

How to “Do” Due Diligence

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When making an investment, the key to a sound decision lies in the questions we ask. It's pretty straightforward: the quality of our inquiries determines the caliber of our investment choices. When beginning due diligence, the right set of questions helps us cut through the noise to focus on what truly matters—the investment's asset class, the track record and strategy of the manager, and the underlying risks and potential for consistent returns.

The first step is to get answers to a series of questions about an investment's asset class or category. Is the asset class investable? How does this asset class fit into a portfolio? Where is the asset class in its cycle of returns?

The next step is finding a manager in that space who has the process, the people, and the expertise for the strategy's mandate. When interviewing a manager for any business, especially in the investment fund world, a demonstrated track record of success is important. Still, the "how" and key drivers of the strategy are critical.

Understanding the "how" is essential for two reasons:

1. **Risk** – Was performance achieved by taking on more risk than similar managers or funds? Was there more debt taking on? Was there more volatility?
2. **Repeatable**—We have all seen the following disclosure on an investment pitch: "Past results are not a guarantee of future performance." And yes, there is no guarantee, but by understanding how the results were achieved, one can learn from past results. We can get closer to determining if a process may be repeatable or if the manager was just lucky.

A simple way to measure the risk is by comparing the manager's "risk-adjusted return" to the peer group. In other words, we want to make sure that the manager outperforms while keeping the risk at the same or lower level than the category. Another way to measure is by looking at historical holdings and exposures. Did the portfolio or underlying holdings have more leverage? Were the fundamentals of the assets or businesses higher quality than average? These and other questions uncover the connection of the process to the portfolio.

Next, we want to analyze how repeatable the results could be. A common way to evaluate this is through a diligence process called return attribution. This process identifies the source of the excess return over its benchmark. It involves digging deep into the specific winners and losers in a set period and determining whether they match the fund's stated process.

For example – If a fund states that it has expertise in identifying good international companies – we would like to see that the attribution report will show a contribution to performance from international securities across a variety of sectors. We also want to avoid 'one-hit-wonders' where a single stock or two drive performance. We prefer to see performance spread across many securities and periods, which can potentially indicate process and expertise.

The quantitative part is important, but it is not enough!
Speaking to the management team and hearing directly from the decision-makers is essential. There is much to learn from talking to the people and understanding who makes the decision. Is it a one-person show, which can add risk or a team-

based decision-making process, or are there any material changes expected in their process?

We also want to identify the incentive structures. Is the manager invested alongside investors? Will the manager's bonuses be tied to an investor's success (an excess return target or minimum hurdle rate)? Is the organization set up to achieve this?

To wrap up, the article has shown that diligent investing is about much more than numbers; it's about the critical questions that bring those numbers to life. Effective due diligence involves a balanced approach of quantitative analysis and qualitative assessment. By understanding the how and why behind a manager's performance, we can attempt to make well-informed 'buy' decisions rooted in a deeper comprehension of risk and repeatable success. The better the questions we ask, the more likely we are to uncover the investments over the long term.

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