

(INSIGHTS FROM CFA SOCIETY SINGAPORE)

# What to expect from due diligence on and by an investment adviser

By CFA Society Singapore  
 advocacy team

**W**E often ask around if we need advice. We talk to our colleagues. We call on friends, and sometimes family members. They may be able to offer insights to whatever we want to know. The prudent among them would qualify their opinion with disclaimers such as "I have never used their maid services before". Or, "They were well-known back then for prompt service, but things might have changed with the new owners." And, "Best you do your own checks before committing to the renovator."

As a recipient of good-faith advice, we should conduct our own due diligence.

What then is the difference if we were to engage a professional to advise us? We should still do our checks and due diligence. But we do expect professionals who dispense advice to exercise diligence themselves, and have a reasonable and adequate basis for recommending a course of action.

Similarly, when investors engage investment advisers for investment recommendations, they expect these professionals to exercise diligence and have a reasonable and adequate basis for recommending a particular course of action.

**Diligence and reasonable-basis standard**

CFA Institute, a global professional body for investment management professionals, provides guidance on exercising diligence and providing adequate basis for investment recommendations through the Diligence and Reasonable-Basis Standard.

The institute believes that every investment decision is based on a set of facts known and understood at the time. Clients turn to investment advisers for advice and expect the advisers to have more information and knowledge than the clients do. This information and knowledge form the basis on which investment advisers apply their professional judgment in making recommendations.

On a basic level, clients want assurance that investment advisers are putting forth the necessary effort to support the recommendations they make. Communicating the level and thoroughness of the information reviewed before the adviser makes a judgment allows clients to understand the reasonableness of the recommended investment actions.

## Applying the standard in sub-advisers

Financial instruments and asset-allocation techniques continue to develop and evolve. This progression has led to the use of specialised managers to invest in specific asset classes or diversification

strategies that complement a firm's in-house expertise.

The Diligence and Reasonable Basis Standard applies to the level of review necessary in selecting an external adviser or sub-adviser to manage a specifically mandated allocation. Investment advisers must review managers as diligently as they review individual funds and securities.

Investment advisers who are directly involved in the use of external advisers need to ensure that their firms have standardised criteria for reviewing these selected external advisers and managers. Such criteria would include, but would not be limited to, the following:

- Reviewing the adviser's established code of ethics
- Understanding the adviser's compliance and internal control procedures
- Assessing the quality of the published return information
- Reviewing the adviser's investment process and adherence to its stated strategy

When selecting external and sub-advisers, the firm should also be encouraged to:

- Develop measurable criteria for assessing outside providers, including the quality of information being provided, the reasonableness and adequacy of the provider's collection practices, and the accuracy of the information over time. The established policy should outline

how often the provider's products are reviewed

■ Adopt a standardised set of criteria for evaluating the adequacy of external advisers. The policy should include how often and on what basis the allocation of funds to the adviser will be reviewed

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## Ethics in action: practise, practise, practise

This case is based on and adapted from content by CFA Institute. As a guide, the desired ethical behaviour is based on the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards).

Andre Shieh owns and operates Conduit, an investment advisory firm in Singapore. Prior to opening Conduit, Shieh was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Ramos.

To attract clients to a new Conduit fund, Shieh offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Ramos. Given his personal friendship with Ramos and the prior performance record of these two funds, Shieh believes the new fund is a winning combination for all parties. High-net-worth Asean clients quickly invested with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management to

Clients and potential clients turned to Shieh for advice and expected Shieh to have more information and knowledge than they do on the funds and Ramos' firm. And this information and knowledge are the basis on which Shieh applies his professional judgment in making recommendations.

On a separate note, Shieh should also consider the suitability of investment products for clients. Investment advisers who are in an investment advisory relationship with clients must consider carefully the needs, circumstances, and objectives of clients when determining the appropriateness and suitability of a given investment or course of investment action.

In judging the suitability of a potential investment, Shieh should review many aspects of the client's knowledge, experience related to investing, and financial situation, regardless of whether the clients are high net worth individuals or otherwise. These aspects include, but are not limited to, the risk profile of the investment as compared with the constraints of the client; the impact of the investment on the diversity of the portfolio; and whether the client has the means or net worth to assume the associated risk.

Not every investment opportunity will be suitable for every portfolio or every potential client, regardless of the potential return being offered by Ramos' two top-performing funds.

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