

The importance of ODD

Crisis or no crisis

It's times like these that bring the importance of thorough Operational Due Diligence ("ODD") to the forefront. Not only is initial ODD important when selecting managers but ongoing ODD monitoring in times of crisis is paramount.

During, and in the wake of, the 2007-2008 Global Financial Crisis, we saw a number of non-investment related events occur within the asset management industry which adversely impacted clients and ultimately end savers. Such events included redemption suspensions, withdrawals of leverage, counterparty defaults, firm closures, and even frauds. The current COVID-19 pandemic is a crisis that is not only impacting the financial markets but one that also brings on health and social related issues, amongst others, and for many there is no clear end in sight. This has created many of the same concerns we have seen previously and, in addition, has brought about new operational risks given the uniqueness of the events currently unfolding. Here are examples of some of the operational issues investors should be mindful of:



Liquidity

As liquidity in the general market deteriorates so too can the liquidity of the underlying portfolio. Additionally, material redemption requests may be difficult to satisfy without further deteriorating the liquidity

profile of the remaining portfolio. Where the redemption terms of the product are more favourable than the liquidity of the underlying portfolio, this may result in redemptions being deferred or even suspended. Large declines in assets under management ("AUM") can also raise concerns with respect to a manager's ability to continue operating as a going concern. Therefore, it is important to assess potential liquidity mis-match risk and understand at what point a manager's profitability and ability to sustain its current infrastructure will be impacted.



Leverage

Price declines can lead to increased margin calls which may require managers to raise cash in a market where reduced liquidity is already a factor. Some strategies are reliant on leverage and any reduction in the availability of financing can have an adverse effect on the strategy's ability to perform or drive forced selling. Therefore, it is important to understand a manager's usage, sources and terms of leverage.



Counterparties

Counterparties, whether prime brokers, ISDA counterparties or executing brokers, are key to a manager's ability to access the market. For this reason, it is important to assess how managers monitor counterparty creditworthiness and understand how they manage counterparty exposure to ensure there is a sufficient level of diversity. Contractual terms are also important as relationships may be automatically terminated in certain circumstances, including in the event of material AUM declines.



Valuation

The integrity of investment valuations may deteriorate with extreme market volatility and uncertainty. For example, stock exchanges may become suspended, companies may go into bankruptcy, and valuers may be unwilling to opine on values due to the lack of comparable transactions within the market. Thus, we feel it is important that managers have robust valuation policies in place which address such eventualities and appropriate governance arrangements to oversee the consistent application of those policies and overall valuation of assets.



Business Continuity

Active portfolio monitoring, performance measurement, risk management, liquidity monitoring, and client communication are just some examples of the types of activities that are currently vital. But what underpins all of this? A robust and well tested business continuity plan, one that allows all employees to continue to operate effectively and efficiently from alternate locations. Nowadays many managers offer flexible working arrangements and business travel is common, resulting in frequent informal testing of remote working capabilities. However, having a small percentage of employees working remotely is a scenario that is very different to having all employees operate remotely, whilst also generally being under increased stress. Core to many managers' business continuity plans is the ability to rely on other offices located in different geographies for support in times of need. This strategy may become less effective when a crisis is global in nature. Another consideration is the well-being of employees; cross-contamination risk has become, for many, a new area of focus and having redundancy within each business function is imperative. It is also worth noting that most managers rely heavily on service providers such as back and middle office providers and administrators and are thus heavily dependent on the outcome of these service providers' business continuity plans. It is important to assess the effectiveness of

managers' and service providers' business continuity plans and what other facets are being considered when it comes to considering employee well-being and succession planning.



Cybersecurity

As people work in isolation and as inboxes fill with COVID-19 related links, the risk of cybersecurity attacks increases. Whether it be ransomware, an attempt to redirect funds or even an attempt to gain employee personal information for identity theft purposes, the current situation provides cyber criminals with ample opportunity. It is important to assess a manager's cybersecurity controls in order to ensure they are stringent enough to reduce the risk of a successful cybersecurity attack. Employees also perform a vital role in defending against such attacks, so it is important that they receive frequent awareness training to enable them to identify suspicious activity and raise the alarm.

For many, it remains unclear when life will return to normal, and what the new normal will look like. As employees continue to work in isolation from one another, new challenges will arise. Managers will need to consider aspects such as how to keep culture alive; how to maintain communication; how to motivate employees; and, how to manage employee stress levels. Longer term considerations include how to recruit and integrate new employees and how to continue operating in a world filled with various travel restrictions. Whilst many of these aspects are not directly investment related, they are equally important in ensuring success in these trying times.

We would encourage investors, either directly or via their ODD providers, to consider these various points when initially investing with, and performing ongoing monitoring of, their managers as outcomes are dependent on both investment and non-investment aspects.





For more information

For more information, please contact your
Willis Towers Watson consultant or:

Josh Hall

+1 212 309 3593

josh.hall@willistowerswatson.com

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

Disclaimer

Willis Towers Watson has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Willis Towers Watson to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice.

This material is based on information available to Willis Towers Watson at the date of this material and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without Willis Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or the opinions we have expressed.



willistowerswatson.com/social-media

Copyright © 2020 Willis Towers Watson. All rights reserved.
WTW-HP-2020-0305

willistowerswatson.com

Willis Towers Watson