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Other Voices: The psychological dimension: assessing character in manager due diligence

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As an Outsourced Investment Office acting for endowments and foundations, and ultra-high-net-worth families in Europe, North America and Asia, we advise our clients on their total investment programs, including asset allocation and portfolio construction. Most importantly, we provide access to what we believe are best-of-breed asset managers. A core focus of our firm is the identification of managers with true competitive advantages who will perform well in client portfolios over the long-term. Of increasing importance to our due diligence process is the assessment of the ethics, motivation and character of the senior leadership at an asset manager and, in the case of activist managers, often of the CEOs of the companies they back with concentrated bets.

Character is a complex and nuanced attribute that often is overlooked or ignored. In its simplest form, it is being prepared to say "no" to things that are wrong and "yes" to things that are right and, often, require courage to act upon. It also most often comes with a degree of humility, a recognition that none of us are actually Masters of the Universe, for whom the normal rules need not apply.

In diligencing and monitoring managers, our job is not simply to confirm all the positive statements that we learn from the manager's pitch materials and in conventional interviews. Instead, we endeavor to figure out "what could be wrong with the picture" in the sense of attributes of the manager that may undermine its ability to deliver the investment returns as underwritten. In some respects, we operate in ways similar to investigative journalists, intelligence officers and detectives.

To be clear, we do not seek to filter out risk-takers, as competitiveness and the capacity to take risk is the essence of successful investing. Rather, we are focused especially on attributes that may reveal a manager who is prone to taking excessive risk, or risk we are not compensated for, because of his or her psychological make-up, potentially leading to adverse reputational, legal or regulatory developments, in addition to possible portfolio losses.

Recently, Valeant served as a very public test case for a number of managers. In that situation, a group of leading activist, growth and momentum investors demonstrated questionable judgment leading to out-sized investment losses and reputational damage. We may all have different views of "what went wrong" at Valeant, but arguably several strands of this questionable judgment ultimately converged in the last months of 2015 and early 2016. In retrospect, several behavioral patterns were observable among investors and managers that we believe would have been flagged in a due diligence process that emphasized character.

Against the backdrop of Valeant, it may be useful to consider some of the things we look for in a manager in assessing their character. At a high level, we seek to take the manager off-script and outside their comfort zone. This typically means that we ask them questions they haven't been asked before, and also prompt them to turn their lens on themselves and their own organizations, much in the way they do in their investment positions. We look to determine how honest and objective they are with themselves and whether their evaluation of a risk is biased by their investment in a particular outcome. Key signs we look for include:

1. **Excessive or unchecked ego.** We ask for examples of mistakes made along the way – in investing or in their business -- and determine if the manager can talk objectively about those mistakes, has learned appropriate lessons and displays some humility. We also consider whether the manager seeks excessive attention from the media, appears on the society pages frequently, and tends to show off expensive possessions publicly. Lastly, we look to understand how they talk about their colleagues. For example, do they see them as experts and peers? Do they speak predominantly in terms of "I" as opposed to "we"? Does the manager evidence low regard for colleagues and competitors, displaying an "everyone-else-is-an-idiot" attitude?

2. **Delusional thinking or a tendency to build highly complicated narratives**. Does the manager seem able to readily rationalize their own errors or wrap them in a narrative that makes them more palatable? Do the narratives evolve over time to accommodate unavoidable new facts -- i.e., to maintain the nominal plausibility of the story and the storyteller's credibility?

3. **Willingness to "win at any cost."** Does the manager display a keen ability to objectively assess risk in positions that are producing outsized returns? Do they have a well-considered set of factors they are watching that would guide them to reduce or take off the position? Is there evidence that their egos and competitiveness have taken over from facts and analysis in the defense of outsized or well-known positions they are in? Do they fear risk and bad outcomes? One of our managers has stated to me that his hands tremble every time his firm puts on a big position. That's the kind of sensitivity and modesty we value in our managers.

4. **Disregard for law, regulation and recognized best practice standards of public or workplace behavior**. Does the manager have a thorough knowledge of the legal and regulatory environment or do they delegate this knowledge and responsibility to others? Does the manager evidence any tendency to minimize legal or regulatory risk or to treat it casually? Are they known to often cross the line on workplace behavioral norms?

5. **Insensitivity to reputational risk.** Does the manager seem to appreciate fully the implications of investments and market positions they are associated with in the eyes of the public, the media, regulators or politicians? Do they understand the wider political, social and ethical context in which their investment activities are being seen?

6. **Incentives that may tend to induce excessively risky behavior.** This can manifest itself in both the compensation program in the manager's own firm and, in the case of activist and private equity investors, the programs they sponsor for investee company managements. Are their compensation programs designed with a degree of balance, so that the incentees are rewarded in part for the long-term success of the enterprise vs. strictly for the performance of their own book or the investee company's top line in the short-term? Does the compensation structure or culture of the firm encourage "all-or-nothing" behavior, with comp leveraged to outsized revenue growth, as opposed to emphasizing the quality and long-term stability of revenue?

While these character tests represent only one element of our manager assessment, they receive significant attention from us because attitudes and behaviors that fail to meet appropriate norms may add materially to the risk of adverse performance from a manager or damage to our reputation, or standing with our clients from association with the manager. This may extend not only to the manager's own attitudes and behavior, but also to the companies and people with which they allow themselves to be associated.

Mr. Dimitruk is the Chairman and Co-Founder of Partners Capital, an Outsourced Investment Office acting for endowments and foundations and ultra-high-net-worth families in Europe, North America and Asia. Partners Capital's 115-member team, which is based in London, Boston, New York, Hong Kong and Singapore, manages assets of more than $17 billion.