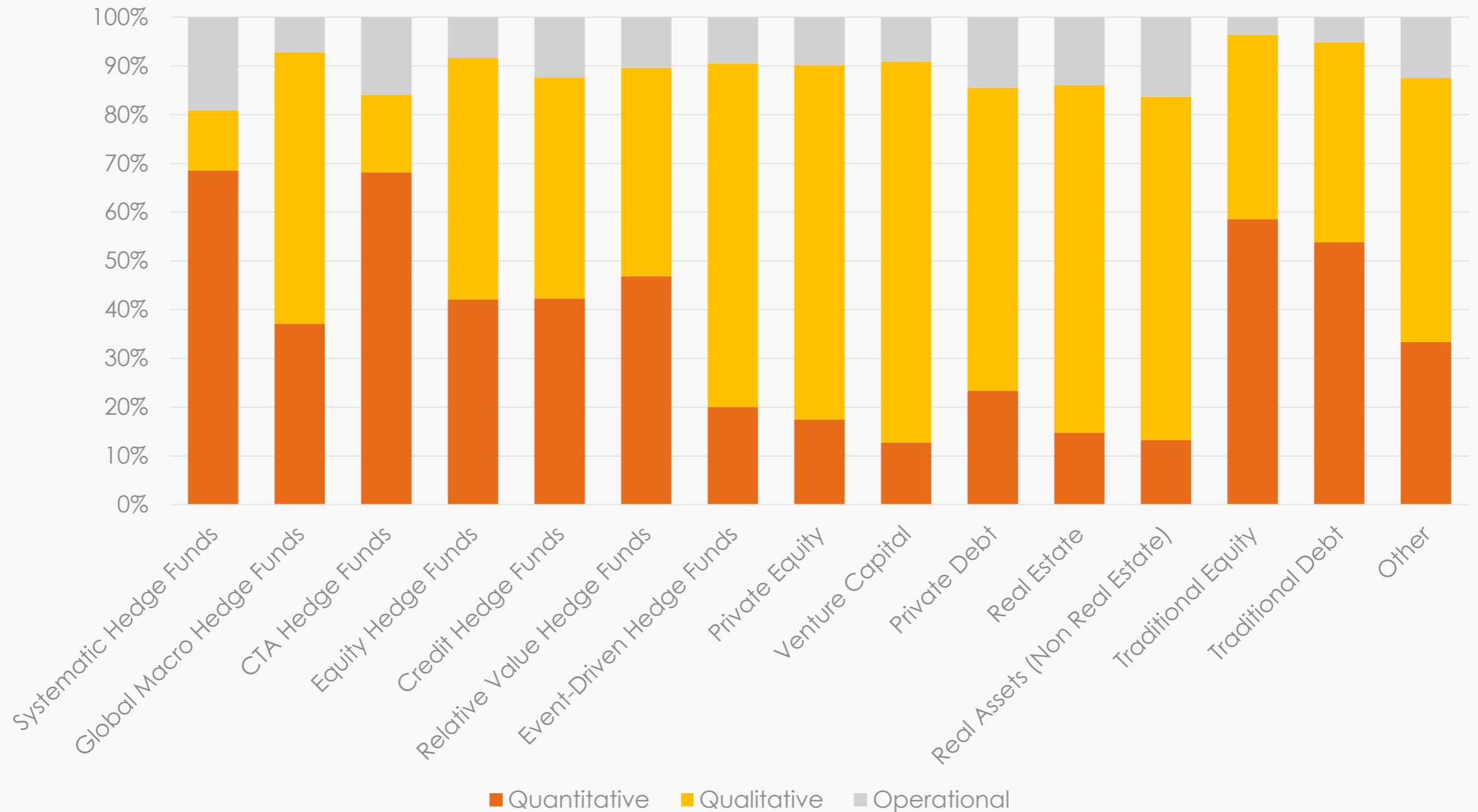
# THE SELECTION OF ALTERNATIVE INVESTMENT MANAGERS

# Which Strategies Are the Most Difficult to Assess?

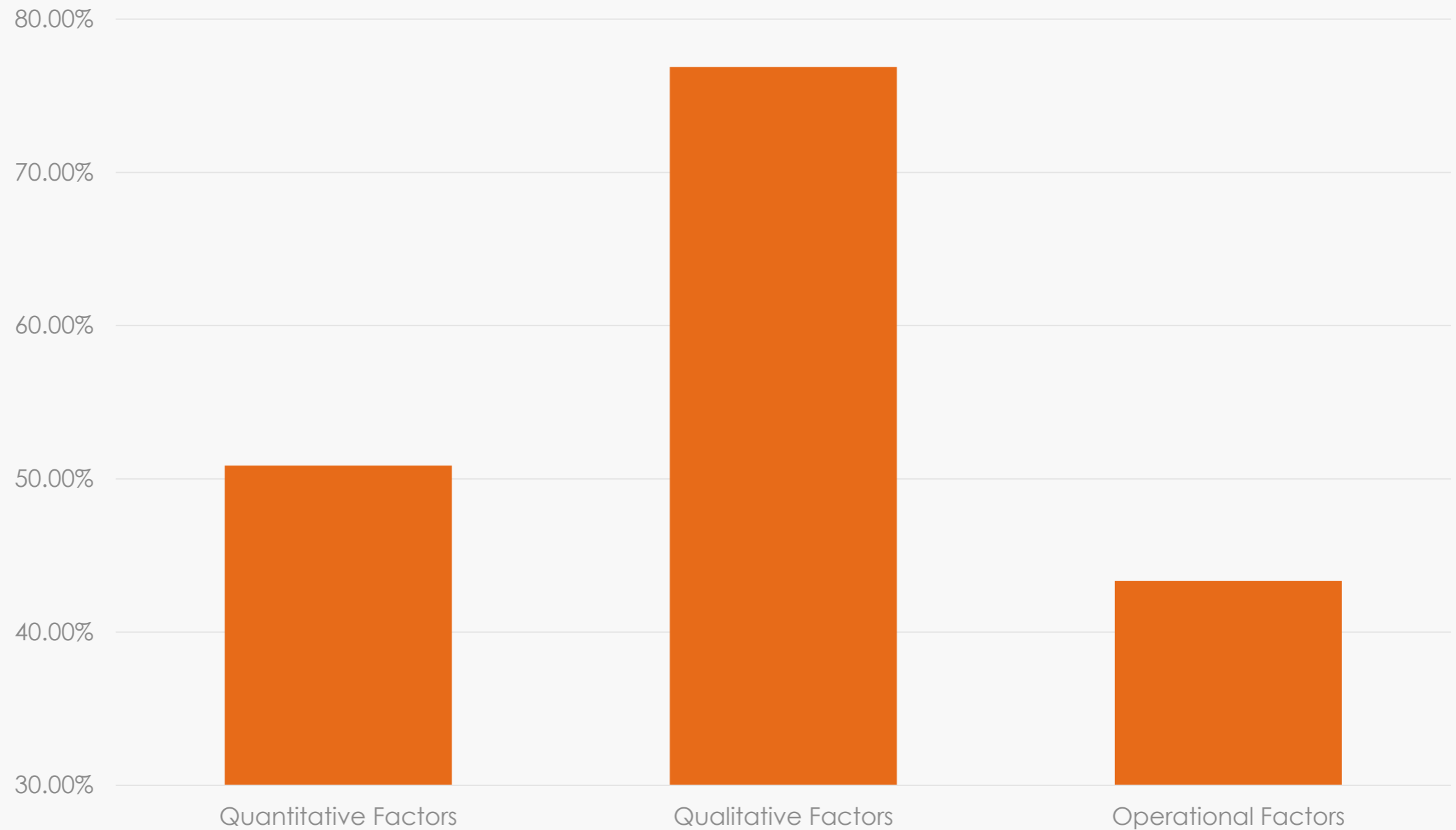


(Weighted average of responses based on a scale of 1, not at all difficult, to 5, extremely difficult)

# Which Type of Due Diligence Is Most Important: Quantitative, Qualitative, or Operational?

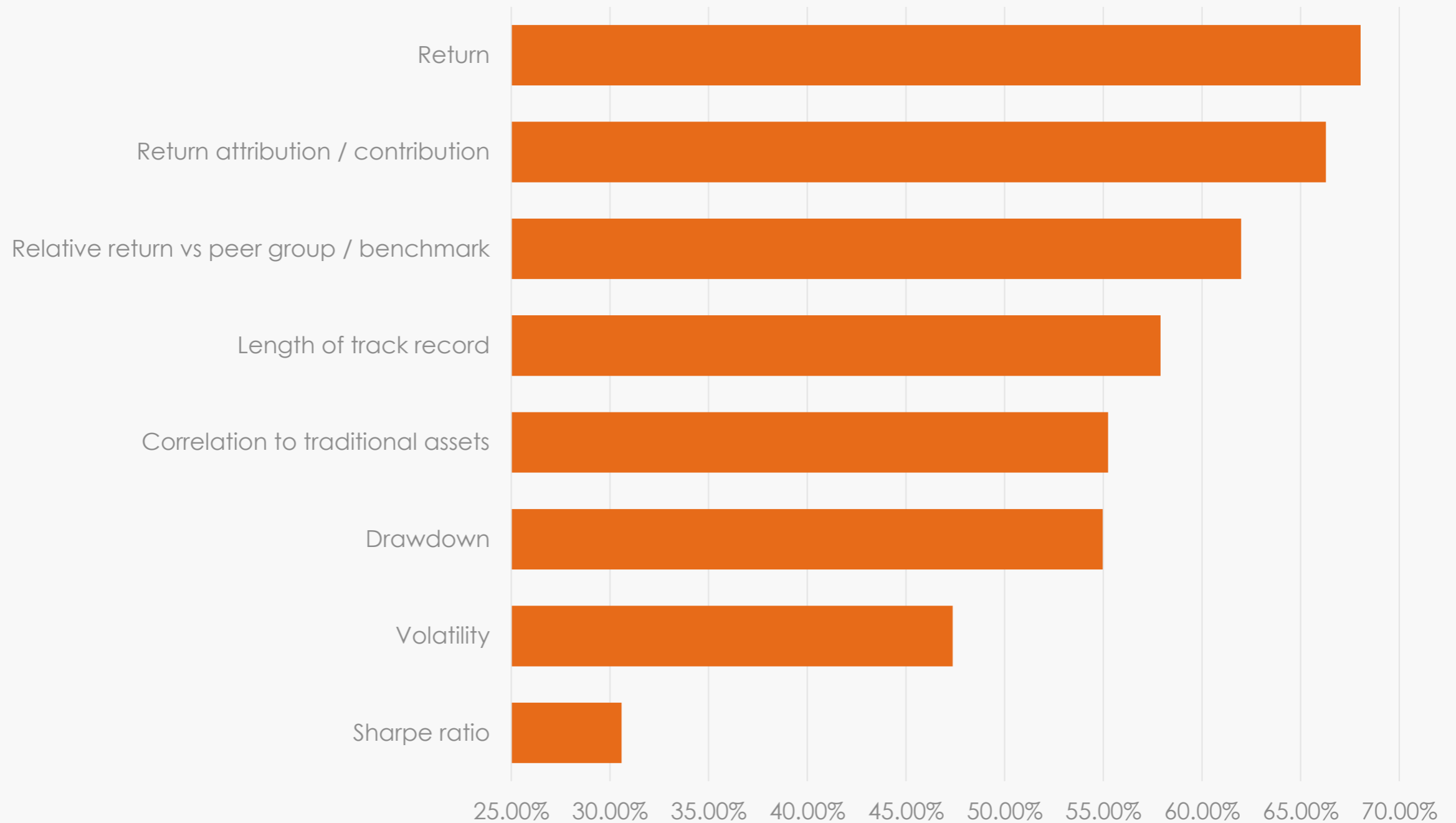


# Which Has the Most Predictive Power of Future Performance?

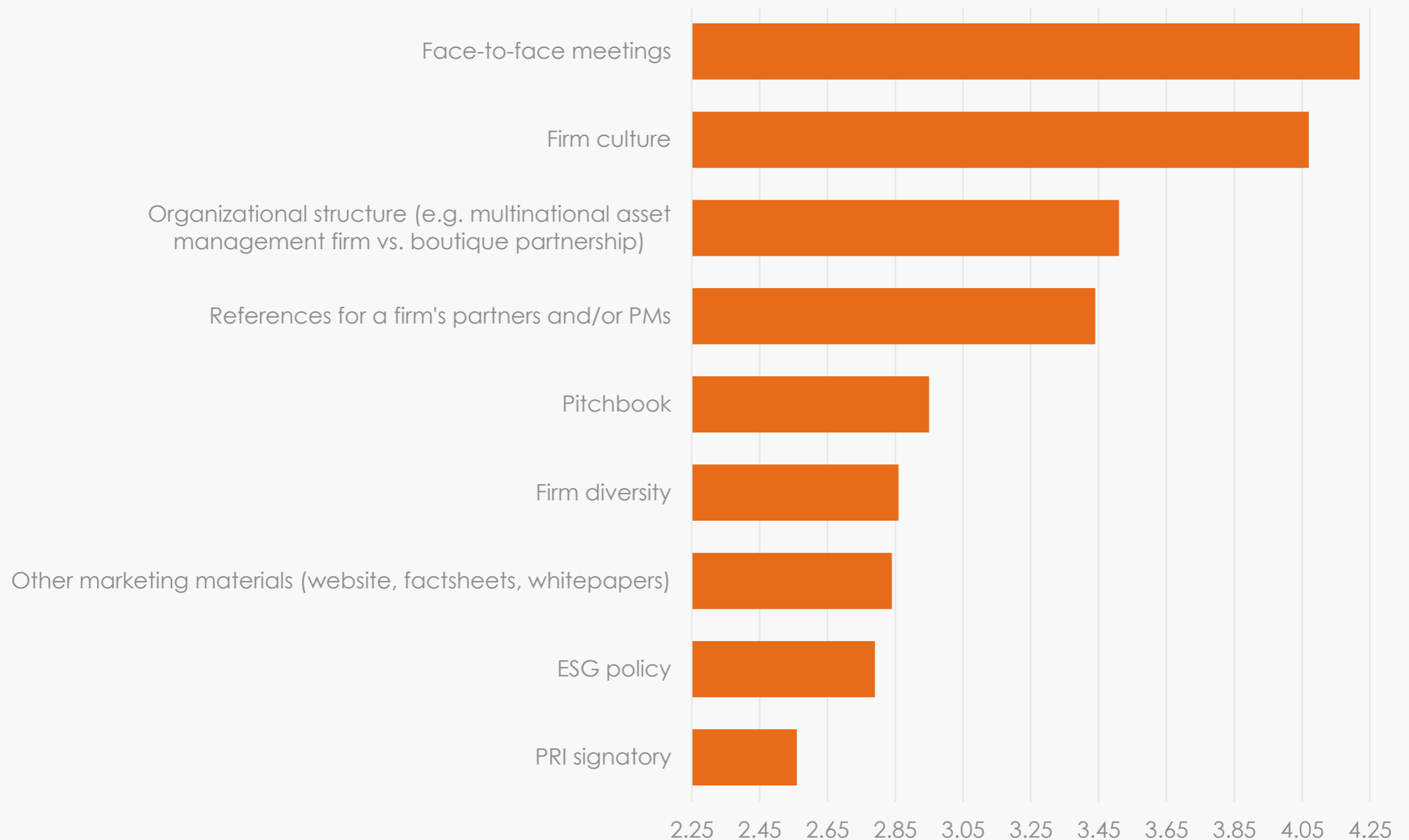




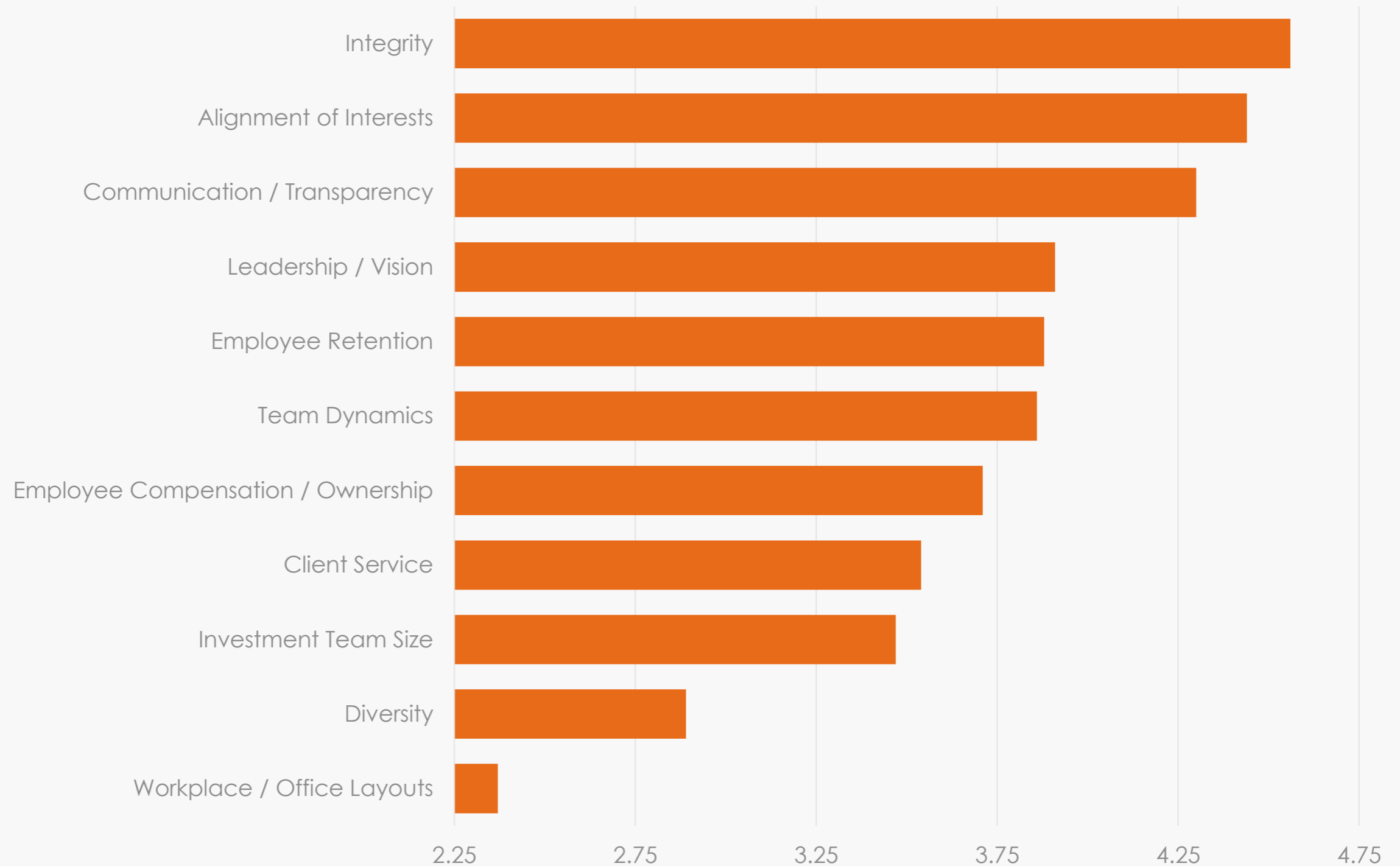
# Which Quantitative Factors Are Most Important?



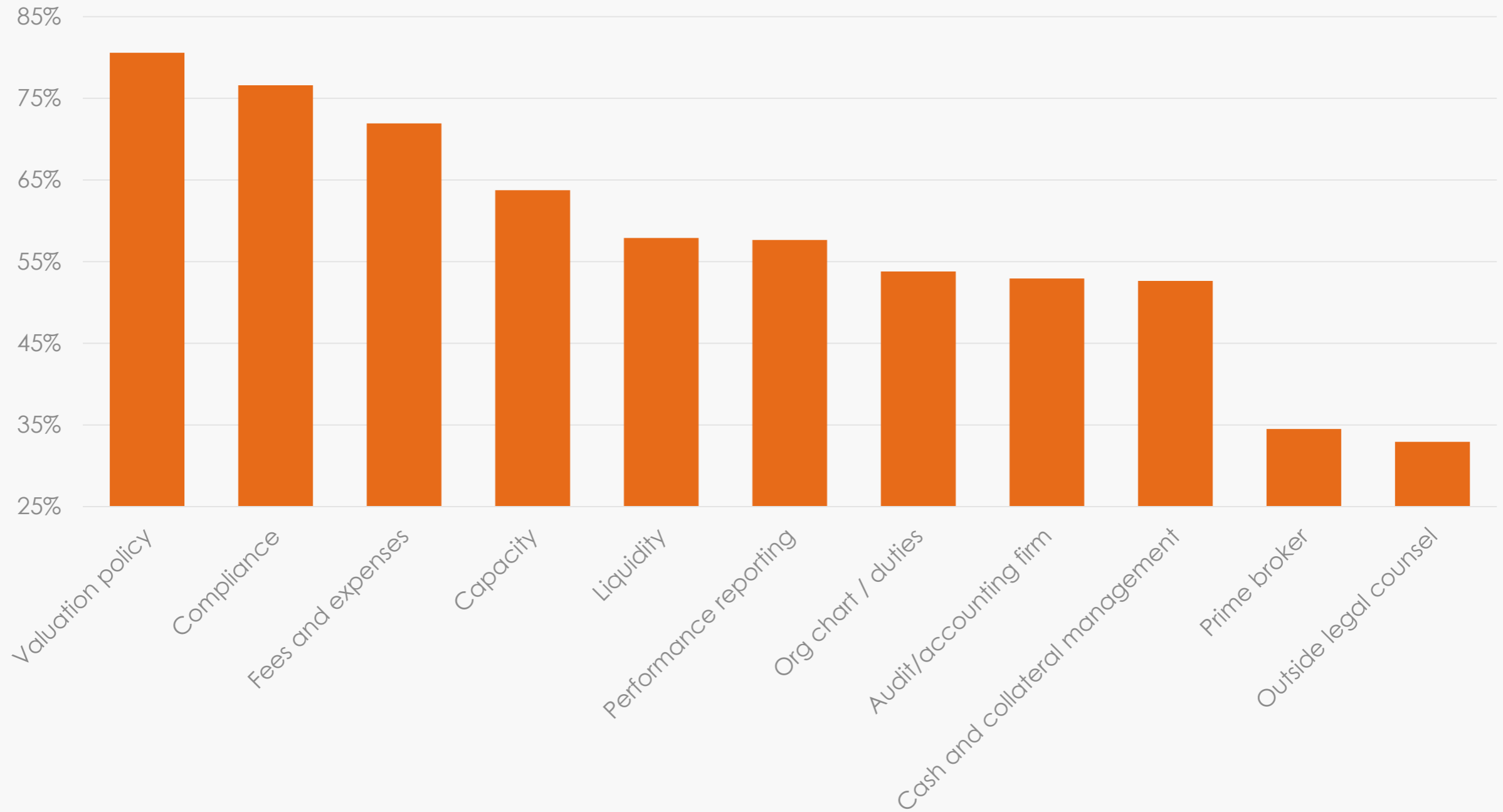
# Which Qualitative Factors Are Most Important?



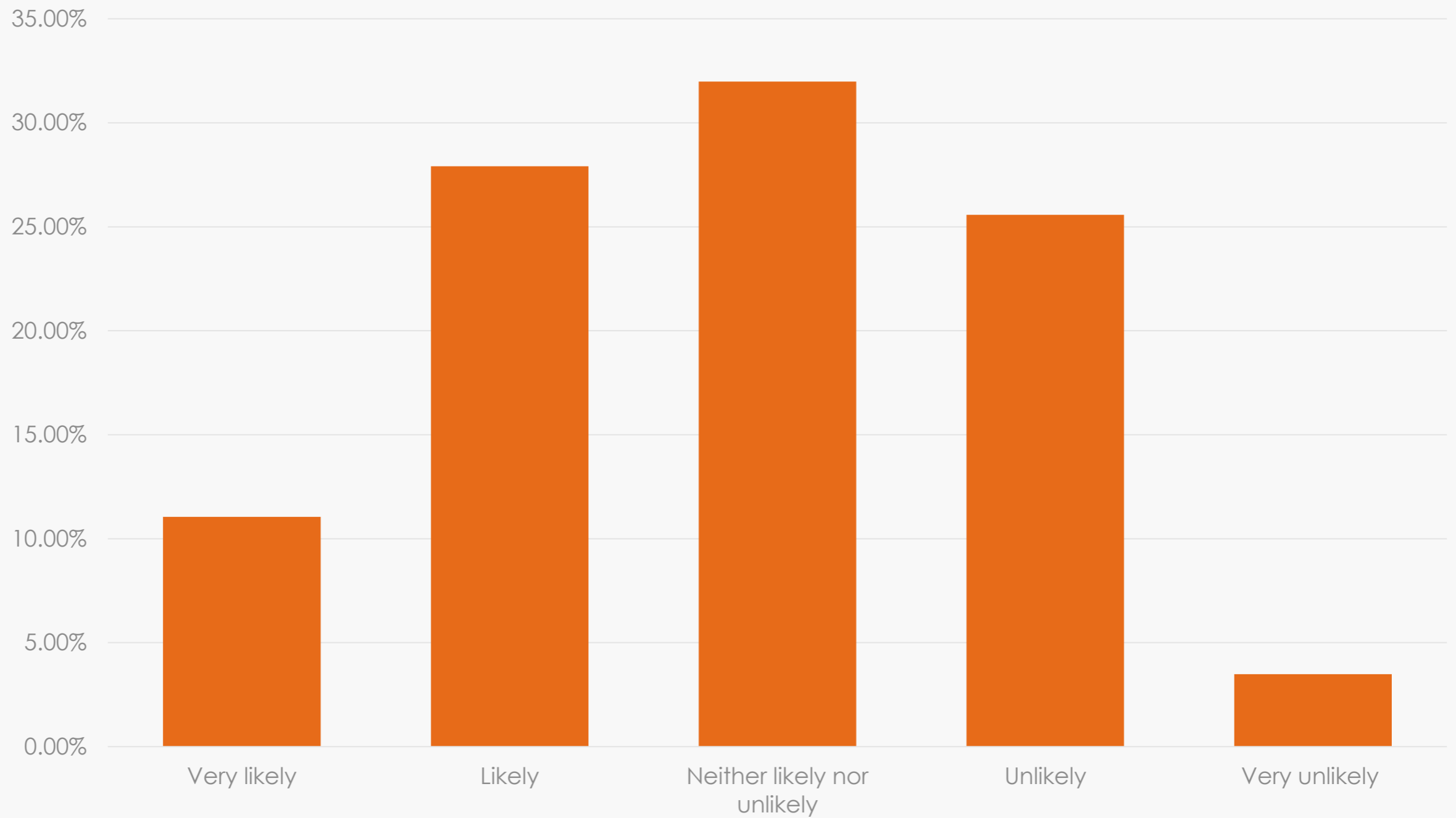
# Cultural Values that Impact Manager Selection



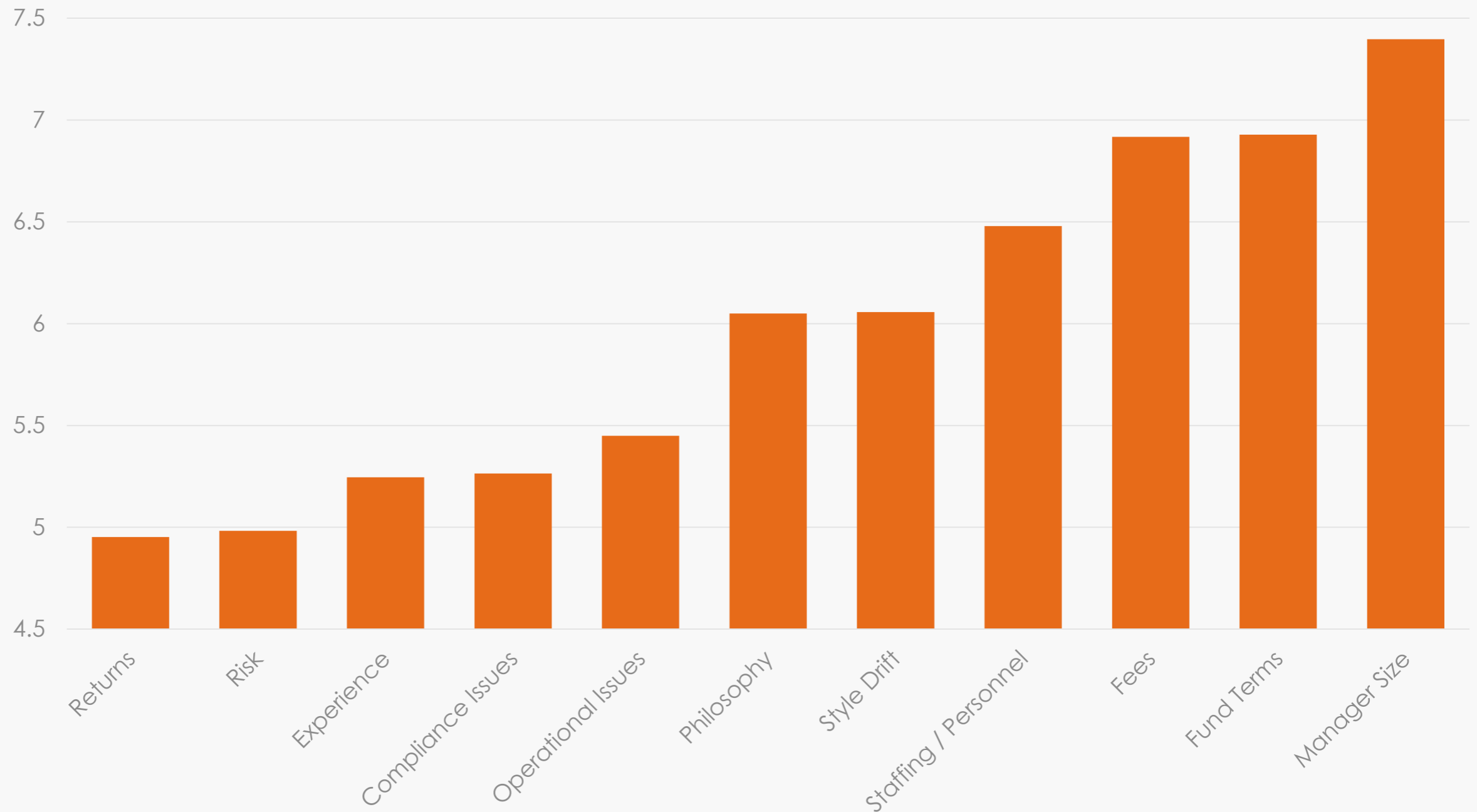
# Which Operational Factors Impact Manager Selection?



# Likelihood of ODD Overriding IDD

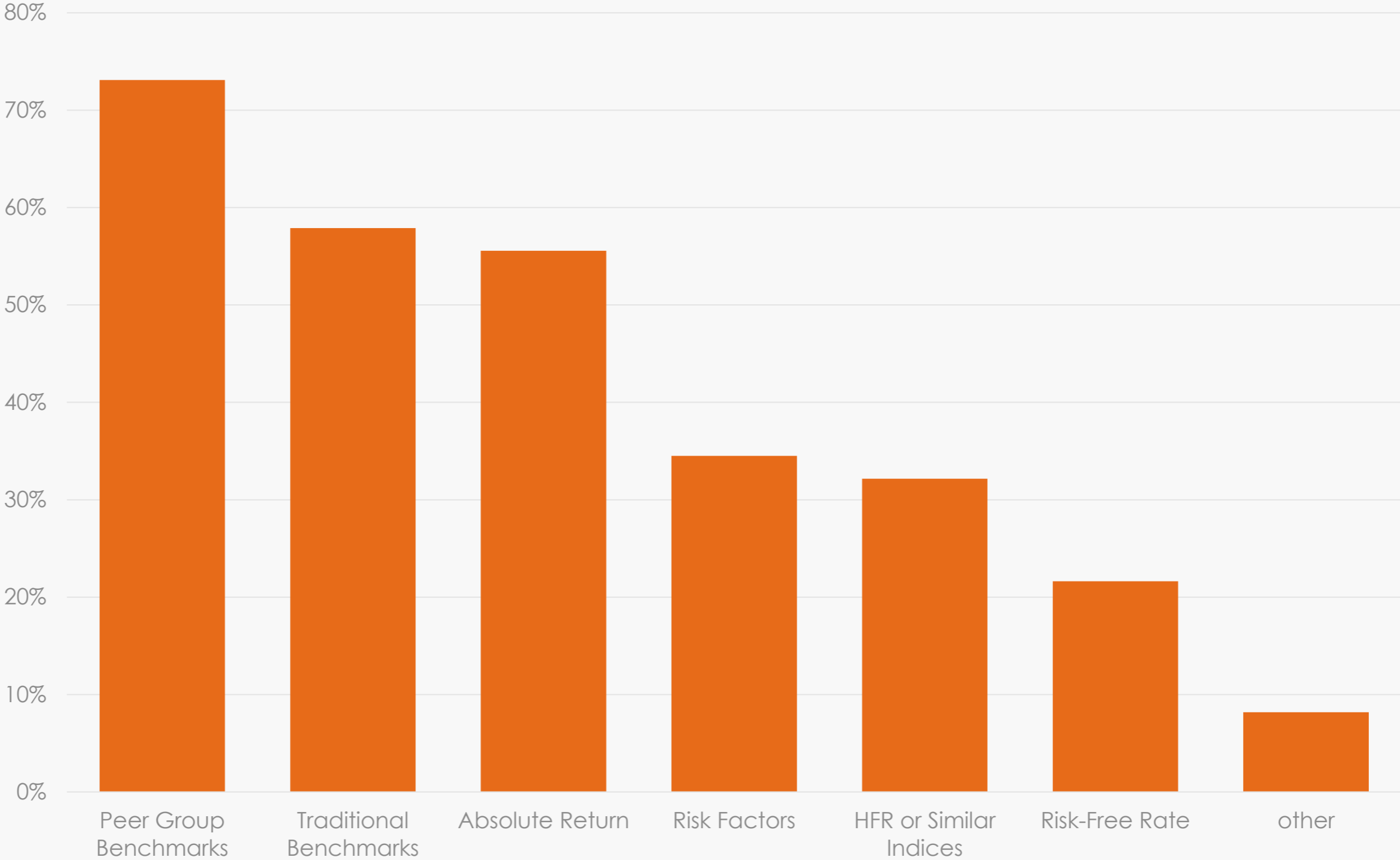


# What Disqualifies a Manager?

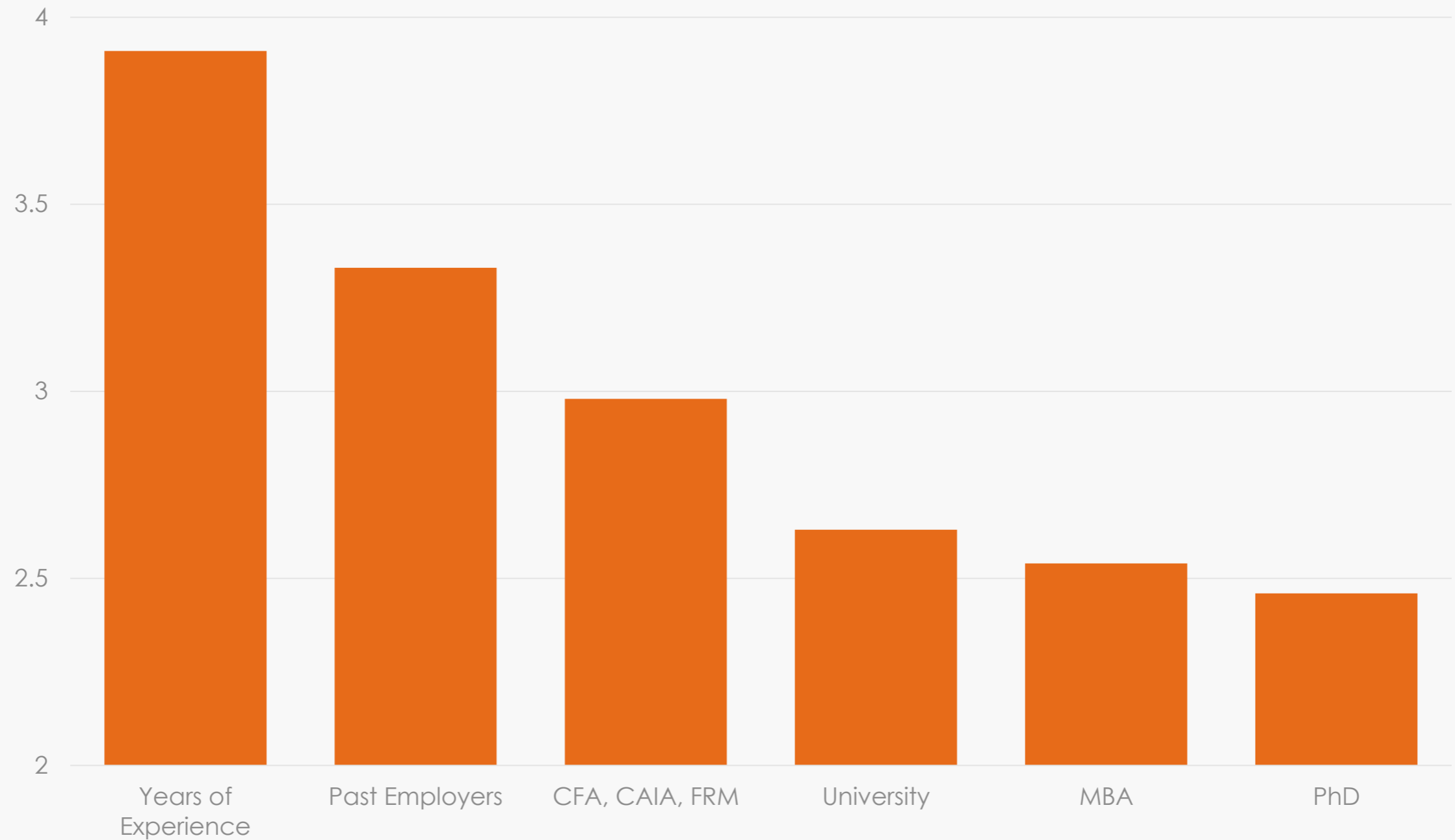


(Respondent ranked the eleven choices below from high to low (1 to 11); Low value means more likely to disqualify)

# Benchmarking Manager Performance

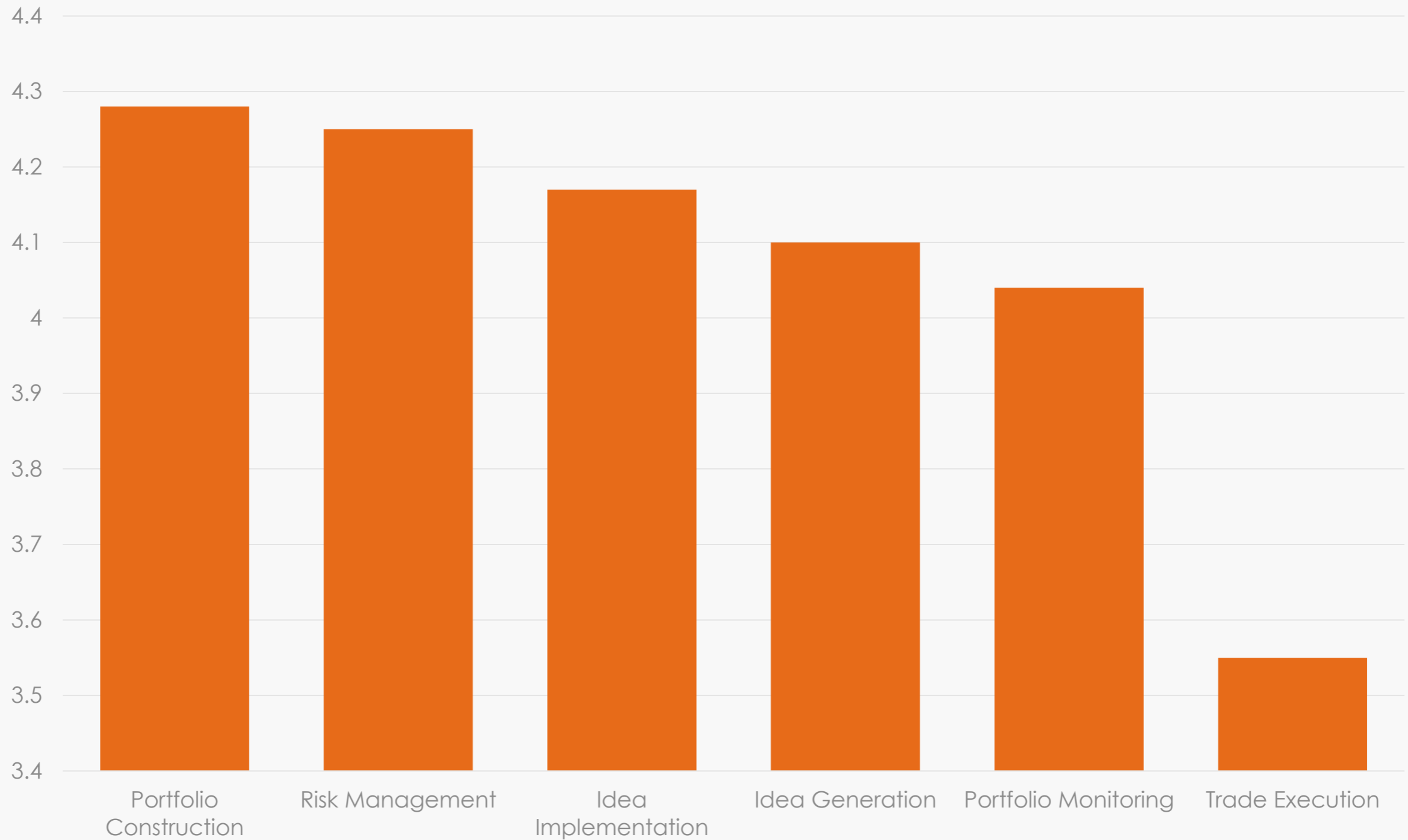


# Experience & Pedigree

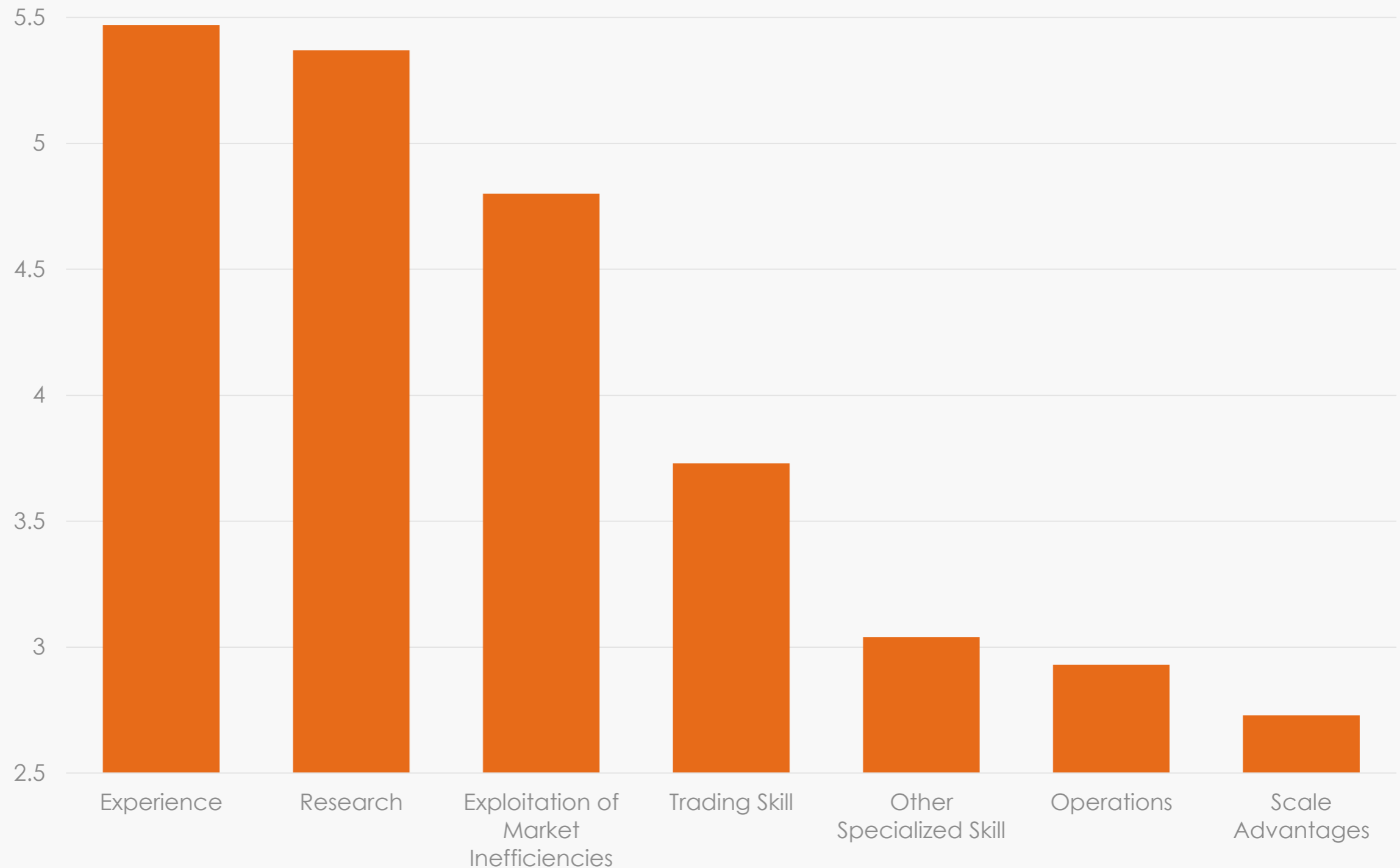




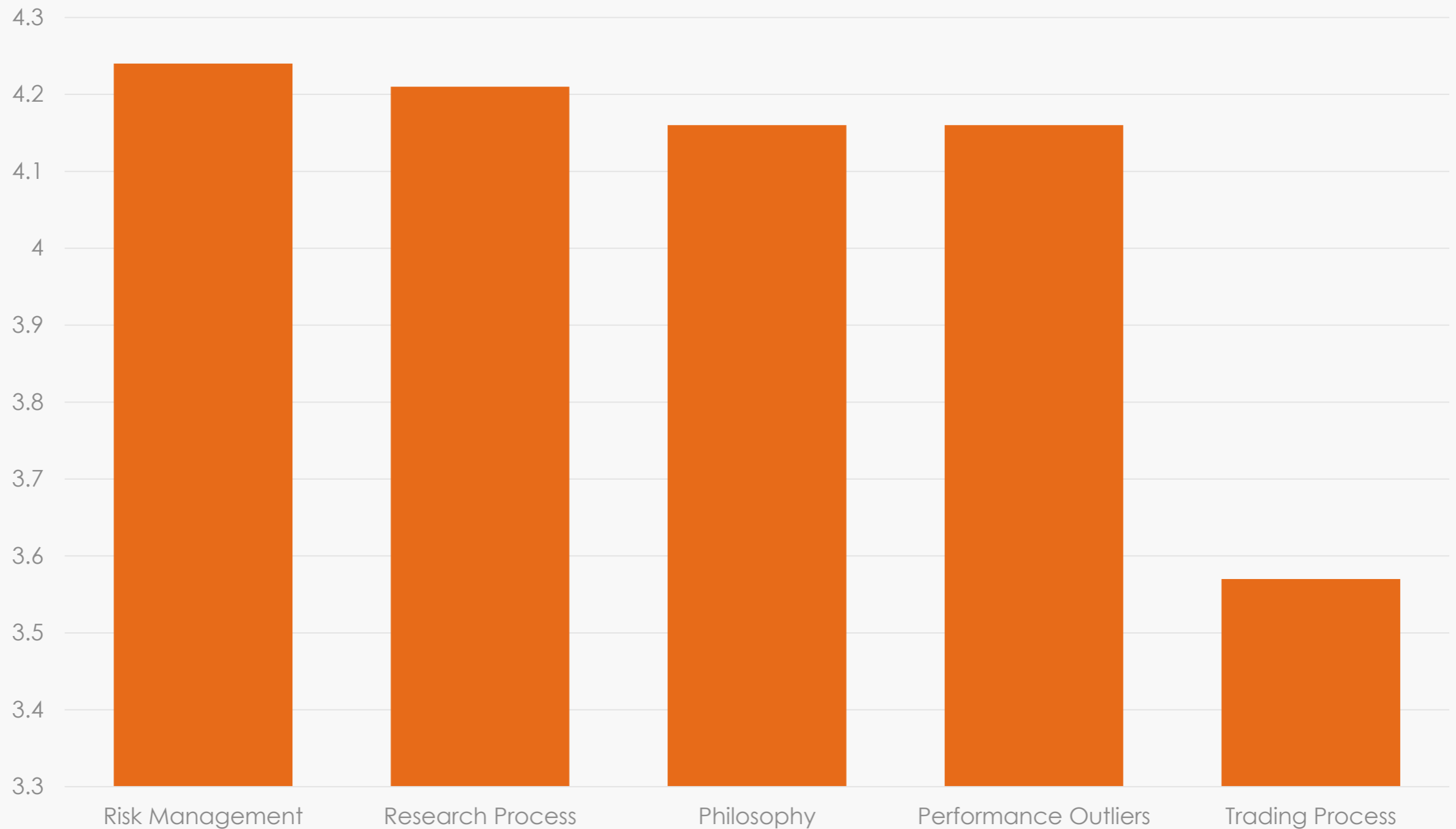
# Importance of Different Components of the Investment Process



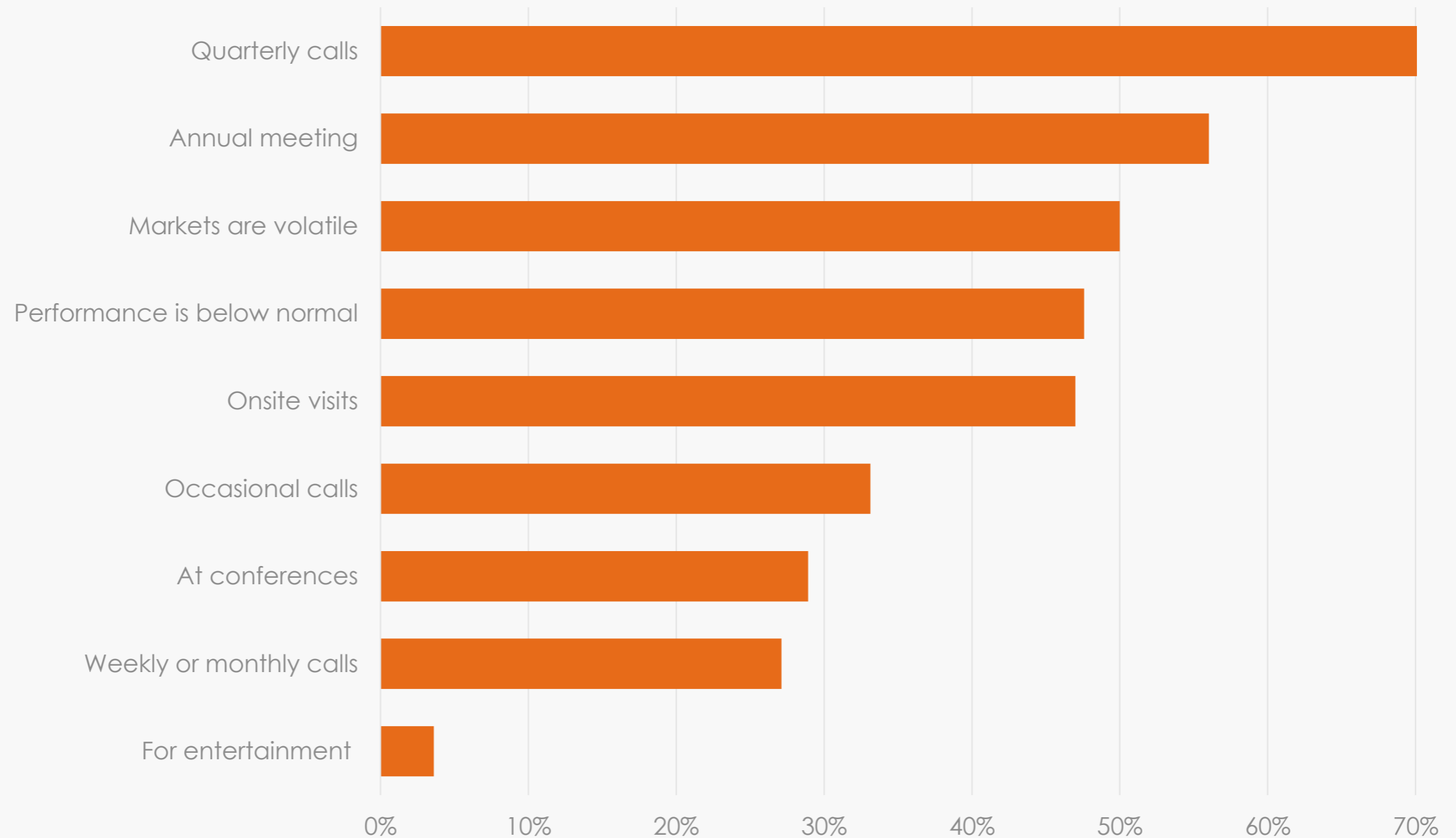
# What Gives Managers an “Edge”?



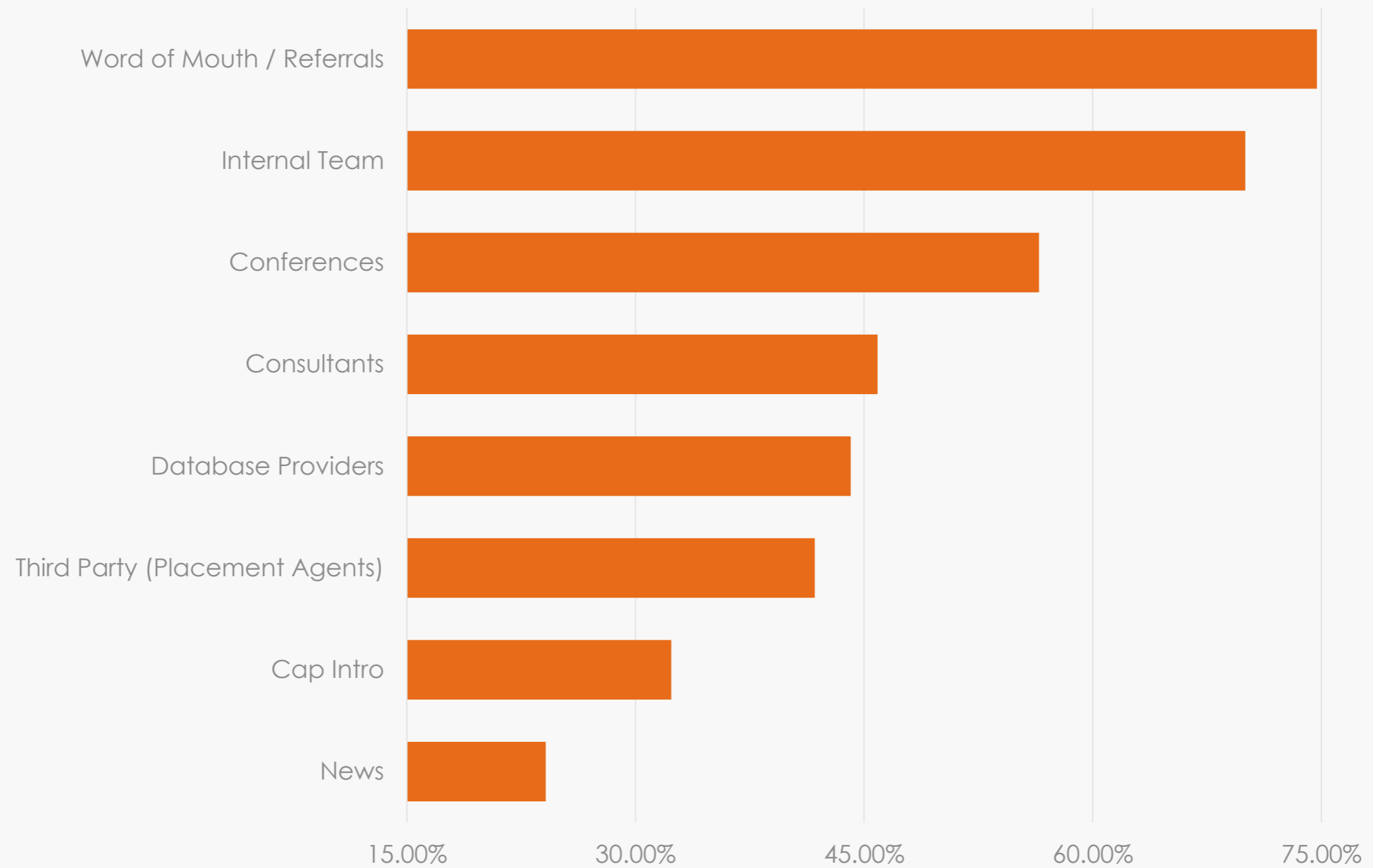
# How Important Is the Manager's Ability to Explain Components of the Investment Process?



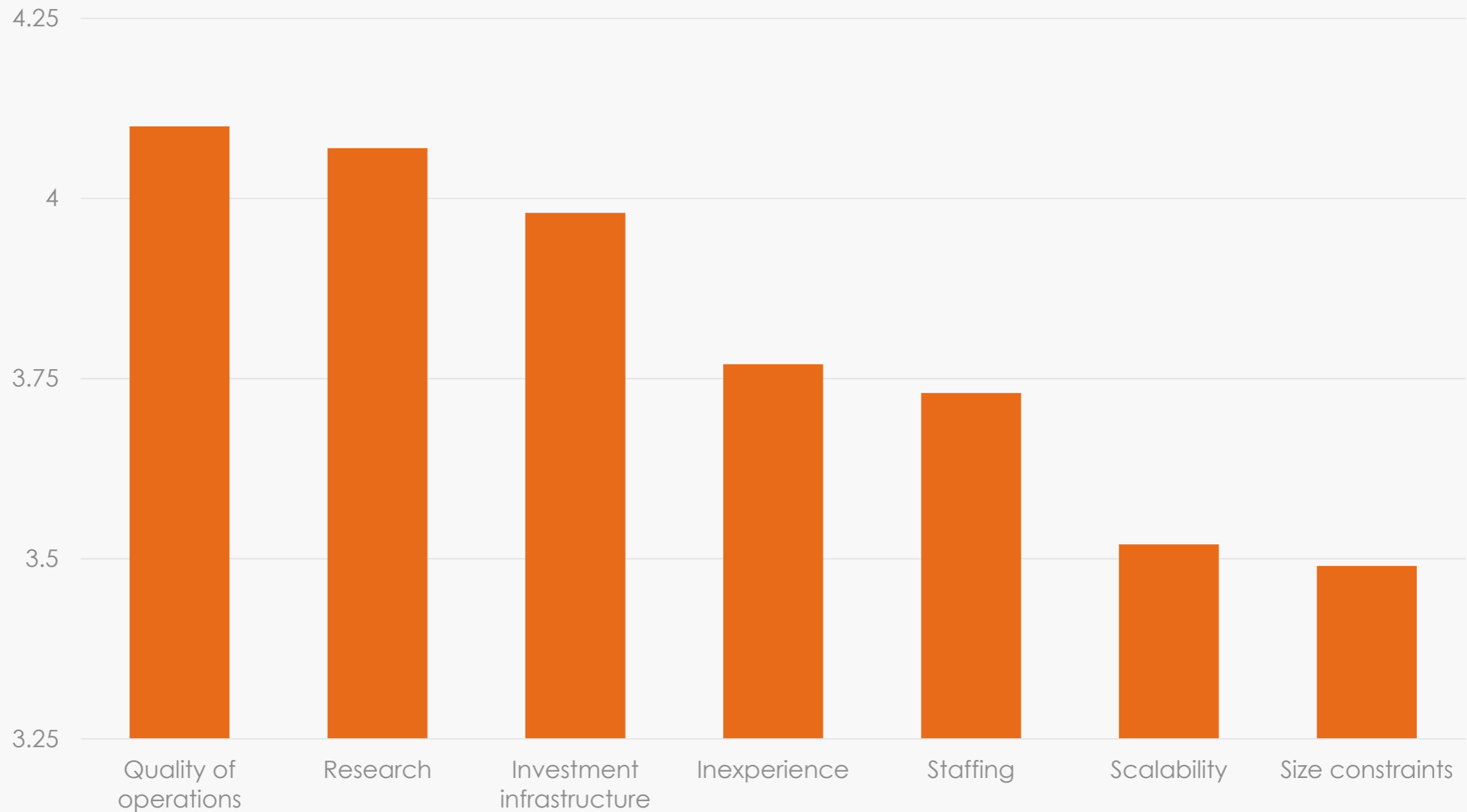
# How Often Do You Communication with Managers After They Are Hired?



# How Do You Source Managers?



# What's Most Important When Assessing Emerging Managers?



# What Were the Major Differences In Answers Between Managers and Investors?

- Managers view that the level of difficulty associated with selection is lower across all alternative strategies.
- Managers generally believe that quantitative analysis is the primary tool, more important than qualitative analysis and operational due diligence.
- There is a difference in perception between who makes the investment decision. Investor responses suggest that most decisions are made by committee while managers perceive that decisions are more concentrated with portfolio managers and analysts.

# CONCLUSIONS

Experienced professionals, both investors and managers, clearly demonstrate in their questionnaire responses that due diligence is a complex decision process:

- Employs quantitative analysis of performance track records and trading data only as one indicator of skill;
- Uses extensive review of qualitative information on investment process and firm culture a significant driver of skill
- Focuses on operational issues to uncover business risks that will impact the return of principal.