Asset management operations under scrutiny

OPERATIONAL DUE DILIGENCE

GAIL MOSS

The role of outsourced operational due diligence on asset managers is becoming more prominent

KEY POINTS

- Regulation and market changes are driving increased use of due diligence
- More sophisticated products and sustainable investing have encouraged asset owners to outsource the function
- Hybrid collaborations are a way for inhouse due diligence teams to co-opt the expertise and technology of external providers

Operational due diligence (ODD) has become increasingly relevant in recent years, not only for selecting stocks but also managers. Regulation, greater transparency requirements and more sophisticated investor preferences are all adding to the imperative to carry out proper checks on providers.

Moreover, the arrival of COVID-19, the increasing emphasis on environmental, social and governance (ESG) investing, and growing market complexity are now driving pension funds to outsource ODD.

"ODD demands have evolved significantly over the past five to 10 years," says Rian Akey, partner and global head of ODD Solutions for Aon. "What started as a risk discipline focused on pre-investment diligence on hedge funds has expanded to include all asset classes, including traditional and private markets, and ongoing monitoring requirements post-investment."

He says this has also expanded in the range of factors and risk areas that are part of a comprehensive assessment: "So there has been a steep increase, but without a corresponding increase in resource commitments."

Andre Boreas, head of marketing at DiligenceVault, a digital platform dedicated to due diligence, says: "The growth of alternative investments, particularly in private markets, is driving the need for deeper, more sophisticated ODD processes.

"As assets under management continue to climb for alt managers, their own businesses are becoming more complex. How these firms manage this growth – by adding more people, developing new processes and changing their operating model – can have significant ramifications for investors and how they conduct due diligence in this changing environment."

At the same time, Boreas adds, interest in ESG investing is exploding. "Greenwashing remains a challenge for investors, as asset owners and managers are still coming to terms with how to define ESG, and the metrics and benchmarks to support it, given the lack of standards in the industry."

Dutch pension provider APG incorporates all these factors into the scope of its ODDs, but believes another is cybercrime.

Michiel Vetkamp, manager for operational due diligence on APG's ODD desk, says: "Assessing the cybersecurity measures taken by managers is an increasingly important component of ODDs."

Regulatory pressures

While market developments are one driver of the evolution of ODD, regulatory pressures are another, especially in the Netherlands, where outsourcing is subject to legislative requirements.

"Dutch pension law dictates that pension funds are responsible for outsourced processes," says Stan Leistra, partner and head of public markets ODD at investment consultancy Lestrade. "We see a growing awareness of this within pension fund boards in relation to managing operational risk, reputational risk and going concern risk."

Leistra says that with strong consolidation and great change in the manager industry, ODD focuses on the ecosystem of an investment strategy and, as such, is a great predictor of going-concern risk.

"Trustees are becoming more aware of the reputational risk that stems from operational risk in ODD factors, and want blind spots to be removed," he adds.

Lestrade sees ESG discipline as an example of the growing need for strong data logistics in the asset management relationship. Leistra says: "These types of complexity often end up with the ODD practitioner who is capable of managing large information streams using the right technology."

The size of the pension fund is one factor in deciding whether to outsource.

"APG's size allows us to keep performing ODD ourselves," says Vetkamp. "Nevertheless, there can occasionally be instances when it is more efficient to hire local third-party specialists. In particular, this has happened because of previous COVID-19 travel restrictions."

Leistra says: "Many institutional investors are considering outsourcing ODD but are also aware of the need to integrate outsourced ODD back into their decision-making and monitoring process," adding that Lestrade focuses on utilising technology to enable "integrated ODD".

According to Leistra, the newest trend is a hybrid collaboration: "ODD providers become a flexible workforce for the local ODD team, who can leverage on our experience with the same managers and our technology."

Another benefit that ODD brings to the manager-selection process, he says, is a countervailing weight to the unconscious human bias involved.

"People tend to be very biased in their decision-making, and we sometimes see a 'love story' unfolding between an allocator and an external portfolio management team," says Leistra.

"So ODD assesses the supporting ecosystem around the portfolio management team that should facilitate performance. This goes from leadership commitment, the firm's financial stability, and the profitability of the strategy, to the state of systems and support functions. And, of course, it provides a thorough assessment related to fraud and operational weaknesses."

Vetkamp agrees. "The ODD provides an objective assessment on the operational risk profile of a manager," he says. "This, in turn, should be part of the decision-making process for the approval or rejection of investment proposals. An ODD also identifies the actions that are needed, or not seen or considered by the external manager, to enhance its operational set-up, moving forward."

As for the most important aspects of ODD, APG feels that the asset class and underlying investment strategy to a large extent determine the operational risk profile of an external mandate.

"Therefore, we apply such a risk-based approach," says Vetkamp. "Ultimately, this is not a one-size-fits-all exercise."

Nuanced implementation

However, commentators stress the need to avoid a headlong rush into the implementation of ODD, preferring a more nuanced path.

"ODD teams need to find the optimal balance between speed and thoroughness," says Boreas. "The most successful organisations will have a dedicated, experienced team – whether in-house or outsourced – coupled with a well-thought-out process, and the right technology to support it. Being able to synthesise a vast amount of data in a short period of time can only be done with purpose-built technology that can quickly identify manager-specific risks to support better decision making by everyone involved."

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UN PRI releases standard due diligence questions

Investors in listed equities now have a new tool to alert them to greenwashed products.

In March, the United Nations' Principles for Responsible Investment (PRI) published a due diligence questionnaire to help asset owners assess managers' approaches to responsible investment for listed equities.

The questionnaire is the latest in a series that started in 2018 and now covers eight asset classes including private debt, hedge funds, real estate and infrastructure.

Questions cover policy and governance, investment process, stewardship, and reporting and verification.

Toby Belsom, director of investment practices at the PRI, says: "As the number of product offerings and providers increases, asset owners are becoming more sensitive to the issue of greenwashing. For non-specialists, differentiating between providers and products can be tricky – an issue sometimes exacerbated by the sector's use of acronyms and industry speak."

The due diligence questionnaires are intended to give asset owners a clear idea of a manager's approach to integrating ESG factors into an investment process.

Belsom continues: "These questionnaires provide a flexible, practical and open-source tool that asset owners and their advisers can use to identify products and providers which best align with the requirements of their responsible investment policy."

However, he cautions that while the questionnaires are designed to act as a starting point in a dialogue between an investor and a manager, they are not meant to be considered in isolation, but rather used to support a wider information-gathering process.

In developing the questionnaires, the PRI encountered several challenges.

"Responsible investment due diligence needs to root out greenwashing while recognising that there are many different valid approaches to investing responsibly," says Belsom. "A challenge is making the questions robust without being overly prescriptive."

Furthermore, the questionnaires are designed

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to be used by investors headquartered in a broad spread of regions globally. But given that responsible investment regulation and approaches vary across jurisdictions, making them applicable across geographies also poses challenges.

The questionnaires are developed with input from PRI's advisory committees, including asset owners and managers. The input helps tackle these challenges by steering the topics they cover, and their design and wording, so that they can be used in different contexts.

The PRI is planning to develop a responsible investment questionnaires for public fixed income investors, while existing ones will be updated periodically.

Meanwhile, it is also working to develop issue-specific questionnaires to complement existing asset class ones. A questionnaire on diversity, equity and inclusion is in development, with a climate-focused one also planned.

The questionnaires can be accessed at: www.unpri.org

One consideration is what constitutes an ODD report, says Akey, observing that the length of an ODD report used to be promoted as a differentiator.

"But longer is not necessarily better," he cautions. "In fact, it can be worse. The burden of manually generating chapters of content can promote burnout, and raises concerns about overlooking key risks, while focusing on length."

He adds: "I don't think the next hedge fund fraud is going to be uncovered by an analyst trying to churn out a 40-page report, but by one who is relieved of that burden and can really dig into areas of concern. The longest report in the world is worthless if it's not being read."

In the long run, is it helpful for clients to add another intermediary between pension funds and asset managers for ODD, considering the costs involved?

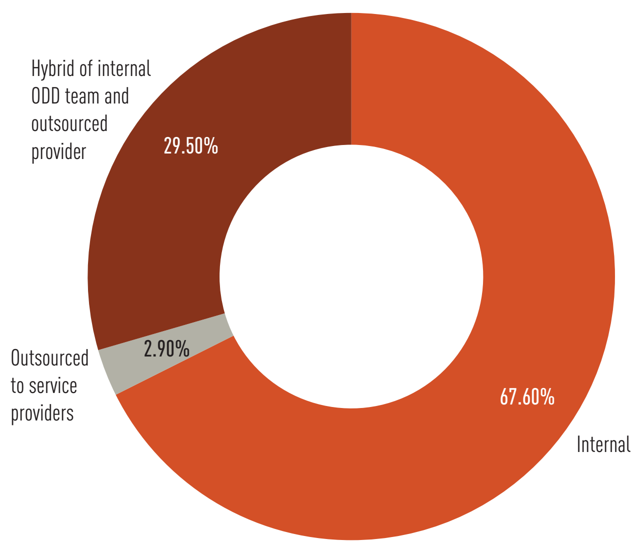
APG has adopted a fiduciary model, the pension provider's size allowing it to carry out ODD exercises in-house. "Besides avoiding additional costs, we prefer to keep our knowledge about external managers in-house," says Vetkamp. "Occasionally, ODDs are outsourced to external parties in order to manage peak demands on ODD."

"In the long run, proper ODD practice pays off financially and also reputationally," says Leistra. "For many investors, it can be cheaper to work with an intermediary than building a local ODD capability, because of the scalability that can be achieved."

Akey says that Aon's ODD approach focuses on helping organisations make better decisions by being as comprehensive as possible, but also incorporating cost into the equation.

"The best ODD work in the world is worthless if it's not affordable and accessible to the consumers of this information," he concludes.

ODD insourcing versus outsourcing



Source: DiligenceVault, based on over 100 globally-based allocators and institutional investors polled by DiligenceVault in 2021