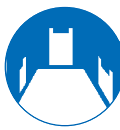

Investing with Care: How to Avoid Investment Scams and Surprises

Be sure you and your advisors are conducting due-diligence reviews of your investments.

By Rory Cohen and Sally Blinken

The arrests of Bernard Madoff and other investment managers alleged to have defrauded investors have sent shock waves through the nonprofit community. These events, combined with the historic volatility and disruption in global financial markets, are shining a spotlight on nonprofit investments. Here's what you need to know.

What's Your Responsibility?

If you're a nonprofit board member or investment committee member (also known as an "investment fiduciary"), you should be taking a close look at your organization's investment policies and due diligence. As an investment fiduciary, you aren't required to guarantee that your investments perform well. But you do owe a "duty of care" with respect to the investment and management of investment funds.

This duty of care requires the exercise of reasonable diligence, care, and skill. Among other things, you should consider the role that each investment or course of action plays within the context of the entire portfolio and the expected total return from income and appreciation of investments. Seek to verify the accuracy of information used in making decisions, and generally seek to diversify investments.

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> The arrests of investment managers have sent shock waves through the nonprofit community.

Your duty of care extends to the hiring of third-party investment managers responsible for selecting securities for your organization and, if applicable, to your ongoing retention of advisors to help you select investment managers. Now's a good time to review the due-diligence processes you use to select these people as well as the due-diligence processes they themselves use as they invest your funds.

What Is Due Diligence?

Due diligence is far more than a simple "check-the-box" exercise. It's not simply a matter of documenting the receipt and completion of questionnaires and filing them away. As an investment fiduciary, you should be actively engaged. You should be sufficiently knowledgeable about financial markets and investment instruments and remain abreast of current events.

If you hire investment managers, analyze the information they provide. Ask independent sources to help evaluate the accuracy and completeness of such information. Ask thoughtful questions so that you can understand the relative risks and sources of investment returns.

When evaluating investment managers, look carefully at their investment processes, compliance with registration and regulatory requirements, management of potential conflicts of interest, risk management, and performance, among other things. Though the level of due diligence will vary depending upon your organization's needs and financial resources, the following questions and considerations will improve the robustness of any due-diligence process and help identify red flags:

Questions to ask investment managers (and how to assess their answers):

- Can you please articulate your investment strategy? (Does the manager clearly explain this strategy?)
- How do you generate investment ideas? (Evaluate whether security selection and portfolio composition are consistent with the manager's articulated strategy and investment selection process.)
- What specific investments have performed well, and what investments have done poorly?
- Are you registered with the

Securities and Exchange Commission (SEC)?

• May we review your compliance policies and procedures, code of ethics, and insider trading procedures? (If the manager doesn't maintain such documents, consider why.)

Now's a good time to review your organization's investment and due-diligence processes.

• Who is your Chief Compliance Officer? (Any manager registered with the SEC is required to appoint a CCO.) To whom does this person report? (Does the manager separate roles and responsibilities, have adequate checks and balances, and reflect a "culture of compliance"?)

• Do you assess the effectiveness of your compliance policies at least once a year? May we see this annual assessment and any SEC deficiency letters?

• How do you identify conflicts of interest, and how quickly do you resolve them? Do you use affiliated broker-dealers, engage in principal trading or other related-party arrangements, permit personal trading, or have side-by-side trading considerations that might affect your portfolio decisions? (Contrast conflicts identified in a firm's compliance policies with disclosure in the firm's Form ADV and, if applicable, fund offering documents.)

• Do you have a risk manager? If so, to whom does this person report? (Does the risk manager have sufficient independence to make changes to a portfolio if necessary?)

• How do you evaluate operational risks and risk controls? How effective is this process?

• Do you conduct scenario analysis to determine how securities and other portfolio positions may react based on historical reactions?

Many board members are taking a closer look at their investment policies.

• How do you identify risks, including excess concentration, excessive leverage, changes in correlation (among securities, sectors, countries, and so on), and counterparty risks with prime brokers and other financial institutions?

• What do you foresee for the economy and markets in the future? How are you positioning portfolios in light of these views?

• How quickly can you react and reposition a portfolio when situations change?

• What cash movement, trade processing, and reconciliation controls do you have in place?

• How are your investments valued?

Questions board members and investment committee members should ask themselves:

• Have you recently reviewed your investment policy?

• Have you recently reviewed your written agreements with any third parties to whom investment discretion is delegated? Do these agreements clearly delegate discretion? Do they clearly articulate the responsibilities of investment advisors with respect to buying and selling securities as well as hiring and firing portfolio managers? Do your agreements relieve the board or investment committee of liability with respect to such decisions?

What is your due-diligence process for selecting a third-party investment manager?

• Do you seek to verify the accuracy of information used in any investment decisions you make by obtaining information from independent sources?

• Do you apply due diligence consistently? Does your due-diligence process differ for equity, fixed income, currency, and real estate managers?

• Do you document your due-diligence procedures? Do you collect similar documents from each investment manager and fund? Do you keep notes of your review, analysis, and investment-committee decisions?

• Do you periodically review investment performance, portfolio concentration, and the relative merits of continuing to maintain each investment within the portfolio? If you notice continued underperformance of your investments or excessive concentration in one area, do you discuss your concerns with outside consultants and advisors?

• When investments perform poorly, do you look for factors you may be able to change or emphasize in future investments?

Due diligence won't solve all problems, but a well-designed process can help you decide when it's time to question or abandon an investment. Such a process, together with thoughtful analysis, will also help you assess whether outside consultants and advisors are performing due diligence in their work for your organization. ■

Bring Investment Knowledge to You

For more on choosing the best investments—and the best investment managers—see these *Nonprofit World* articles at www.snpo.org/members:

•How to Pick the Right Investments (Vol. 15, No. 6)

•Who's Managing Your Money? (Vol. 6, No. 5)

•Investment Policies for Endowment Funds (Vol. 11, No. 2)

•Are You Fulfilling Your Financial Trust? (Vol. 17, No. 1)

•Rule Requires Board Members to Be Expert Investors (Vol. 14, No. 1)

•How Responsible Is Your Investing? (Vol. 20, No. 6)

•Investment Guidelines for Nonprofits (Vol. 13, No. 1)

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