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Jo Leaper is JANA's Manager, Operational Consulting. Jo focuses her time on the operational needs of JANA's client base, including building new product, custody and operational research (including operational due diligence), governance reviews and assisting JANA's clients with broad operational expertise. With almost 20 years of industry experience, Jo's background in asset servicing and relationship management has honed her core strengths of operations management and client strategy. Her current role enables her to assist clients and is ever expanding with regards to researching better ways to help and guide JANA's client base.

WHAT DO FAST CARS AND GLOBAL BEST PRACTICE OPERATIONAL DUE DILIGENCE HAVE IN COMMON?

At first glance, not much. However, recent research by Professor Stephen Brown, of New York University's Stern School of Business, has indicated there is indeed a relationship. Brown's research has found that car preferences can be an indicator of an investment manager's behaviour with respect to risk taking.

This discussion paper examines what makes a global best practice Operational Due Diligence (Ops DD) process and how Brown's research contributes to the assessment of this. It also provides a framework for investors to assist in adequately obtaining, assessing and using Ops DD to best advantage to understand and manage risk.

In Australia Ops DD is often viewed as a concern primarily for superannuation funds. **However, it should not exclusively be a concern for superannuation funds as it is an issue for all investors.** Risk knows no boundaries, be they geographic or investment style, and accordingly this discussion is globally applicable and for all investor types.

Risks can be:

- 1) Accepted on face value
- 2) Accepted and mitigated as appropriate
- 3) Assessed and deemed unacceptable
- 4) Unknown

Operational theory – what is 'best practice'?

The pinnacle of operational theory in an investment environment is a robust process, with strong governance and independence of functions and processes. At a minimum, best practice incorporates:

- Independent oversight and verification of information
- Appropriate segregation of duties between and within functions
- Transparency and consistency of processes and documentation
- Rigorous checks and balances
- Oversight of, and partnership with, key service providers
- Consistency between client outcomes and incentivisation of investment, executive and operational staff
- Solid risk culture, including a culture of compliance and performance

In observing this theory, it becomes apparent that there are varying levels of operational risk; and that some elements of risk are not only acceptable, but sought out, as they may potentially enhance investment returns. In assessing these risks, investors must not only be cognisant of best practice theory, but that there are often manager, or sector-specific circumstances, such as the size of the firm, the investment capability, 'first-to-market' opportunities, start-ups, private equity and other factors which may form part of the risk profile of the investment.

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What does global best practice operational due diligence look like?

Ideally, best practice for Ops DD would be consistent around the globe, though at present this is not the case. The one globally consistent element, however, is that **independence is key**. Accordingly, asking a service provider to assess itself is not satisfactory. Independence of information and of assessment is the 'gold' standard, and is consistent with JANA's firm belief that this is crucial to the prudent investment of other people's money. Many who have reviewed outsourced relationships would have seen first-hand improvements made once the service provider becomes aware of being monitored!

For many investors Ops DD is considered a reactionary or 'box ticking' function, and is often only undertaken after incidents such as the Madoff or Opes Prime investment scandals, or prior to making an investment. In reality Ops DD can, and should, be a preventative risk measure, with ongoing assessment aiding the investor, and the manager, in understanding and managing risk and therefore delivering higher quality investment returns. US investors, in particular, are sensitive to the aforementioned scandals, which perhaps explains the US-specific expectation of triple verification, where information is investigated prior to being vetted by private investigators. Whether this will become global best practice remains to be seen.

Assessment components of operational due diligence

The assessment of any service provider involves both qualitative and quantitative components. Arguably the quantitative components are far easier to assess, and often result in binary outcomes. Quantitative 'slicing and dicing' of data requires precision and accuracy, after which some qualitative interpretation is required, but the assessment is drawn from a factual base. Qualitative components are, however, far 'softer', making them more difficult to assess and require broad industry knowledge, peer relativity, as well as assessment of categories such as risk culture. Both qualitative and quantitative components should be subject to peer relativity assessments.

Since risk culture permeates all processes, is a precursor to client responsiveness and error resolution, and is at the heart of an organisation's psychology, it is a key input into the qualitative assessment of an investment manager.

Further, some quantitative elements of Ops DD require specific qualitative observations. As an example, it is not sufficient for an investment manager to simply have insurance cover. Associated insurance assessment criteria should include "What type of insurance is provided?", "What exactly is covered?", "What is the quality of the provider?", "How much is the coverage?", "Is there currency risk?", "How does the insurance compare to the manager's funds under management (FUM), to the life cycle and growth profile of the manager and to the manager's peers?", "How large is the client base that the FUM is spread over, given all clients are reliant on the same insurance?", and "What types and quanta of excess are involved?". Investors should never assume that the mere presence of a policy or procedure equates to appropriate implementation. Let alone implementation that is consistent with an investor's risk tolerance.

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How does JANA consider the qualitative aspect of operational due diligence?

At JANA, the key to qualitative assessment of Ops DD is alignment between the risk culture of an investment manager and that of the investor. In addition, there are several key factors that we consider best practice when conducting Ops DD reviews, namely independence of assessment, trust of, and verification of, information, and, most importantly, interpretation of that information according to the risk sensitivities of the client. Naturally the more granular factors are easier to assess. Others, like risk culture, and subsets thereof, are more difficult, which is where behavioural and qualitative traits, including Brown's sensation seeking concept, can become outliers that assist in the assessment of risk culture.

A question many investors are no doubt asking at this stage is related to the cost of Ops DD. How expensive is it and would it not be better for the manager to appoint an independent expert to carry out the review, similar to what happens with an internal controls report? That the global investment community does not follow such a model is one factor to be conscious of. We would also point out:

- Internal controls reports are completed to a known and set standard by recognised global bodies. They are subject to some decisions, such as specific inclusions, but have a baseline as a minimum. Notably, there is still room for some service providers to choose a higher / lower standard of report, such as a Type I over a Type II report, the latter of which is more costly, but provides a far higher standard.
- Unlike internal controls reports, which are quantitatively based, a significant proportion of the Ops DD assessment is based on qualitative factors, intending to give due consideration to the size and structure of the manager, and crucially, to the investor's specific risk profile.

It is JANA's view that the independence afforded by the global best practice model, though it does come at a price, goes a long way to ensuring investors can be confident of receiving independent, free of conflict, impartial and transparent advice. Further, the cost savings of having the manager commission an Ops DD report may turn out to be at least partly illusory as these come with the potential of the costs being passed back to investors, as well as a likely impact to insurance premiums, given the limited recourse to the party providing the generic Ops DD assessment. An investor can also obtain this independence in conducting self-sufficient reviews (by the investor themselves) rather than utilising a third party such as JANA.

Sensation seeking and risk culture as an indicator of qualitative operational due diligence

Research by Brown (see the Breakout Box for the research paper abstract) into sensation seeking intimates that someone's car choice is directly related to their approach to work, which is a rather bold assertion. However, Brown's research demonstrates that this concept is not that far-fetched, and courtesy of the transparency of the data in the US, is not all that difficult to prove in that market. The concept has also been called 'Red Ferrari Syndrome'.² Brown's research indicates that behaviour surrounding sensation seeking can be linked not only to personal risk choices, but also to the risk adjusted performance potential of hedge fund managers. In reality, however, it is worthwhile to remember that this performance, and the sensation seeking behaviour, is not confined to portfolio managers. Risk culture, and sensation seeking as a subset, is a whole-of-firm phenomenon, permeating all aspects of an organisation, from investments, to the executive team and to operations. Brown's research provides one avenue through which a firm's risk culture can be observed.

"Risk culture, and sensation seeking as a subset, is a whole-of-firm phenomenon, permeating all aspects of an organisation, from investments to the executive team and to operations."

¹ 'Sensation Seeking: Beyond the Optimal Level of Arousal', Zuckerman, M, 1979, p10.

² 'Here are the biggest 'red flags' that keep people from giving a new hedge fund manager money', [businessinsider.com.au/red-flags-allocators-see-in-new-fund-managers-2016-2](https://www.businessinsider.com.au/red-flags-allocators-see-in-new-fund-managers-2016-2), 19 February 2016.

³ 'Sensation Seeking, Sports Cars and Hedge Funds', Brown, S, Lu, Y, Ray, S and Teo M, papers.ssrn.com/sol3/papers.cfm?abstract_id=2882983, last revised 1 February 2017.

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Abstract: 'Sensation Seeking, Sports Cars and Hedge Funds'³ (Brown)

Hedge fund managers are widely perceived to be risk takers. Do they take risk to enhance returns or do they take risk for non-pecuniary reasons? Sensation seeking, a personality trait defined by the seeking of varied, novel, complex, and intense experiences and the willingness to take risks for the sake of such experience, is an example of the latter. In this paper we argue that manager revealed preference in the automobile market captures the propensity for sensation seeking, which in turn shapes manager behaviour in the investment arena. In line with that view, we find that managers who purchase powerful sports cars take on more investment risk while managers who own practical but unexciting cars take on less investment risk. The incremental risk taking by performance car buyers does not translate to higher returns. Consequently, they deliver lower Sharpe ratios than do car buyers who eschew performance. In addition, we find that hedge funds managed by performance car owners exhibit higher operational risk attributes and are more likely to fail. Managers who purchase performance cars demonstrate other attributes commonly associated with sensation seeking, such as a preference for lottery-like stocks, unconventional strategies, and active trading.

Putting operational due diligence theory into practice

Earlier, we noted the four stages of risk acceptance and mitigation. Ops DD information is a tool that facilitates risks to be **consciously** assessed. Risk acceptance is an essential component of investing, and is key to ensuring that investors' sensitivities and risk profiles are appropriately represented. The most critical component of an Ops DD review is translating the information assessed into a useable and digestible format. There are several key questions an investor can ask when reviewing a service provider, for Ops DD or otherwise:

- Is there sufficient depth and quality of information?
- Is it independent?
- Can it be verified?
- Is the information specific to the investor / beneficiaries? (Fund, Trustee, Endowment, Insurer, etc.)
- Does it give consideration to the investor's risk sensitivities?
- Is there reliance on the information received, contractually and commercially?
- Is the provider best practice on a peer relative basis? Is the manager being assessed on a peer relative basis?
- What framework will be used to assess the information?
- When the assessment is done, what will be done with the information and subsequent opinions formed?

If the answer is 'no' or 'unsure' to any of the above, how will this be corrected? Usually at this point, an investor needs to take the discussion internally, which can be both time and resource consuming, but is time well spent, as appropriate consideration of the risks is where the true application of operational due diligence takes place.

JANA's proposal to investors for implementing a practical framework

There is no intellectual property in the collection of documentation required to conduct operational due diligence. JANA proposes that the investment industry as a whole, regardless of domicile or investment strategy type, facilitates the distribution of a documentation pack on an annual basis to its investors. This is standard information the industry would ordinarily provide when an operational due diligence review is undertaken. Our intent in providing this proposal is to:

- a) streamline client requests for like information;
- b) reduce the load on clients and service providers by the updating and distribution of this information on an annual basis; and
- c) ensuring that all clients receive the same baseline of information.

We recognise that managers may wish to utilise contractual / mandate or non-disclosure agreements to provide comfort that this information is not shared outside the client or prospective client relationship. Should investors wish to interrogate this information further, this can be undertaken by investors themselves or by third party providers. We anticipate this may have the by-product of reducing fees and internal expenses to a degree, given a portion of the workload is systematised.

Table 1 outlines the documentary minimums that JANA believes should be included in the Ops DD pack. Where possible, investors should consider inserting the requirement for the provision of this information into investment mandates and trust deeds.

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Table 1: Documentary minimums for operational due diligence reviews

Policy on Broker Selection	Proxy voting Policy and Guidelines
Code of Conduct and Ethics	Business Continuity and Disaster Recovery Plans
Policy on Personal Dealing	Extract from Personnel Manual or Policy
Policy on Insider Trading	Policy on Soft Dollar and Directed Brokerage
Policy on Managing Conflicts of Interest	Trading Policies and Procedures
Policy on Fraud Prevention and Cyber Security	Middle and Back Office Procedures
Policy on Broker Selection	Reconciliation Processes and Procedures
Investment Compliance Monitoring and Reporting manual / procedures	Latest audited Annual Financial Statements
Derivatives Policy	AFSL License or Exemption
Independent Audit on Derivatives Policy	Risk and Compliance Framework
Internal Controls Report (GS007 Type II or equivalent)	Current organisational chart and biographies of senior personnel
Form ADV or equivalent	Authorised signatory list
Certificates of currency for insurance	Cybersecurity

Conclusion

Should investors be stalking managers in the underground carpark before a meeting to try to work out what car they drive to ascertain their level of sensation seeking behaviour? Probably not. We should, though, consider the varying aspects of an Ops DD review. The theory of sensation seeking is able to provide further colour to the consideration of the risk culture of investment managers and how this may be embedded not only in investment decision-making but also in an operational context.

Ultimately, independent review combined with open and transparent discussions are key to ensuring the alignment of risk culture between investor and investment manager. Ops DD is a key facilitator to this exploration, and a contributor to the process of understanding the nature and extent of risks in order to manage risk better and deliver higher quality investment returns.

Should you wish to discuss further, please do not hesitate to contact JANA's Operational Due Diligence team (opsdd@jana.com.au), your consultant or the author at jo.leaper@jana.com.au

IMPORTANT INFORMATION

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