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INSIGHTS FROM CFA SOCIETY SINGAPORE

By CFA Society Singapore Advocacy Team

Diligence and thoroughness in investment decisions

Fund managers need to put in effort, do their homework and have a reasonable basis for decisions they take

RETAIL investors pay fees to investment professionals to manage funds. These recurring fees for actively managing funds typically range between 1 per cent and 2 per cent per annum of the funds' net asset value. What do retail investors expect in return for paying management fees?

They would expect the fund to be managed professionally. Retail investors expect fund managers to utilise their investment expertise and knowledge in allocating funds, selecting securities, monitoring performance and managing the fund through a market downturn, among other pertinent duties.

This implies, in laypersons' terms, that fund managers need to put in effort, do their homework, and have a reasonable basis for the decisions they take.

So, are retail investors getting what they paid for? Many professional bodies require their members to exercise diligence and thoroughness in discharging their duties.

This includes CFA Institute, which is a global association for investment professionals. One of its standards is the Diligence and Reasonable Basis Standard.

The Diligence and Reasonable Basis Standard

CFA Institute requires fund managers and investment professionals to:

- Exercise diligence, independence, and thoroughness in analysing investments, making investment recommendations, and taking investment actions.
- Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

What is deemed 'diligence and reasonable basis'?

Every investment decision is based on a set of facts known and understood at the time. Retail investors turn to fund managers for advice and expect these advisers to have more information and knowledge than they do.

This information and knowledge is the basis on which fund managers apply their professional judgment in taking investment actions and making recommendations.

At a basic level, retail investors want assurance that fund managers are putting forth the necessary effort to support the recommendations they are making.

Communicating the level and thoroughness

of the information reviewed before the fund managers make a judgment allows clients to understand the reasonableness of the recommended investment actions.

As with determining the suitability of an investment for the client, the necessary level of research and analysis will differ with the product, security, or service being offered.

In providing an investment service, fund managers typically use a variety of resources, including company reports, third-party research, and results from quantitative models. A reasonable basis is formed through a balance of these resources appropriate for the security or decision being analysed.

Complying with the standard

Fund managers should encourage their firms to consider the following policies and procedures to support the principles of the Diligence and Reasonable Basis Standard:

- Establish a policy requiring that research reports, credit ratings, and investment recommendations have a basis that can be substantiated as reasonable and adequate. An individual employee (a supervisory analyst) or a group of employees (a review committee) should be appointed to review and approve such items prior to external circulation, to determine whether the criteria established in the policy have been met.
- Develop detailed, written guidance for analysts (research, investment, or credit), supervisory analysts, and review committees that establishes the due diligence procedures for judging whether a particular recommendation has a reasonable and adequate basis.

Ethics in action: practise, practise, practise

Today's case is based on an enforcement action by CFA Institute. The member of the institute was reprimanded and fined by the regulator. And CFA Institute suspended the member's right to use the CFA designation for a period of time. As a guide, the desired ethical behaviour required is based on the CFA Institute Code of Ethics and Standards of Professional Conduct.

Case study: Diligence and thoroughness in investment decisions

Bee Leong is a portfolio manager with discretionary control over the portfolios of more than 400 clients. He pursues a "medium risk, value strategy" for his clients, and they hire him on that basis.

After scrutinising the risk of potential invest-

ments, he makes a risk assessment for each of the securities he recommends based on the risks facing the issuer's business.

The majority of securities Bee Leong invests his clients' assets in are small-cap companies in the oil and gas sector and commodities that he considers "medium" risk. As a result, Bee Leong's client accounts are concentrated in those sectors.

Are Bee Leong's actions acceptable?

Analysis

This case involves CFA Institute Diligence and Reasonable Basis Standard, which states that investment professionals "must exercise diligence, independence, and thoroughness in analysing investments, making investment recommendations, and taking investment actions".

Under this standard, fund managers must also "have a reasonable and adequate basis, supported by appropriate research and investigation" for making investment recommendations and taking investment action.

In this case, there is nothing to indicate that Bee Leong's investigation and analysis of the individual securities that he chooses for his clients' accounts is insufficient or inadequate.

The facts state that he "scrutinises" the risk of potential investment on an individual basis. But in making the investment decisions, he does not appear to exercise diligence or thoroughness, because he does not give sufficient weight to factors that go beyond long-term risk of the individual securities themselves.

Bee Leong does not consider such factors as security concentration in client portfolios, price volatility, or liquidity risk.

Without considering all these factors in their entirety, Bee Leong's actions underweight the risk of the securities, likely making them a more risky investment for his clients than the "medium" risk that investors wish to assume.

Hence, Bee Leong's actions are unacceptable because he does not exercise diligence and thoroughness in executing his investment strategy.

The writers are CFA charterholders who volunteer with the Singapore chapter on advocacy issues with a view towards promoting financial literacy among retail investors and improving overall standards and integrity in the industry. Should you have comments and feedback, do write to the CFA Society Singapore Advocacy Committee: advocacy@cfasocietysingapore.org