

October 22, 2020

TO: Trustees – Board of Investments

FROM: Esmeralda del Bosque, Senior Investment Officer   
Quoc Nguyen, Investment Officer   
Operational Due Diligence Working Group

FOR: November 5, 2020 Board of Investments Meeting

SUBJECT: **OPERATIONAL DUE DILIGENCE – DEEP DIVE ASSESSMENT**

Please find attached a presentation reviewing staff's in-depth assessment of operational due diligence ("ODD") for investment managers.

**BACKGROUND**

The attached presentation (**ATTACHMENT**) is intended to provide Trustees with a review of and suggested enhancements to LACERA's ODD process. A ten-person team of investment staff representing all asset classes ("Team") reviewed the operational due diligence processes of internal staff and consultants across pre- and post-investment ODD. The presentation describes the Team's analysis, ways to address differences, and suggested enhancements to LACERA's ODD approach. Notably, the handful of initiatives that the presentation identifies will be incorporated into LACERA's forthcoming 2021 Workplan.

Attachment

Noted and Reviewed:

  
Jonathan Grabel  
Chief Investment Officer

# ODD Working Group: Deep Dive Assessment Observations & Recommendations

Board of Investments Meeting

November 5, 2020



Amit Aggarwal

Calvin Chang

Cindy Rivera

Daniel Joye

Esmeralda Del Bosque

John Kim

Mel Tsao

Quoc Nguyen

Robert Santos

Shelly Tilaye

# Outline

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- I. Background
- II. Objectives & Process
- III. Observations
- IV. Staff Action Plans
- V. Final Thoughts

# Background



# What is ODD versus IDD?

## Operational Due Diligence

(To identify and evaluate operational risk factors)

- Management and governance
- Risk management
- Investment Operations
- Infrastructure and business continuity
- Compliance resources and policies
- Disclosures
- Manager organization
- Background checks
- Fund terms
- Custody and counterparties
- Valuation policies
- Financial Statements and ADV's
- Diversity and Inclusion
- ESG

## Investment Due Diligence

(To identify and evaluate risks that can impact outcomes due to investment decisions and processes)

- Investment Philosophy
- Portfolio construction
- Strategy and investment process
- Management and team
- Risk Management and risk exposures
- Performance and benchmarks
- Alpha, beta
- Diversity and Inclusion
- ESG Integration

# Why ODD is Important

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- ODD can help mitigate risks stemming from operational issues which increases the likeliness of improved outcomes
- In a low interest rate environment, anything that can reduce the chance of return degradation matters
  - Understanding the procedures, practices, and controls of our investment partners is crucial
  - Increased complexity of regulatory environment demands heightened ODD awareness
- LACERA's increasing allocation to private market investments requires in depth ODD analysis
  - Complex fund structures, increased leverage, fund lock-ups, illiquid/hard-to-value positions must be evaluated via an ODD lens

Whereas increasing investment risk may lead to outsized returns; increasing operational risk does not lead to an asymmetric payoff – unmitigated operational risks can lead to lower returns and/or headline risks



# Operational Due Diligence Process

ODD Working Group's Focus



Pre-  
Investment  
ODD  
screening

Pre-Investment  
ODD

ODD  
Pass/Fail

Post-Investment ODD

ODD & IDD Processes are Concurrent

Pre-  
Investment  
IDD  
screening

Pre-Investment IDD

IDD  
Pass/Fail

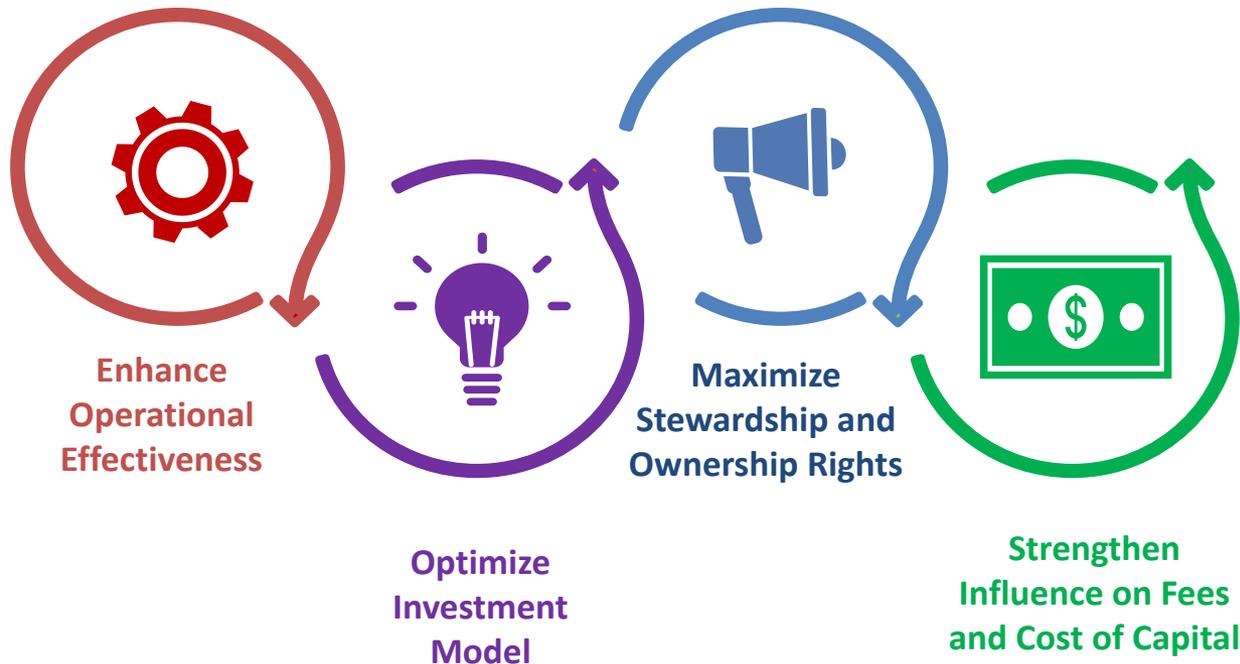
Post-Investment IDD

*Board Recommendation & Investment*



# LACERA's ODD

ODD covers multiple aspects of LACERA's workplan;  
Enhancing ODD will therefore improve total Fund effectiveness



# Manager Scorecard: Organization and Operations

LACERA MANAGER SCORECARD June 30, 2020				Performance 1 to 5 (with 5 the best)	Organization & Operations S+, S, or S- (with S+ the best)	ESG 1 to 5 (with 5 the best)	Partnership A, B, or C (with A the best)	Fees 1 to 5 (with 5 the best)
Manager	Market Value (in \$ millions)	% of Total Fund	Risk-Adjusted Return	SCORE	SCORE	SCORE	SCORE	SCORE
<b>GROWTH</b>	GLOBAL EQUITY							
	ACADIAN DEVELOPED MARKETS	554.8	1.0%	5	S-	4	B	3
	BTC EURO TILTS	640.9	1.1%	5	S+	4	A	3
	BTC RUSSELL 3000	* 2,117.4	3.6%	3	S+	—	A	5
	CAPITAL GROUP DEVELOPED MARKETS	354.0	0.6%	5	S	2	B	3
	CEVIAN CAPITAL II - ACTIVIST	272.3	0.5%	3	S+	4	B	1
	CORNERCAP US SC - EMP	* 51.0	0.1%	3	S	1	A	3
	FRONTIER US SMID GROWTH	333.9	0.6%	4	S-	2	B	1
	GENESIS EMERGING MARKETS	517.5	0.9%	4	S+	4	B	1
	GLOBAL ALPHA IE SC - EMP	* 161.8	0.3%	3	S	4	A	3
	JANA ISI FUND V - ACTIVIST	86.1	0.1%	2	S-	2	A	1
	JPMAM STRATEGIC BETA U.S.	* 2,043.9	3.5%	3	S	+	B	3

As part of the **Manager Scorecard**, staff provides an **Organization & Operations** score for all public market managers and is developing a similar scorecard for private market managers



The ODD Working Group evaluated each asset category's Post-ODD process; the results of which can be used as a basis for determining a manager's **Organization & Operations** score



# Objectives & Process



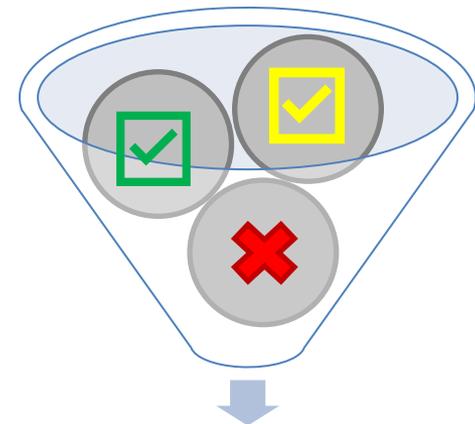
# ODD Working Group

## ODD Deep Dive Assessment:

- Evaluate staff and consultants' ODD processes

## Output:

- Identify
  - Best practices
  - Process and procedural gaps
- Implement
  - Process and procedural enhancements

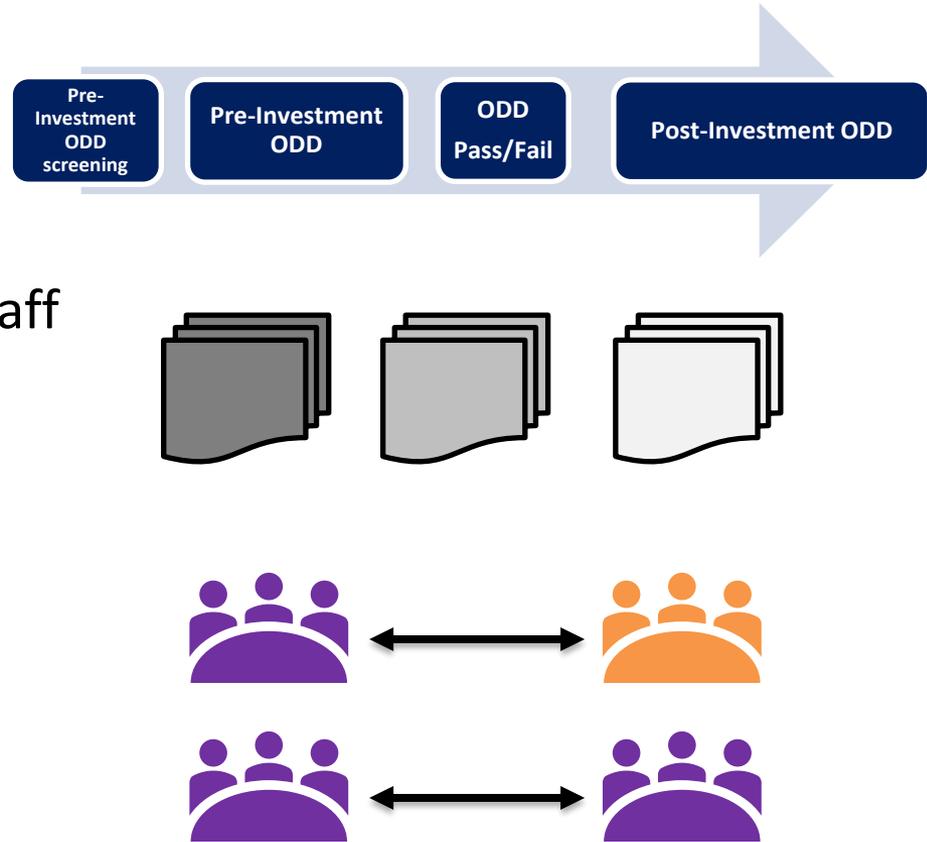


**Enhancements**

# What did the ODD Working Group evaluate?

## We evaluated:

- the full ODD process of each asset category
- due diligence reporting from staff and consultants
- the ODD resources of:
  - LACERA consultants
  - LACERA staff



To identify opportunities for enhancements

# Observations



# ODD Evaluation and Resources

Differences exist across the portfolio with regards to the:

- comprehensiveness of ODD performed and reported
- # of resources that perform ODD

Areas Reviewed	Observations
Who Performs ODD?	<ul style="list-style-type: none"><li>• Staff leads ODD for public market investments</li><li>• Consultant leads ODD for most private market investments</li></ul>
ODD Evaluation and Reporting	<ul style="list-style-type: none"><li>• Depth of ODD evaluation varies</li><li>• Select have dedicated ODD reporting, others incorporate ODD as part of broader due diligence</li></ul>
ODD Resources	<ul style="list-style-type: none"><li>• Resources vary across different parties</li><li>• Select have dedicated, others have shared</li></ul>



# List of ODD Risk Factors

To help standardize ODD:

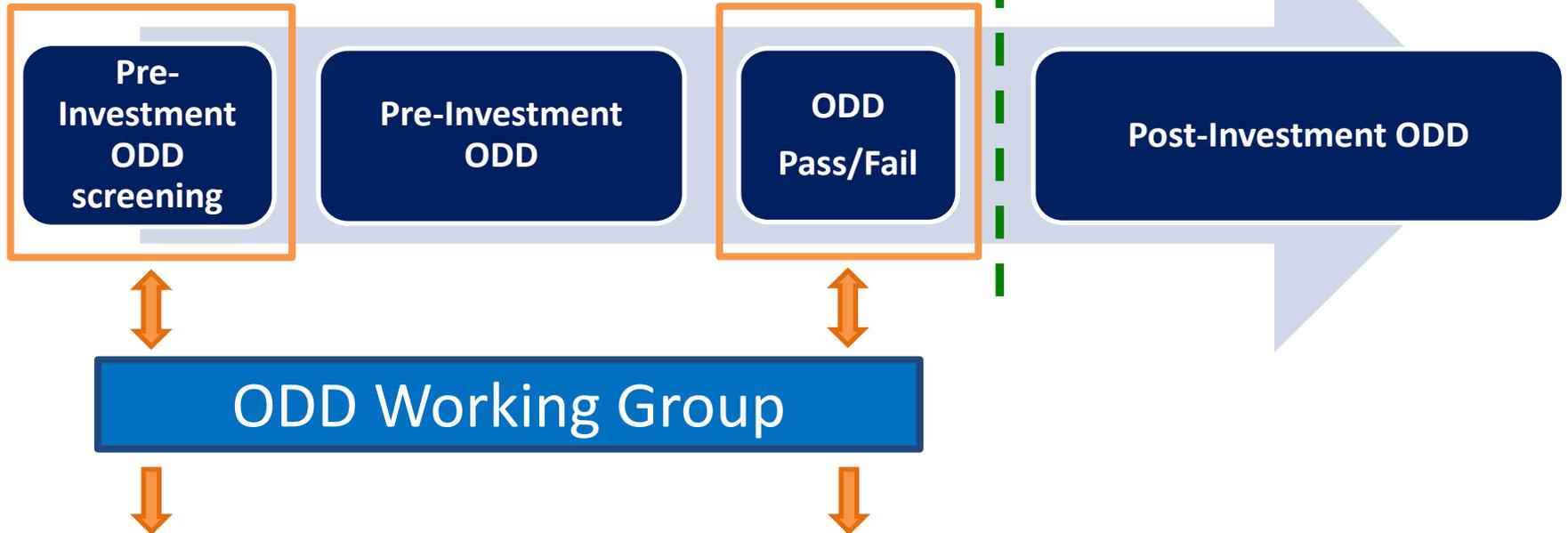
- Team developed an **ODD Risk Factors List** using collection of all ODD consultant/staff criteria
- The **ODD Risk Factors List** can be used for each asset category

List of ODD Risk Factors	Public Markets & Real Estate Separate Accounts	Unique to Private Equity	Unique to Real Estate	Unique to Hedge Funds
<b>Manager Organization</b>				
Assets & Products		IDD Also		
Chief Compliance Officer Structure, Employee Oversight, Process, Frequency & Training				
Code of Ethics				
Committees				
Conflicts of Interest (Overarching)				
Disaster Recovery and Business Continuity Plans				
Firm's Internal Control Structure, Risk Assessment (e.g., SAS 70, SOC 1, 2 or 3)				
Insurance Coverage (General Liability, Fidelity Bonds, Errors & Omission, Directors & Officers)				
Key Person & Succession Planning				
Litigation or Legal Proceedings				
Non Investment Team Overview/Key Non Investment Staff				
Offices				
Oversight Functions & Employees		IDD Also		
Overview/Background				
Ownership, Control, Economics		IDD Also		IDD Also
Regulatory Actions and Violations				
SEC Audits				
SEC Form ADV's Part 1A, Part 2A, Part 2B				
<b>Fund Terms &amp; Governance</b>				
Capital - Investor Base and Concentration				
Fund Expenses				
Fund Terms				
Governance & Oversight - Body, Structure, and Changes				
Proprietary Capital				
Service Providers				
Side Letters				
<b>Background Checks</b>				
Background & Media Checks				



# ODD Pre-Screen & ODD Pass/Fail

*Board Recommendation & Investment*



Create pre-screen questionnaire:

- identify riskier investments
- identify managers that share organizational priorities
- save time and resources

Incorporate an ODD pass/fail step:

- elevate ODD
- enhance ODD vetting process
- enhance risk management

# Staff Action Plans



# Staff Action Plans

## Pre-Investment ODD

- Standardize ODD across asset categories as applicable
- Incorporate pre-screen questionnaire
- Incorporate ODD pass/fail decision
- Enhance staff's ODD board reporting
- Request additional ODD services from consultant(s) or seek from 3<sup>rd</sup> party
- Continue to refine and incorporate T.I.D.E. initiatives
- Enhance ODD of internal Investment operations

## Post-Investment ODD

- Standardize monitoring across asset categories as applicable
- Request additional ODD services from consultant(s) or seek from 3<sup>rd</sup> party
- Continue to refine and incorporate T.I.D.E. initiatives
- Enhance ODD of internal Investment operations

# Final Thoughts



# Final Thoughts

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A comprehensive investment program should focus on both investment and operational due diligence as a means of optimizing risk-adjusted returns

