Striking the Right Balance: Navigating Operational and Investment Due Diligence in Institutional Investments

Investing is hard!

Risk and returns go hand-in-hand. Institutional investors take risks to achieve the returns required to meet their obligations, e.g., pension payments or long-term funding of non-profit causes. While risk is fundamental to the investment process, there is a natural trade-off whereby higher risks should be accompanied by higher expected returns (and vice versa). However, there are some risks whereby this trade-off relationship is broken.

Investors do not earn higher returns by assuming higher operational risks. On the contrary, unchecked operational risk can lead to substantial monetary losses and reputational damage!

While Investment Due Diligence (IDD) is concerned with assessing the potential returns, risks, and suitability of investments, Operational Due Diligence (ODD) is focused on assessing operational risk. ODD is a critical component of the investment process and has become substantially more formalised over the past 15-years following the infamous Madoff Ponzi scheme. Yet, recent cases of fraud suggest that even 15-years on, ODD still may not get adequate attention.

No investment is without operational risk. The challenge facing Chief Investment Officers, Investment Committees, and other organisational leaders is to strike the right balance between allowing investment teams to pursue attractive opportunities that are in line with investment mandates and not allowing the undertaking of undue operational risks. While excessive (operational) risk aversion may slow down and cripple the investment process – a cursory approach to ODD can leave a portfolio dramatically exposed to loss.

Professionalisation of Operational Due Diligence (ODD)

In the 15-years since Madoff, the role of ODD has become substantially more professionalised (and specialised) as an area of expertise – driven largely by lessons from past failures. ODD covers an ever-wider range of topics, including governance structures, internal controls, (regulatory) compliance procedures, cyber security, business continuity, cash and collateral management, service providers, and more. Further, ODD plays an increasingly active role in the ongoing monitoring of external managers, including the impact of major risk events (such as bank failures, see Key Lessons from SVB).

The impact of scrutiny by investors should not be underestimated as a driver of better practices and professionalism in the asset management sector. Investment firms do not just compete on past performance, but also the efficiency and robustness of their overall operations (see Operational Alpha).

Standard-setting and professional bodies such as the Standards Board for Alternative Investments (SBAI) and the Chartered Alternative Investment Analyst Association (CAIA) play an important role in championing better industry outcomes, by creating common understanding of standards and norms as well as establishing a collaborative process for continuous education and improvement for managers and industry practitioners.

Key lessons from the post financial crisis Goldilocks era

While the 2007/08 financial crisis provided important lessons for investors, including assessment of counterparty risk, funds' liquidity terms, and investor concentration in funds, the subsequent Goldilocks era of low inflation and steady growth perhaps resulted in some latent exuberance. Low interest rates and quantitative easing facilitated increased use of leverage, increased asset price levels, and expansion into private markets including 'exciting' and 'new' investment opportunities in areas such as digital assets or venture capital placements in adjacent technology. Some investors may have looked towards substantial reported returns by peers and wanted a piece of the pie! But as is the case so often, the latecomers to the party miss out and now nurture the greatest losses.

The dynamics observed in investment organisations during this period highlight key challenges for investment leaders:

- **"Fear Of Missing Out" (FOMO):** Not just a phenomenon among retail investors – institutional investors can fall victim to FOMO too, which can put undue pressure on investment teams which may compromise consideration for operational risk.
- **Reliance on others' due diligence or regulatory registrations**: By the same token, as some retail investors can fall for celebrity endorsements, 'get rich, quick' schemes, or trendy investments – institutional investors may take comfort in other reputable firms' decisions (touting narratives such as *"they should know what they are doing"*, *"they are sophisticated and have large teams"*, *"they got it right in the past"*). Equally, manager registrations with regulators in their respective jurisdictions should not result in less scrutiny. These shortcuts can lead to missteps in both IDD and ODD.
- **"Operational washing":** Investors should not rely solely on firms' marketing materials or what is stated in manager policies and procedures. Investors must ensure that they see manager operations in action to assess whether appropriate controls and procedures are in place. Despite an evolving industry, it is typically the same operational issues that re-emerge and ultimately hurt investors, including weak cash controls, counterparty risk, failures in (or lack of) risk management, and breaches in cyber and information security.
- **Compromising standards/expectations:** Investors expanding outside their core area of expertise may run the risk of inadvertently neglecting transparency requirements, investor protections, fees, etc., for the sake of "gaining access".
- **IDD and ODD in competition:** ODD teams may be perceived as disrupting progress if the review process raises concerns that impact the path to an investment.
- **Resourcing and power imbalance:**
    - Resourcing may favour IDD over ODD if operational assessments are deemed less important than sourcing managers and overseeing investment strategies.
    - Allocator teams are typically led by senior investment personnel which may result in return profiles becoming the dominant discussion point in meetings.

    - Investment due diligence teams tend to be larger than their operational counterparts, despite the growth of areas scrutiny and monitoring.
    - Investment teams typically meet with manager on many occasions, while ODD teams are expected to complete their assessment within a shorter period, thus creating the impression that that the decision to invest already has been made.
- **Flexibility:** Investors deploy capital across a wide range of heterogeneous managers operating in different jurisdictions, with varying levels of resource and sophistication. Investors may have to adapt their processes to assess operational risk, potentially requiring them to endure greater initial operational risk, so long as they believe that those risks can be adequately mitigated as the relationship evolves.
- **ODD, the 'fixer':** Some investment risks are tolerated as part of the risk-return considerations, while issues that may arise in an operational review tend be more "black and white" and are benchmarked against best practices. As a result, ODD teams are often tasked with 'fixing' these issues to make a manager more acceptable for approval. Whilst some changes may be feasible, miracles cannot be performed. It can be difficult to walk away from an investment opportunity once substantial time and resources have been spent analysing the investment manager, potentially even working with the manager to address issues.

For leaders of investment organisations, the challenge lies in designing a cohesive process that harnesses and combines both strong IDD and ODD while addressing the above issues.

Building successful institutional investment programmes: Striking the right balance

Any institutional investment programme should be anchored in clearly defined investment objectives, including expected returns, investment goals and risk tolerance. To ensure a consistent approach to evaluating investment opportunities, institutional investors need a comprehensive due diligence framework with IDD and ODD considerations, detailing the relevant key areas of focus, and potentially drawing on external (consulting) support where internal resources and capabilities are insufficient.

While all this provides a useful structure and guardrails, it is not enough to ensure optimum outcomes when considering the challenges highlighted above. Below we outline additional areas of focus for investment leaders, including governance, organisational set-up, and the overall culture.

Governance

- Put in place a formal structure for investment decision-making, including related documents such as an investment committee terms of reference (describing members, frequency of meetings, strategy, objectives of the committee, voting, quorum, escalation and resolution procedures, as well as processes around how ODD and other aspects such as risk and ESG are considered).
- Irrespective of organisational reporting lines for ODD and veto rights (see next section), ensure that ODD has a "seat at the table" to present concerns during investment committee meetings and that ODD, legal, compliance, and reputational risks are part of the overall assessment.

- Put in place a process for appointing consultant(s) and consider the role of external reports in the decision-making process when ODD is partly or fully outsourced.

Organisational set-up, reporting lines, veto powers:

A number of approaches are available for the organisational set-up of ODD – ranging from separate reporting lines to the Chief Risk Officer, Chief Investment Officer, or Operational departments (including controlling, compliance, operations, internal audit), or integration into deal teams.

Key considerations:

- Structures, where the ODD function is too remote from the investment teams run the risk of disempowering the ODD team, resulting in their concerns being overlooked in the investment process.
- Structures where the ODD team is part of the deal team can result in undue pressure on ODD to approve transactions at the expense of standards and protections.

A key question is whether ODD teams should have veto powers over investment decisions, which can include a pre-agreed list of non-negotiable red flags, or if the decision-making should ultimately reside with the investment team while taking ODD concerns into account.

In many organisations the ODD team may not have explicit veto powers, particularly when the IDD team fully appreciates ODD considerations and where concerns from both disciplines are given equal respect by senior investment leaders. This also prevents pitching one team against another. However, ODD teams must be empowered in those organisations where failures (and subsequent losses were incurred) as result of their recommendations being overlooked in the investment decision-making process.

In all instances, clearly defined red flags and minimum standards help firm up an investor's position, as the ability to walk away is the strongest tool in negotiations. ODD and IDD teams should work together to determine what constitute potential ODD "red lights" that would end an investment's consideration or "yellow lights" which would prompt further discussion. Prioritising key risks also can prevent teams from getting lost in long lists of detailed issues without qualification of their severity.

Most important in this process is accountability: when IDD teams or investment committees have the final say they need to be accountable for all aspects, including issues flagged by the ODD teams. Executive leadership teams need to be aware of the risks associated with the overall investment recommendations so that post-investment insights/learning can objectively occur.

Independent of the design of the decision-making process, other important aspects include:

- Empowerment of teams: taking concerns raised seriously, in particular when there are imbalances in seniority between IDD and ODD.
- Spot herding / reliance on others' decisions: scrutiny should be exercised when narratives like *"reputable investor XYZ is allocating, what is the problem?"* arise.

- Detect FOMO: caution should be taken when there is undue pressure to make allocations in a "hot" or "trendy" area.

Process:

- Clarify involvement of respective teams, ensuring sufficient time for ODD.
- Consider establishing "ODD mini reviews" early in the process to identify major red flags and minimise "sunk cost" fallacies associated with lengthy IDD and potential resentment (*"if you fail them, fail them fast"*).
- Institutionalise ex-post reviews of investment decisions and post-mortems to nurture a culture of continuous improvement. This can include post-mortems of other fund failures (*"would our ODD process have detected the risk?"*). This should not be an *"I told you so"* moment.
- Establish cooling off periods and opportunities to assess managers over longer periods – in particular when ODD teams are expected to offer recommendations to managers to improve their operations to make them more investible.
- In situations where issues have been detected pre-investment (with an expectation for prospective managers to fix them), establish an action plan with clear accountability of who (ODD or IDD) manages ongoing interactions with the prospect to address the issues and track any improvements.

Resourcing:

- Ensure teams have adequate resources to cover expanding responsibilities in terms of ex-ante DD and ongoing monitoring.
- Consider technology that makes the process more efficient, such as information gathering tools.
- Provide ongoing training, e.g., new asset classes, direct / co-investments, etc. This includes facilitating staff involvement in industry forums and communities to stay on top of frontier questions, such as CAIA Chapters and/or the SBAI ODD Community.
- Consider the use of third-party service providers / investment consultants to leverage internal teams.

Insisting on standards:

- Ensure expectations are consistent across different areas of investment. When compromises are made, these should be documented along with a clear rationale.
- Clarify what is negotiable and what is not.
- Insist on standards and widely accepted industry frameworks as a benchmark (such as the SBAI Alternative Investment Standards, Administrator Transparency Reports, Open Protocol, and Standard Total Expense Ratio), so that a baseline of good practice does not become a matter of negotiation.

Collecting Data:

- Track investment decisions, particularly when flagged risks were tolerated (including rationale for those decisions), and revisit over time. This can include tracking decisions not to invest.
- Undertake consistent post-mortems and document key lessons to present to investment committees and senior leadership.

The potential to deliver 'Operational Alpha'

In a narrow sense, ODD can be seen as a mechanism to prevent monetary loss and reputational damage for investors. However, a well-resourced and experienced ODD team can expand the scope of ODD to make positive contributions to overall goals and objectives. 'Operational Alpha' can be delivered in several ways:

- **Negotiation Leverage:** An in-depth understanding of a manager's operations can provide institutional investors with valuable insights that can be used in fee and term negotiations. For example, if a manager has high operational costs due to inefficiencies, this could be a point of discussion during fee negotiations.
- **Cost Savings:** An experienced ODD practitioner will be able to identify potential cost savings by recommending alternative trading counterparties or prime brokers when implementing the trading strategy. This also may extend to recommendations for trading infrastructure which can improve the level of straight-through processing reducing potential manual mistakes and trade errors. By identifying and recommending improvements in processes, an ODD team can help enhance a fund's operational efficiency resulting in cost savings for investors and their ultimate beneficiaries.
- **Data:** Accurate and transparent reporting is paramount for informed decision-making. ODD teams can assess whether a manager's reporting systems and processes are robust and meet investor's needs. Quality and timely reporting allow more sophisticated investors to receive data and quickly assess risks within funds and across portfolios on aggregate to act on divergences in strategy or increases in risk.
- **Other Emerging Tools:** The use and deployment of emerging technologies and tools such as generative AI, distributed ledger, alternative data, etc., should be carefully assessed. While the potential for operational improvement is high, the risks around integration, implementation, education, and privacy all need to be fully evaluated and understood.

Operational alpha is derived not just from preventing potential losses but also from enhancing the efficiency, transparency, and reliability of the investment operations.

Conclusion

Building a successful investment organisation that best serves its ultimate beneficiaries is not easy. It requires strong organisational capabilities, which includes a combination of governance, organisational design, process, diverse specialist skills, culture, technology, information, and leadership that facilitates the pursuit of attractive investment opportunities in line with the overall risk mandate and objectives.