Commentary

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Risk Management: Operational Due Diligence

- Operational due diligence focuses on whether investment managers can accommodate both regulatory mandates and SEI's requirements.
- There are many practical implications in determining if a manager's business is compliant and sustainable.
- Managers approved for SEI's strategies have an arms-length relationship with the assets they are expected to manage, which helps shield investor assets from misuse.

SEI's Manager Research team seeks to determine how third-party investment managers will execute strategies on our behalf. This is accomplished through a combination of what the managers tell us about their philosophies and processes and what we can observe about their practices. We judge how their philosophies and processes align with our risk and performance expectations in a given environment.

Separate and distinct from this, our Operational Due Diligence team conducts another level of manager evaluation. While this effort is also heavily reliant on observations, it is focused on answering more fundamental questions: can the manager accommodate current and anticipated regulations, SEI's requirements and the demands of running a sustainable business?

Like our Risk Management team, Operational Due Diligence is focused more-or-less exclusively on gauging risk exposure. The venue for observing those risks is outside of our security risk-factor model, however, and inside the investment manager's business.

At this point, we are *not* interested in a portfolio management team's skill or an analysts' ability to ferret out worthwhile investment ideas. Our Manager Research team has already judged the merits of those functions. We are instead seeking to ensure the manager is running a sustainable and compliant business.

A Going Concern

Operational Due Diligence is a practical evaluation of the success of the investment manager's business model. We need to be confident in the financials, from profits and losses to income sources and growth plans. Growth rate is an important factor — we want to know that management is satisfied with the company's trajectory, but not so much that they are likely to hit capacity constraints prematurely.

Along similar lines, we need to know that an investment manager has established an official succession plan. Reducing the risk of a leadership crisis helps us determine whether a manager will likely be a viable entity looking out past the short term.

Playing by the Rules

We need to be confident that managers understand these rules and are capable of operating within their constraints. We also seek to determine whether a manager would consider closing up shop in light of the business impact of anticipated rule changes. An unanticipated investment manager closure might not be a catastrophic development, but it is disruptive, and we work to avoid surprises where possible.

Outside of gauging whether a manager can operate in a high-regulation environment, we also need to know if the firm has faced any recent regulatory or legal issues. Accordingly, we require disclosure of everything from outstanding litigation to regulatory mistakes uncovered in an audit. We need sufficient explanations and evidence of how any issues were resolved. Were the offenders fired? Was the issue isolated to an affiliate (e.g. the bank, not the asset-management company)?

We scrutinize each investment management firm's ability to work within these constraints, as well as their legal and regulatory track records, in an effort to gain a sufficient level of assurance with their prospective work on behalf of our investors. But we don't just leave it to chance thereafter: we require investment managers to maintain sound compliance policies and procedures, and a robust code of ethics.

Show Me the Systems

Functionally, nearly every part of an investment manager's operations exists on their information systems. We therefore focus heavily on evaluating technology infrastructure and the processes through which it is employed.

Boring though it may sound, record protection and retention policies and procedures are some of the most important factors in our assessment of a manager's systems:

- What are they keeping and for how long?
- How stringent are their data security measures?
- Is there a disaster recovery plan in place?
- Do their systems meet SEI's standards?

Portfolio management activities are also likely conducted via a combination of proprietary and third-party systems. For example, workflow may start with inputs from an outside financial data vendor, which are then interpreted by a custom model, and ultimately routed to an off-the-shelf order management system. We need to understand the process and be comfortable with how it functions as a whole.

Meeting the Team

And while information systems represent a significant point of interest, we also need to engage the portfolio managers themselves. We discuss the types of securities they bring into the portfolio — do they use derivatives? Do they invest on margin (i.e. with borrowed capital)? if so, what are their cover rules (i.e. the minimum equity level they must maintain in margin holdings)?

We also seek to get a sense of their familiarity with trade aggregation — how do they prioritize trading decisions across multiple accounts? How do they manage the potential conflict that arises from trading their own assets?

As for risk and compliance officers, we need to determine how frequently they conduct risk assessments, and what types of risks — both regarding portfolio management and in general operational terms — they are monitoring closely.

Whether the answers come from portfolio managers or compliance officers, we also need to determine the firm's policies on a range of other subjects, from best execution to soft-dollar arrangements.

We pose these questions and scenarios face-to-face in on-site meetings at each investment manager's office. These due diligence sessions take place before we hire a manager and every two years thereafter. We conduct a thorough annual review of any changes to senior management, profitability and systems, during which we also scrutinize whether there have been any updates to the manager's compliance program — specifically, what policies and procedures have changed?

These comprehensive reviews are supplemented with a quarterly questionnaire to remain current in the event of any relevant changes.

Follow the Money

Let's assume a manager satisfies all of SEI's due diligence criteria. How can we be sure they will deploy our investors' assets in good faith?

We don't leave it up to trust. Investor assets that come into our strategies are directed to a custodial account, which contains sub-accounts designated for the investment manager's use. SEI dictates the inflows and outflows to and from these sub-accounts. The manager, in turn, references these sub-accounts when transacting with their brokers to buy and sell securities.

Setting the Standard

Investors can take comfort in the knowledge that SEI holds itself to the same high standards that we apply to managers. Our strategies are overseen by an independent board, and we are scrutinized in our capacity as a manager via an internal audit process. We apply the criteria outlined in this paper to SEI as though we were considering whether to hire ourselves.

Risk Management: Asset Allocation

Our series on SEI's approach to risk management will continue with a paper that explores the balance of risks that we take into account during the asset allocation and portfolio construction process. We also plan to address the following, in terms of their contributions to risk management, over the coming months:

- Balancing risk for goals-based investing
- Enterprise-level risk management

Glossary

Best execution: Best execution refers to the duty of an investment firm executing orders on behalf of customers to ensure the best execution possible for their customers' orders.
Derivatives: Derivatives are a type of security in which the price is derived from an underlying asset. They are typically a right or obligation to buy or sell an underlying asset (such as a stock, bond, commodity or currency) at a set price at a specific date in the future. The most common types of derivatives are futures and options. Derivatives are often used by sophisticated investors or within a pooled investment.
Soft dollars: Soft dollars are a means of paying brokerage firms for their services through commission revenues, rather than through direct payments.

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Past performance is not a guarantee of future performance.

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