

Operational Due Diligence: bringing the back office into the sunlight

In July 2014, in its e-magazine *Insight* (Issue No.1 2014), APRA detailed its expectations of Registrable Superannuation Entity (RSE) Licensees regarding Operational Due Diligence (Ops DD):

“The need for investment due diligence, examining the investment philosophy and process, portfolio composition and performance of the investment manager and the relevant products is well recognised. Also of great importance, but frequently receiving less attention, is the need for operational due diligence on the investment manager. This is essential for the RSE licensee to understand the ability of the investment manager to adequately deliver on its representations, and hence to be able to fulfil its intended role in meeting the RSE licensee’s investment strategy and achieving its investment objectives.”¹

APRA’s *Insight* document is a useful introduction for the industry to APRA’s expectations with regards to Ops DD. While the document itself is addressed to RSE Licensees, it is not unreasonable to extrapolate that the concept of Ops DD applies to all responsible investors.

A key element of *Insight* is centred on the RSE Licensee’s need to not only understand **what** a manager has been mandated to achieve, but to also understand exactly **how** the manager will do it.

¹ http://www.apra.gov.au/Insight/Documents/Insight_Issue1_2014_FINAL.pdf

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Typically, a meaningful amount of time and effort is expended by investors and their advisers of our industry in searching for the right manager, and ensuring they are capable of delivering the best possible investment outcomes for members and beneficiaries. We call this Investment Manager Due Diligence (IMDD). While it covers the “*what*”, it doesn’t necessarily reach down fully into the “*how*”, that is, into the recesses of what is called the “back office”.

perform the functions for which it has been appointed” with Ops DD providing for an assessment of “whether the investment manager has the operational capabilities required.... therefore (the RSE) needs to assess all aspects of the investment manager’s operations.”¹

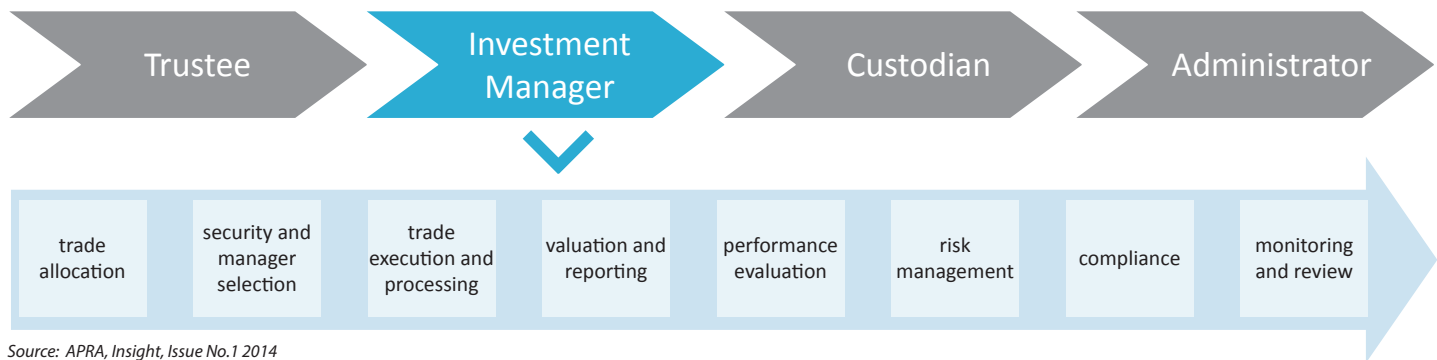
Figure 1, depicting APRA’s Value Chain, identifies APRA’s spectrum of processes which ought to come under scrutiny in an Ops DD review.

JANA’s manager monitoring program.

We have been thinking about the increasing need for Ops DD for some time, and in response, have recently developed the capabilities to complement our IMDD services with a new Ops DD service, which we believe at least meets, if not surpasses, the new hurdle that APRA has set.

For JANA, Ops DD is focused almost exclusively on non-investment related factors (i.e. non-IMDD factors), touching on

Figure 1: APRA’s Value Chain



Source: APRA, *Insight*, Issue No.1 2014

APRA has also observed this limitation, noting that the industry gives less attention to the need for Ops DD, which it believes complements IMDD in evaluating how the managers fulfil delivery of these outcomes. But while in *Insight* APRA recognises this distinction, it is not able to clearly draw a line where IMDD ends and where Ops DD commences, simply because it cannot be easily done.

Hence, while IMDD has been well covered in previous APRA communications (particularly Superannuation Prudential Standard SPS 530, Investment Governance), it was not until the *Insight* paper that Funds had a clearer indication of APRA’s expectations around Ops DD.

So Ops DD is here, and it is here to stay. But what is Ops DD really, and what can be done to meet APRA’s expectations of RSE Licensees regarding Ops DD?

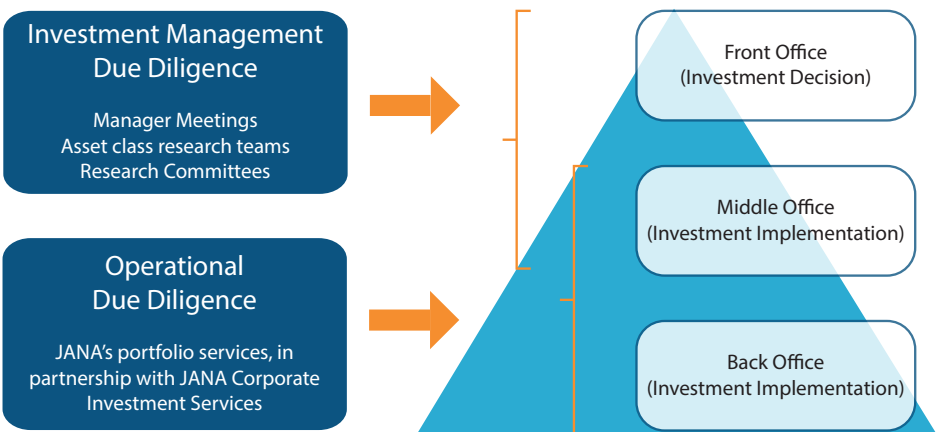
Ops DD’s relationship to IMDD – Completing the investment circle

APRA’s definition of Due Diligence identifies “the process of analysing the philosophy, people and processes of the investment manager to ensure that it is able to

JANA’s definitions of IMDD and Ops DD are reasonably similar to those of APRA. JANA’s IMDD activity, which is the manager selection component of its asset consulting service, scrutinises whether the manager can generate alpha, and whether it has the skills to execute the strategies for which it has been hired. JANA’s IMDD touches upon operational aspects of the manager to gain a high level of understanding that the manager can achieve the objectives for which they have been hired. Historically, IMDD has been completed pre-investment, with subsequent monitoring through

investments only with regard to how they fit within the operational construct. JANA’s ops DD examines topics such as trading practices; compliance regimes; “back” and “middle” office operations and their interactions with the “front” office, through to IT capabilities and business continuity; amongst others. For JANA the key is recognising the crossover between IMDD and Ops DD, and ensuring that the two services complement and supplement each other in a practical and sensible manner. Figure 2 demonstrates this concept.

Figure 2: Investment due diligence relative to operational due diligence



Source: JANA

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Overall our approach to Ops DD is not dissimilar to that utilised within the current JANA IMDD service, and its complementary nature is the key as to why the addition of the Ops DD service provides what we believe to be a holistic service, and one in accord with APRA's new, broader directions.

JANA's approach to Ops DD

While some of the operational functions noted by APRA, such as IT systems and Insurance, are more comprehensively assessed by documentation requests. Other categories, such as Service Providers, are better assessed through a range of qualitative and quantitative factors, including formal assessment processes, meetings with the manager and potentially even discussions with the manager's underlying service providers.

We start with a comprehensive questionnaire that is given to managers in the

initial stages of assessment, complemented by manager meetings as well as ongoing dialogues. The questionnaire should not be considered exhaustive, rather it is the starting point for subsequent meetings and discussions with the actual practitioners within the organisation seeking to elicit a deep understanding of the operations and the risk culture within the organisation. Importantly, we recognise that this is not an audit, nor is it intended to be. Rather, this service appreciates that specialists are hired to perform the audit function, and that what is required is a sanity check, of sorts, with a view to providing comfort that each component of the manager's operations is interacting efficiently, and to market standards, if not best practice.

As with JANA's current IMDD service, the Ops DD service provides for ongoing monitoring, including situational analysis, should there be a sudden issue. We

recognise that the state of affairs can change swiftly for a manager, and while that may impact on performance, it might also increase operational risk. Accordingly our Ops DD is intended to be considered not only a pre investment hurdle, but an ongoing dialogue.

Conclusion

APRA's *Insight* document is a useful introduction for the superannuation industry to APRA's expectations of RSE Licensees with regard to a "complete" Due Diligence assessment of managers, comprising both IMDD and Ops DD. In this respect, JANA believes that the considerations we have brought to framing Ops DD activities to complement our work in IMDD represents an appropriate additional service to meet this new standard. We are happy to discuss Ops DD further, should it be of interest to you.

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