Trust is good – control is better

Investment process standards are highly desirable

Some long-established and well-known "brand names" have been caught out deploying their clients' capital to Bernard Madoff, who is alleged to have maintained a fake investment strategy for many years. In a "post-Madoff" world a key question for clients must be, how they can decide which firms can be trusted to manage their investments.

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Recently the phrase "the Madoff economy" has been used – referring to those firms which received fees, rebates and retrocessions from their role as asset gatherers for Madoff's alleged "Ponzi" scheme. It is difficult to avoid the question as to whether these highly lucrative fee streams led to an obvious conflict of interest in some cases. The red flags signaling possible fraud in Madoff's company would have been evident from the most basic due diligence: a directly related broker-dealer, an unknown auditor, an unexplainable trading strategy, no independent valuation, sponsors controlling and receiving all the fees, little or no access to the man himself and being in cash for long periods of time whilst stating strong and highly consistent returns.

Alternative investments are, by nature, complex, and there is no excuse for making an investment based on scant risk assessments. Most clients place their trust in specialist due diligence professionals to select and monitor these investments on their behalf. The purpose of due diligence is to critically examine the investment and identify points of potential failure. Valuation, custody arrangements, management of the business, IT systems, qualifications and training of people – all these and more are important factors that should never be overlooked. Due diligence investment team members should not be afraid to challenge anything that does not pass the "smell test" – they need to be forensic financial professionals. There should be a clear segregation of duties within the firm between investment management and operational risk management teams, with the latter having a full right of veto over all investment decisions.

Statements that asset management firms have a "world class" investment process and saying they adhere to it rigorously should simply no longer be acceptable to their clients. Any firm which is in the business of selecting alternative investments must be able to produce tangible evidence that their investment process is comprehensive and being applied without any exceptions. It is absolutely unacceptable for a firm to bypass its own investment process.

How can a client be sure, if an investment process is fit for purpose? The key factors are always the depth of analysis and the consistency with which this is applied in taking investment decisions. Everything concerning an investment decision must be explainable, and there should be a series of clear audit points where evidence can be produced. For example, if a firm has decided to accept non-independent valuations on its investments, it is clearly exposing clients to high levels of risk. Is there an acceptable argument backed up with evidence to support the investment decision? Has a background check been run – and if not, why not? Has a visit been made on site? Have audited financial statements been reviewed? Is the investment firm taking any "kickbacks" or "soft dollar" commissions? When is the next onsite visit planned? And, most importantly, what were the findings last time and what actions are planned?

These are just a few examples of the type of questions that should be asked in an effective due diligence investment process. How can clients be assured that the knowledge gained from the process is properly captured and applied? Compliance of an investment process to an international quality management standard is highly desirable – in such an environment meaningful levels of evidence are collected and rigorously assessed in order to ascertain, if the investment process is relevant, effective and, above all, that it is being adhered to across the organisation. External audits of process should be conducted by independent specialists from the quality management field. The results of independent audits should be shared with clients – thus demonstrating the firm has an unswerving commitment to transparency, responsibility and accountability. Anything less will usually mean that the investment process is not "industrial strength" and that there is plenty still hidden in dark corners.

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