Issues
AND INSIGHTS

Spring 2009

WILMINGTON TRUST

Protecting a sacred trust: Investment manager due diligence at Wilmington Trust

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The term "due diligence" has two definitions in the *Merriam-Webster* dictionary, and both of them apply in the financial world. The first definition is "the care that a reasonable person exercises under the circumstances to avoid harm to other persons or their property." The second definition is "research and analysis of a company or organization done in preparation for a business transaction (as a corporate merger or purchase of securities)."

Although the term became more commonly used in financial matters as a result of the Securities Act of 1933, the dictionary says its origin can be traced back to 1903. Coincidentally, this is the same year that Wilmington Trust was founded by members of the du Pont family to manage their wealth. Now, as then, due diligence involves the performance of an investigation of a business or person that implies a certain standard of care and fiduciary oversight.

WHOM TO TRUST?

As an unwelcome adjunct to the severe recession and financial crisis in the United States, investors today are faced with seemingly daily news stories about financial scandals and Ponzi schemes that have taken down once-reputable investment managers and stripped thousands of individuals and institutions of staggering amounts of wealth. As we are learning, the schemes seem to come in all shapes and sizes and their victims cut across all segments of our society, from major celebrities and titans of business—including some investment managers—to everyday, hard-working people whose life savings have disappeared.

These sad and cautionary tales underscore the need for clients to understand as fully as possible the people to whom and organizations to which they trust their assets. The one thing that all victims of these schemes seem to have in common is that they had the misfortune of misplacing their trust in people who promised greater-than-market investment returns. In some cases, such promises were made or implied without being accompanied by a clear, understandable explanation of how such a return could be consistently achieved. Unfortunately, too much emphasis was placed on the "results" and not enough on the investment processes that led to them. Tellingly, these managers may have been unwilling or unable to share their investment philosophies and approaches to making buy and sell decisions. In other cases, solid explanations were made, giving the illusion of transparency, but little or no securities trading was taking place, belying what may have been reported on account statements.

ROLES OF THE INVESTMENT STRATEGY TEAM AND THE MANAGER RESEARCH TEAM

As with most matters at Wilmington Trust Investment Management, due diligence on outside investment managers takes place under the purview of our Investment Strategy Team (IST). The IST develops capital markets forecasts, sets diversification targets, and makes asset allocation decisions in an attempt to capture undervalued assets in the financial markets. With respect to due diligence activities, it also oversees the research process used to select and monitor investment solutions for our clients, including outside investment managers.

The team comprises seven voting members, whose combined investment experience totals 150 years, and four non-voting members. In the true spirit of due diligence, all outside investment managers that Wilmington Trust Investment Management considers adding to its list of managers available to our clients across a range of investment platforms that Wilmington Trust offers—including private partnerships, separately managed accounts, and mutual funds—have been through a rigorous analysis that is based on a number of variables and uses a number of tools.

The responsibility of evaluating, selecting, and monitoring outside investment management firms to be included on Wilmington Trust Investment Management's list for client portfolios at Wilmington Trust rests directly with the Wilmington Trust Investment Management Manager Research Team. This team of seasoned professionals conducts its specialized work through the consistent execution of a five-step process, with each step involving the consideration of many variables and the application of many due diligence activities.

Manager Evaluation Model

- Manager sourcing
- Professional evaluation
- On-site visit
- Manager recommendations
- Ongoing monitoring

A FIVE-STEP PROCESS

Managers selected for Wilmington Trust's investment platform go through a rigorous five-step evaluation process. These steps include:

Step 1: Manager sourcing

We use multiple qualitative and quantitative techniques to help ensure that we are considering a diverse group of managers for inclusion in client portfolios. Our research team continuously searches for investment managers that provide exposure to the strategic asset allocation targets set by the IST and represent a good fit with other managers we currently use. We may know of these managers through industry contacts, conferences, and other means of publicly available information. We also use proprietary computer models to understand a manager's investment practices, with the goal of separating lucky managers from skilled managers. We look at the manager's level of assets under management, the length of its track record, and the consistency of its investment returns and volatility versus appropriate benchmarks and peers. Because costs detract from the results achieved by our clients, we carefully examine explicit costs such as manager fees and implicit costs such as trading efficiency, portfolio turnover, and taxes. Reasonable compliance and internal control procedures are a prerequisite for engaging a manager.

Step 2: Professional evaluation

Once suitable managers have been sourced, we begin our strategy-specific evaluation of them. We present managers with a questionnaire that covers a wide range of topics, including firm structure, business planning, risk management, personnel, investment philosophy and research approach, and portfolio management and trading activities, among others. Financial statements are reviewed during this stage of the process. We also examine the manager's filings with the Securities and Exchange Commission (SEC) and other regulatory bodies, conduct background checks, examine the manager's conformity with the stated investment style, and conduct risk/reward analyses. We complete an evaluation score sheet that rates each manager on organizational factors, ownership factors, staff and process factors, and cost factors.

Step 3: On-site visit

If we move to this stage, a manager is under serious consideration. We wish to engage investment managers that have viable and stable business plans, a well-articulated vision for growth, a diversified client base, and thoughtful plans for succession in the event of the departure of a key decision maker. We seek to determine the very best fit between the manager's skills and capacities and our clients' needs. Managers are evaluated in the context of other managers we use, that is, by how their excess returns beyond that of a benchmark may or may not correlate to others. This helps us determine the effect that a particular manager may have on risk in client portfolios. We conduct on-site visits at the prospective manager's offices in which we look for supporting information addressing specific manager traits covered on the questionnaire in Step 2. These traits include the manager's:

- Investment philosophy—it must be based on principles that are academically and intuitively sound, demonstrated, and repeatable.
- Personnel stability—individuals integral to the investment process should have incentive to stay with the firm.
- Ownership and size—the firm must be large enough to support continued research and improvement of the process. The interests of principal members of the firm should be aligned with clients' interest, generally through direct ownership in the firm.

Key Manager Traits

- Investment philosophy
- Personnel stability
- Ownership and size
- Demonstrable results
- Appropriate investment risk exposures
- Reputation and alignment of stakeholders

- Demonstrable results—the firm must be able to offer a successful record, repeated through time and in line with the amount of risk associated with its strategy.
- Appropriate investment risk exposures—for every approved investment manager we create a custom benchmark, which is a formal statement of our expectations for the manager's future performance.
- Reputation and alignment of stakeholders—we want to know as much as possible about the manager's owners, clients, administrators, custodians, trading partners, and auditors.

Step 4: Manager recommendations

Our research team, acting as an agent for the IST, discusses all managers that reach the recommendation stage. Any and all questions and concerns that our analysts may have are fully considered and explored. If all the appropriate criteria have been met, the firm will be added to our roster of outside managers available to clients.

Step 5: Ongoing monitoring

All managers accepted into our investment platform undergo continuous monitoring in order to justify their selection. On a monthly basis, we conduct performance and attribution analysis that tells us how the manager is doing and what factors are contributing to its performance. Included in this are analysis of risk decomposition, which breaks risk-taking into component parts for further study, and a review of individual securities in the manager's portfolio. On a quarterly basis, we require written updates from managers; we also conduct quarterly conference calls with many managers. On an annual basis, we conduct additional in-person visits, both at the manager's home office and at Wilmington Trust and may include compliance inspections of the manager's office. Other compliance updates, such as periodic reviews of the manager's investment adviser registration, are also integral to the ongoing due diligence process.

GENERAL GUIDELINES

Similar to the due diligence we perform on the managers we hire, there are some guidelines individual investors can follow generally to help ensure they are dealing with reputable managers. These include:

Seek transparency

If the person or firm you are considering investing with cannot adequately explain how your money is to be invested, it would be best to steer clear. There are plenty of people and firms that can do this well. A manager should also be willing to address the risks associated with its investment strategies and provide you with a proven track record as well as personal and professional references. Managers should be happy to answer any questions you have.

Understand the returns

Be leery of any person or firm that leads with a discussion of investment return without a well-detailed explanation of how that return was achieved. If the process or the returns still don't make sense to you, seek a trusted advisor who can provide insight. Above-average returns, especially in the face of declining markets, could be a signal for a closer look. And remember the tried-and-true investing axiom that past performance is no guarantee of future results.

Understand the risks

Inherent in every investment strategy, even a conservative one, is a certain amount of risk. Understand the risks associated with a particular asset class or strategy before you invest and assess your level of comfort with the amount of risk the manager is taking. Find out a strategy's appropriate benchmark(s) and compare the results over time. Wide disparities between the strategy results and the benchmark could be another sign of potential trouble.

Consider the source of an opportunity

People who aren't trustworthy obviously should not be relied on for investment advice. But even well-intentioned people, including family members and close friends, could unwittingly pass along potentially dangerous leads if they did not perform sufficient due diligence themselves. Rule number one: if it sounds too good to be true, it probably is.

Do some homework

Make sure you know as much as possible about your advisors and your money managers. Find out as much as you can about who they are, what they do, how they do it, and when they do it. When you receive statements on your account, ask questions about anything you don't understand. Ask how often the firm is audited and who conducts the audit. Ask if there are any securities violations in a manager's history and demand explanations for anything that appears out of the ordinary. Ask to see a firm's Form ADV, which provides information about the firm and its principals. Ask about how assets will be custodied and what segregation exists between the firm's assets and your assets in the event something should happen to the firm.

A LEGACY OF FIDUCIARY OVERSIGHT

The Wilmington Trust corporate family has more than a century of experience in advising our clients and their families about ways to preserve and grow their wealth. Generation after generation, clients have turned to us to serve as a fiduciary in the financial matters that are vitally important to their families. Our due diligence activities in vetting managers for our investment platforms is integral to this responsibility. In the end, carrying out our fiduciary duties is a sacred trust, one whose core is about protecting our clients' best interests.