A Closer Look:
Algonquin’s Manager Research Process
**Introduction**

Investors seeking quality professional investment management face a significant undertaking when attempting to identify strategies suitable for their investment objectives. One reason for this is due to the sheer number of strategies available. With over 7,000 mutual funds in the U.S. alone, thousands of alternative strategies, and more than 10,000 SEC-registered investment advisers, making an informed hiring decision is no easy task.

In addition to the quantity of choice, investors face a great deal of information to review and understand the quality of choices available. A thorough evaluation of regulatory filings and performance data is a time-consuming task by itself. The steps of collecting and analyzing qualitative information, as well as interpreting the finer points, may be beyond the time constraints and experience of individual investors and trustees with fiduciary responsibilities.

Investors may find themselves exposed to risks for which they may not be prepared to deal with. As a result, many investors often decide to work with experienced investment management consultants that employ a time-tested due diligence process as a critical step toward making well-informed investment decisions.

Algonquin Advisors believes that manager due diligence is best designed as a disciplined process that is guided by clearly defined steps in order to cover critical review points. Algonquin also believes that it is crucial to complement a methodical process with interpretative talent. Professional experience can prove to be important for putting findings in context, through consideration of market history and the competitive landscape. Additionally, Algonquin regularly consults its network of contacts within the investment community for valuable insight and information.

Algonquin’s due diligence process begins with an initial sourcing and screening stage, and progresses through an exhaustive evaluation of finalist strategies. At a minimum, investment strategies under consideration are subject to reviews of company’s organization, investment process, performance history and commitment to client service.

Algonquin’s Investment Committee is the decision-making body that oversees the investment due diligence process. In every phase of review, the Committee focuses on identifying risks and searching for reasons to eliminate strategies from consideration. Strategies may be eliminated from consideration at any point in the process, including after being added to the platform of approved strategies. The Committee focuses on screening for “best-
of-breed” strategies, and regularly updating the platform.

**Sourcing**

The Investment Committee uses a combination of resources in order to source the universe of professionally managed investment strategies. Relying upon the industry relationships and the veteran experience of Algonquin’s principals, the Committee reaches out to its network of industry contacts and sources valuable counsel on investment opportunities. The Committee prefers to work with those investment firms for whom the firm has a trusted reference. Such a reference provides insights based on others’ experience. Algonquin’s analysts also review databases to compare strategies based on risk-return metrics and organizational information. Once the field has been narrowed, the analysts prepare an initial due diligence review.

In the initial phase, analysts review critical information including performance history, the investment strategy and process, and the organizational structure of the strategies under consideration. Toward this end, analysts typically obtain and review SEC filings and offering documents which may include ADV Parts 1, 2A, and 2B; audited financial statements; the Statement of Additional Information; tax documents (such as K-1s for hedge funds); prospectuses; and other applicable materials. The analysts focus their research on developing a detailed understanding of the risk-return characteristics of the performance histories, the composition of the portfolios, the experience of the portfolio managers, the expense and liquidity terms, and the company history of the prospective firms.

The lead analyst presents this initial due diligence analysis to Algonquin’s Investment Committee. The Committee assesses the initial due diligence work and adds perspective by probing the initial analysis in a “devil’s advocate” review. Few strategies screened by the research team survive this stage of due diligence. Those select candidates that are approved by the Investment Committee after the initial review are now subject to more in-depth review as well as meetings with firm personnel.

**Quantitative Analysis**

Algonquin’s quantitative due diligence work concentrates on the analysis of risk-adjusted performance, ultimately seeking track records that Algonquin believes have provided meaningful value over long periods of time. Analysts use quantitative methods to dissect performance relative to carefully selected benchmarks over multiple timeframes. Analysis against multiple benchmarks and over multiple timeframes contextualizes absolute performance relative to market cycles, indexes, and peer groups.

Such benchmarks are used to evaluate the performance of the strategy, through an analysis of a battery of performance metrics. For example, alpha is a metric that measures the return that is considered not attributable to the general market. Alpha represents that portion of the strategy’s performance that is attributable to the manager’s skill or luck. Standard deviation,
on the other hand, is a metric used to understand the consistency of returns. Standard deviation measures the historical variability of returns from the average. A greater standard deviation indicates a greater variability of returns, and in effect, can be interpreted as indicative of higher risk. Performance metrics such as alpha and standard deviation are analyzed in relationship to each other in order to quantify risk-adjusted performance. A common risk-adjusted performance metric is the Sharpe Ratio. This ratio compares returns against variability. A Sharpe Ratio measures the amount of return earned above the risk-free rate per unit of risk taken.

Understanding investment risk is a significant concern. In addition to standard deviation, a collection of metrics are used to gauge risk statistically. To assess the left-tail risk, which is the risk of meaningful loss, the Committee uses metrics such as maximum drawdown and down-capture ratio. Maximum drawdown is the greatest peak-to-trough loss of value in the strategy’s history. Algonquin’s analysis involves examination of the circumstances driving a strategy’s maximum drawdown, and comparison of this performance against market indexes and peer groups. Down-capture ratio is another instructive measure related to downside risk. This ratio quantifies the relationship between a strategy’s return stream and that of the benchmark index during down markets. Analysts compare the down-capture ratio in relationship to its up-capture ratio, and consider these ratios relative to the appropriate peer groups.

**Qualitative Analysis**

Research in this stage focuses on how the business is run, vetting the personnel, and examining the investment process. Taking a step beyond the performance data, analysts examine the history of the portfolio’s composition. Analysts study trends in the balance of the portfolio’s weightings across broad categorizations including asset classes, economic sectors, geographic markets, market capitalizations, and security types. Typically through meetings with a given strategy’s investment team, analysts learn what parameters guide the portfolio management process. Portfolio analysis is used to investigate what exposures the portfolio may have to particular segments of the market, what has contributed and detracted from performance, and how the portfolio is positioned moving forward. Whenever possible, analysts obtain the portfolio holdings and their individual weightings from the manager, and conduct an analysis of the portfolio. This holdings-based analysis focuses on examining the concentration of positions, their market capitalizations, growth and value fundamental measures, recent performance of portfolio holdings, and liquidity of those holdings.

In addition to analyzing the qualities of the portfolio, analysts examine the qualities of the firm and the management team. This work is designed to be a look behind the curtain at the firm, the investment team, and the processes. In this stage analysts examine firm-level history, structure, and personnel. The Investment
Committee seeks to understand who owns the firm and what the succession plan is, how the firm compensates itself and its employees, how the firm retains talent, and the background of the portfolio managers. With regards to operations, the analysts seek an understanding of the trading procedures, who the service providers are, how performance is reported, and how compliance is managed. The analysts also evaluate the investment process, from how the investment team conducts its research, to how investment ideas make their way from the chalkboard into the portfolio. Risk management and responsibility for the various aspects of the investment process are also reviewed. During this analysis Algonquin measures the communication qualities of the investment firm, such as how available the portfolio managers make themselves, and the regularity and transparency of performance reporting.

**Due Diligence Questionnaire**

If a strategy makes it through the intensive review described above, the prospective firm typically will be asked to complete the Algonquin Due Diligence Questionnaire. This questionnaire is a way to formalize and confirm the information that the analysts have been examining throughout the process. Review of the completed questionnaire is an opportunity for the analysts to test the consistency of the information that they have gathered. In addition, the questionnaire covers operational and compliance related information. The purpose of the questionnaire is to verify information, make sure it is current, and have the firm attest to its accuracy.

**Investment Committee Review**

The Committee makes the ultimate determination on whether or not to include the strategy on Algonquin’s investment platform. The review of a prospective manager may be terminated at any stage of the due diligence process. Once the review team identifies a problematic issue, it makes little sense to continue. However, should a candidate pass through all evaluations and complete the due diligence questionnaire, the strategy is submitted to the Investment Committee for a final review. Those strategies that are approved for inclusion on the investment platform may be recommended to investors, as appropriate.

**Manager Monitoring**

Approved strategies are subject to ongoing monitoring. Reviews of approved strategies typically are conducted quarterly or on an ad hoc basis. The quarterly review covers any new developments in the strategy or firm, and entails examining much of the same core information as is done in the initial review, including information on the organization, recent SEC filings, marketing materials, performance, composition of the portfolio, and the investment outlook of management. Updated reports are presented to the Investment Committee.

Monitoring the strategies on the investment platform requires maintaining updated information on the dynamics at play with each strategy. Strategies may experience critical
changes after being approved for the platform. As such, the firm feels it is critical to review the status of the strategies on the platform. Issues at the firm- or strategy-level regarding personnel, strategy, performance deviations, and/or process changes compel scrutiny from the Investment Committee. In the event that the Committee deems that changes are material and negatively impact the strategy, it will make the decision to remove that strategy from the platform.

**Due Diligence Case Studies**

Actual examples of the due diligence process help illustrate the work involved and the factors that can affect the consideration of a strategy.

**Case Study 1**
The senior partners on the Investment Committee average 25 years of experience in the financial industry. Their market perspective and industry networks are critical in the due diligence work. This industry expertise proved to be a key component of the identification of a strategy from Manager X as a potential addition to the platform’s long-only equity offerings. A principal at Algonquin had previously worked with Manager X for over a decade, which provided a quality reference for the manager. During the initial due diligence work, this principal offered Manager X as a potentially suitable candidate for the platform, considering that their flagship strategy was specifically geared to the asset class, market capitalization, and investment style under consideration. After an endorsement for further review by the Investment Committee, Algonquin’s analysts conducted a review of the filings and marketing materials, performance history, portfolio composition, and qualitative information. The analysts’ findings showed that the strategy had consistently outperformed its index benchmark and its peer group through market cycles, with particularly strong outperformance during down markets. While delivering greater returns, the strategy also produced lower volatility than its benchmark index over the trailing three-, five-, and ten-year periods. In reviewing the qualitative information, the analysts found that the strategy had an exceptional history of management stability, as the portfolio manager has been leading the strategy for nearly 25 years. The firm is employee-owned, and the portfolio manager also invested a substantial amount of his personal assets in the strategy. Since the Investment Committee found that the performance history demonstrated consistent value-added and that there was sufficient evidence of alignment between strategy management and its investors, the Committee approved this strategy from Manager X to be added to the platform.

**Case Study 2**
Another case demonstrates how the due diligence standards can result in termination of a strategy. In this case, the team was conducting due diligence on Manager Y, which was a manager that a new client had been investing with prior to employing Algonquin’s services. Manager Y is a well-known firm, and the strategy under review had grown to become one
of the largest among its peers. The growth in its asset base was largely due to the inflows experienced following its strong performance in the first years of the new millennium. The analysts established the appropriate background information on the strategy through meetings, document reviews, portfolio analysis, and quantitative and qualitative reviews.

The analysts raised multiple issues with this strategy to the Investment Committee. The quantitative review of the performance history revealed that the fund had not maintained best-of-breed results for the most recent one-, three-, or five-year periods. The portfolio changes during this performance drop-off were more troubling. The analysts tracked the size of the fund in relation to the portfolio composition trends. They found that as the fund had grown in size, the portfolio composition changed meaningfully. Analysis of the investment style indicated that over time the portfolio had drifted from mid-capitalization stocks to mega-capitalization stocks. Additionally, likely as a result of the performance decline, the fund had been experiencing large outflows of funds from investors. Large outflows may harm a fund’s performance and create tax related consequences for the remaining investors. Lastly, Manager Y provided limited transparency, which was cause for concern. With this organizational structure, the Committee was concerned about how the portfolio could effectively generate outperformance and manage risk. Moreover, the portfolio managers rarely were made available for due diligence meetings. Considering the concerns regarding style drift, investment process, and transparency, Algonquin’s Investment Committee decided to remove this fund from the approved platform.

**Concluding Comments**

As covered in this white paper, manager research can be an intensive, full time job for a staff of experienced professionals. Uncovering the crucial details requires exhaustive work, a disciplined approach, and an objective focus. Evaluating investment opportunities in today’s market can be challenging due to the size of the universe of professionally managed strategies, and the quantity of information available. Even after the information is reviewed, it usually takes meaningful experience and interpretive analysis to make the final investment decisions.

To help investors manage the challenges associated with manager research, investment management firms such as Algonquin should be able to provide meaningful assistance. Algonquin relies upon a disciplined due diligence process, led by its seasoned senior professionals on the Investment Committee. Algonquin systematically screens for investment strategies, researches the corresponding data and statistics, and scrutinizes the information in order to arrive at an investment platform composed of what it considers to be best-of-breed managers. Investment management consultants such as Algonquin can provide a valuable suite of services to high net worth families and endowments, including investment
policy statement drafting, asset allocation, manager research, portfolio construction, and performance reporting. Manager research is a core competency of the firm, an area where experienced guidance can go a long way to delivering a satisfactory result and the peace of mind most investors are looking for.

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