INALYTICS

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Due Diligence: Embracing the New Normal

Introduction

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We all know we are living in unprecedented times. The Covid-19 pandemic has fundamentally changed the way we work, live and engage with one another. People will choose to work from home, travel less and use technology to become more efficient and effective. This is the new normal and there is no going back.

It will be no different for asset owners. The technology already exists to make the due diligence process when selecting and monitoring managers more efficient, less arduous and highly productive.

Three recent examples of asset owners using technology in this way illustrate this point.

- **Brunel Pension Partnership**, a £30bn pension scheme in the UK, was able to review over 400 managers in just over a year by incorporating advanced analytics in the due diligence process.
- **Lion Global Investors**, a Singapore based asset manager with over US$43bn of assets under management, is using data science to build curated portfolios of highly performing and skilful managers.
- **A US Public Pension Plan**, who is the first US public plan to adopt the technology

Like so many aspects of our lives these days, technology is playing a central role and the same is happening in the world of due diligence.

What does this mean in practice?

At one level applying technology and data analysis helps to get to the heart of the matter, to identify and analyse investment skill. Because after all, investment skill and alpha are the very things that management fees are paying for. This can be placed within a wider context of improving transparency and helping asset owners to fulfil their fiduciary responsibilities.

Historically, asset owners have selected managers based on qualitative and quantitative factors and there is evidence to suggest that they put a considerable weight on historical track records (see Choosing Investment Managers by Amit Goyal, Sunil Wahal, M. Deniz Yavuz :: SSRN). But we know that historical track records by themselves provide very little evidence about whether returns were generated through skill or luck, or some combination of the two. The one thing we all agree on is that past performance is not an indication of future success.

Data science allows us to get behind these track records to identify the skills that produced them. For the last 15 years, Inalytics has collated and maintained one of the world's largest private databases of institutional investment decisions. This forms the basis of our Peer Group analysis and critically has helped us establish the **four key criteria** in assessing investment skill:

- **Research Process:** a skilful investment manager needs to demonstrate a research process that investigates ideas and adds the best of them to a portfolio.
- **Sizing:** a skilful manager will back these research ideas with conviction, so that they have a real impact on performance and alpha.
- **Rebalancing:** a skilful manager will have the self-discipline and focus not to allow the alpha generated from the research process and sizing decisions to lose value through poor selling decisions.
- **Investment Horizon:** a skilful manager will have a research and investment process in place to ensure long-term positions continue to generate alpha and don't suffer from alpha decay by letting them go past their 'sell by date'.

Data analytics enables asset owners to examine the specific skills an investment manager has, and how their decision-making and investment process add value.

- For the **selection process** it screens out managers from the selection process that don't have the skills needed for the mandate and, just as importantly, helps prevent otherwise skilful managers from being rejected early in the process for the wrong reasons.
- Then for **monitoring**, to get behind the results to understand how they were achieved and be able to ask the really smart questions, questions that need asking and sometimes those that managers would prefer not to be asked.

The term data science may have some negative connotations for some, but the benefits are real and rooted in the simple desire to identify a manager's investment skill and how these skills add value.

Data science and technology play a central role in all our lives now, the due diligence process should be no different.

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This paper was written by Inalytics

Skill does exist.
Skill generates alpha.
Skill can be empirically measured.
Skill is a differentiator.

Inalytics. The world's leading expert at identifying skill.

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