

# Investment Manager Research

*Due Diligence and Selection Process*



RBC Wealth Management®

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## Introduction

Selecting the right professional money manager is an important investment decision. RBC Wealth Management provides meaningful insight and important information on a broad list of investment managers and products, including mutual funds, separately managed accounts, and alternative investments. Our Advisory Research team of analysts employs a comprehensive research and due diligence process to provide you with in-depth, ongoing, and objective guidance.

## Disciplined Search Criteria

Our proprietary, multi-step review process typically begins with the following minimum screening criteria:

- Three years of operating and performance histories
- \$100 million of firm assets under management
- \$25 million of product assets under management
- Three years of portfolio management tenure
- Reasonable management fees and expenses

These are considered basic thresholds for operational viability. Investment managers meeting these criteria are then subjected to a more rigorous fundamental review. An initial evaluation of each product's risk and return record is performed to identify the most attractive candidates. To make the comparisons more useful, portfolio strategies are organized into one of many different asset classes and assigned an appropriate benchmark. In general, products exhibiting superior long-term absolute and/or risk-adjusted investment results receive further consideration.

While historical performance is an important measure of a manager's accomplishments, it is seldom the most appropriate guide to future results. Therefore, our selection process goes well beyond a simple performance examination. We focus on quantitative and qualitative factors deemed to be the most salient contributors to, if not likely predictors of, the future success of investment managers.

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## Comprehensive Evaluation Process

Investment managers meeting our operational viability and performance requirements are subjected to a more rigorous evaluation focused on four fundamental categories:

- Firm and Product
- Investment Professionals
- Investment Approach
- Performance

Our analysts employ well-defined research, evaluation, and reporting activities when assessing each category. Information and insight related to each area of investigation may come from many sources, including:

- Proprietary research efforts
- Third parties
- Investment manager literature
- Regulatory filings
- Industry publications

First-hand information from due diligence of the manager is critical to understanding the firms and products under consideration. Initial and ongoing due diligence is performed via on-site visits, conference calls, and in-house meetings. These interactions produce important qualitative information that is an integral part of the evaluation process.

*First-hand information from due diligence of the manager is critical to understanding the firms and products under consideration.*

Due diligence meetings typically include extensive conversations with one or more senior members of the firm. The majority of these meetings are usually spent interviewing key investment personnel about the four fundamental categories of interest. The primary goal is to gain a full understanding of the firm's investment-related processes. These meetings also allow us to take a closer look at the firm's other functional areas, such as operations, portfolio administration, risk management, and trading.

In a completed analysis, each category is investigated to draw meaningful conclusions about the overall quality of the investment managers and portfolio strategies reviewed.

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## Firm and Product

The history, ownership structure, culture, and infrastructure are all key elements of an investment manager's ability to provide effective portfolio management. These elements must be well understood to make useful judgments about business viability, corporate objectives, and firm potential. To this end, we seek to uncover significant events and factors that have affected — directly or indirectly — the firm's investment activities.

For example, past and present ownership structures are critically analyzed. In some instances, change is necessary and may have a positive impact on the firm. At the same time, changes in ownership or business culture may result in unintended or unanticipated consequences. Although the results — both positive and negative — may not be immediate, changes often have a lasting effect on a firm's stability.

*Changes in ownership or business culture may result in unintended or unanticipated consequences.*

Entrepreneurial firms with high employee ownership, strong and lasting business cultures, and client-focused goals and policies are preferred. Our analysts search for investment management organizations with well-managed infrastructures, diversified client bases, and manageable asset growth.

### Common Evaluation Criteria

- Detailed history of the firm and product since inception.
- Current ownership, changes to ownership, and impact of any changes on investment activities.
- Depth and breadth of client base.
- Pace of asset and account growth.
- Length and quality of the product's reported and/or audited performance record.
- Depth and experience of personnel across key functional areas.
- Quality and/or reputation of service providers (auditor, legal counsel, administrator, custodian) for alternative investments.
- Compliance record, including any adverse findings from audits.
- Review of Form ADV filed with the Securities and Exchange Commission (if applicable).
- Review of subscription and offering documents (if applicable).

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## Investment Professionals

A thorough analysis of investment professional talent is of primary importance in the evaluation of investment managers. Our analysts search for investment managers with seasoned professionals involved in the day-to-day research and portfolio management activities of the firm. In the case of team-managed portfolio strategies, we place a higher value on established groups with a meaningful number of years working together as a team.

The tenure and roles of senior investment professionals within an organization are critically analyzed. Likewise, the perceived continuity and operational efficiency of the entire portfolio management staff are vitally important. It is the expectation, partially confirmed in routine interviews, that the portfolio managers are able to clearly demonstrate intimate knowledge of each strategy's underlying holdings. The managers should be able to provide well-articulated investment rationales supporting each position.

Our analysts also examine the ownership interests and other incentive structures that serve to motivate key investment personnel. When properly structured, these measures may serve to attract and retain skilled talent to the organization. Any notable changes to the employment, roles, compensation, or underlying incentive structures of key professionals is further investigated and will quite often influence our recommendations.

Low professional turnover is generally desirable, particularly among longer-tenured employees. Departures of senior investment personnel may have a lasting or detrimental effect on the ongoing operations of a firm. Often, departures of key personnel are accompanied by other staff changes and alterations to the firm's previously established investment policies. If professional turnover has occurred, we examine the reasons for such departures and assess their importance.

Significant turnover of investment professionals reduces the usefulness of the manager's past performance as a measure for anticipating possible future results. Therefore, we will generally avoid investment managers with above-average and/or notable professional turnover.

### Common Evaluation Criteria

- Qualifications, backgrounds, and experience of investment professionals (note: formal background checks are employed if deemed important/necessary).
- Years of service with the firm and length of tenure in current roles.
- Demonstrated involvement and level of engagement of key investment professionals.
- Extent and impact of changes in leadership or decision-making authority.
- Compensation and incentive structures of key investment professionals.
- Firm ownership and eligibility requirements for members of the investment staff.
- Occasion for, and soundness of, succession planning efforts.

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## Investment Approach

Our analysts gain useful insights into the day-to-day management of products through one-on-one conversations with senior investment professionals. We ask specific questions related to investment philosophy and portfolio strategy, and investigate important details related to the manager's research and investment selection activities. In addition, we investigate portfolio construction guidelines, including risk controls and trade implementation procedures. This information is used to draw meaningful conclusions about the merits of the investment manager's approach to investing.

Investment managers should have a clearly articulated investment philosophy that communicates the basic investment objectives, approaches, and strategies employed. The philosophy may also include key differentiating characteristics of the investment manager or strategy. A manager's investment selection and portfolio construction processes should be well defined. This includes clearly explaining the rationale for establishing positions, as well as how idea generation and research methodologies affect the construction and management of portfolio strategies.

These methodologies often include both quantitative and qualitative considerations. Our analysts attempt to understand and evaluate the consistency and efficacy of the manager's past and present research methodologies. We review each investment manager's implementation procedures, with an emphasis on decision-making processes and how procedures may have evolved. For example, many managers have specific guidelines designed to control risk. The merits of such rules are considered, as are their historical effectiveness when reviewing past performance.

Any major changes in investment policies, guidelines, or procedures contribute to our assessment of the future operations of the firm and products under consideration.

### Common Evaluation Criteria

- Clarity and reasonableness of investment objectives.
- Distinctiveness of investment disciplines.
- Nature and type of instruments employed, as well as how they are implemented in the strategy.
- Consistency of stated and applied investment strategies.
- Adherence to stated buy and sell disciplines.
- Depth and quality of independent research capabilities.
- Evolution and method of decision-making processes.
- Consideration of primary tools and resources used to facilitate investment strategies.
- Risk management controls and procedures.
- Operational infrastructure relative to accounts and assets under management.
- Sufficient transparency and disclosure to assess and monitor the material risks of the strategy.

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## Performance

A common evaluation pitfall is overestimating the usefulness of recent and/or simple performance measures. Past performance is seldom the most useful guide for anticipating a manager's future results. Likewise, no single performance statistic contains sufficient information to make rational judgments.

To make performance comparisons more meaningful, our analysts use a multi-factor approach for reviewing each portfolio's longer-term historical investment results. Our analyses include both absolute and risk-adjusted returns, as well as metrics of return consistency and volatility. As appropriate, comparisons are made versus style-based benchmarks and selected peer groups.

Accurately assessing performance requires discipline, a long-term focus, and sophisticated analytical tools. Simple esoteric, incomplete, or inconsistent methodologies may offer random luck, but seldom yield long-term investment success. Our analysts are properly trained in both the "art" and "science" of analyzing investment performance.

Objectively understanding the quality and effectiveness of an investment manager or particular portfolio strategy requires in-depth examination of performance, including a detailed analysis of the sources of returns. Not all investment managers should be compared to one another, nor are all products directly comparable. Information learned in performance reviews is used to build expectations about each investment manager's capabilities and the potential return behavior of different portfolio strategies during various market environments. Analyzing performance within the context of these predetermined expectations is a major philosophical underpinning of our approach to investment manager research.

### Common Evaluation Criteria

- Determination of whether or not the historical risk and return record provides an accurate representation of the product currently being offered.
- Compliance with CFA Institute performance presentation standards, including third party verification (preferred, but not required).
- Quality of the composite determined, in part, by the number of accounts, percentage of assets, length of record, and amounts of dispersion (if applicable).
- If available, third party audit/review of the firm's financial statements (preferred, but not required).
- Absolute return comparisons that include trailing total returns, calendar period performance, and rolling-period results versus appropriate style-based benchmarks and/or peer groups.
- Risk-adjusted metrics, such as Alpha, Information Ratio, Sharpe Ratio, Sortino Ratio, and/or Treynor Ratio.
- Relative results demonstrated via risk and return scatterplots, as well as up and down market capture ratios.
- Various risk or return volatility measures, such as standard deviation, beta, downside deviation, maximum four-quarter loss, and/or maximum drawdown.
- Asset class fit determined via correlations and tracking error, as well as returns-based style analyses and/or holdings-based portfolio reviews.

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## Investment Committee Review

The initial evaluation concludes when the most promising investment managers are considered for approval by the appropriate Investment Committee. To be approved, each candidate must pass a thorough Committee review that includes a detailed discussion of facts and informed opinions derived from the aforementioned research process. We strive for consensus agreement in all Committee decisions.

## Continuous Evaluation Process

Every aspect of our due diligence requires ongoing investigation and evaluation. Equally important, our analysts routinely scour the universe of available investment options for other potentially attractive candidates.

*Every aspect of our due diligence requires ongoing investigation and evaluation.*

Regular meetings are held to discuss key events and announcements impacting capital markets around the world, as well as the asset classes and individual strategies that are monitored. Investment performance is routinely monitored to ensure it conforms with our basic expectations about each product. In the absence of a material cause for concern that would lead to more frequent evaluation, we generally conduct more formal due diligence proceedings annually. Our goal is to confirm that the main contributors to a product's past success are still meaningfully intact. Furthermore, this continuous evaluation process seeks to confirm the investment manager has developed its infrastructure and administrative practices to properly support its current and prospective business activities.

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## Watch List and Removal

We maintain a Watch List, which provides a means to communicate developments of potential concern. Placement on the Watch List initiates a probationary period that allows time to better assess the effects — negative or positive — stemming from the development in question. We attempt to resolve Watch List assignments as soon as possible. These attempts are balanced with a goal of making more informed judgements that are consistent with maintaining a long-term investment perspective.

The most common reasons for Watch List assignments have included:

- Major ownership changes.
- Significant firm and/or product asset declines.
- Excessive asset growth in products with limited capacity.
- Professional turnover.
- Notably altered incentive structures for key professionals.
- Questionable changes in investment decision-making authority.
- Material changes in investment approach.
- Extended period(s) of unexplainable or unanticipated relative or absolute underperformance.

In certain instances, managed account portfolios or alternative investments are temporarily assigned to a Restricted List. This prevents investors from opening new accounts and/or initiating more capital while more significant concerns are under review.

We may recommend the termination of a manager if our original investment thesis is materially and permanently impaired. This most commonly is the result of fundamental developments that are determined to be detrimental to the potential longer-term success of the manager or underlying investment strategy.

## Conclusion

RBC Wealth Management offers insight and important information that helps you select and monitor professional money managers. The combination of detailed quantitative and thorough qualitative analyses gives us the means to identify attractive long-term investment options organized according to investment style or asset class. Differentiating the various investment options in this manner makes the selection process easier and facilitates improved portfolio diversification. Ongoing monitoring of this select list of investment managers helps to keep you informed about material developments so that you can make appropriate decisions about your investments.





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