

OPERATIONAL RISK – RISK WITHOUT REWARD

Operational risk is defined as the “risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.”¹ When applied to investment management, operational risk represents the ability of an investment manager to implement the desired investment portfolio for a client in a manner that is efficient, accurate and that meets applicable regulatory requirements.

As investors are not compensated for taking on additional operational risk, it makes sense to minimize this risk when selecting an investment manager by extending the due diligence process beyond a manager’s investment acumen to its viability as a business, i.e., operational due diligence.

Investor scrutiny has increased since the 2008 financial crisis. Evidencing a rigorous operational due diligence process can build investor confidence and reassures investors that Northern Trust is managing the risk.

OPERATIONAL DUE DILIGENCE

An operational due diligence review entails a qualitative analysis of an investment manager’s business processes to identify the associated risks. The findings from these reviews enable investors to make informed decisions about who should be trusted to manage their money. Performance can no longer be the only measure for investors. A manager’s business, people and process must be reviewed regularly.

While factors such as size, location and the nature of the applicable investment product impact the depth and scope of an investment manager operational due diligence review, three areas are typically addressed: the manager’s compliance program, operational controls and technology infrastructure.

- *Compliance* – Has the investment manager adopted and implemented policies that allow the firm to meet the requirements of the securities laws of the jurisdictions in which it operates?
- *Operations* – Has the investment manager installed a control structure that allows the firm to accurately and effectively produce its investment products?
- *Technology* – Does the investment manager have the infrastructure to achieve its business objectives, protect its data and continue operation in the event of a disaster?

Ultimately, an investor’s approach to operational due diligence is determined by the investor’s sensitivity to operational risk, e.g., a public pension fund often has different priorities and investment parameters than a typical family office.

An in-depth look at the operational due diligence process and industry best practices will be provided in subsequent publications.

We believe the key to investment success is the management of risk. Hiring investment professionals to manage your money brings risk beyond the performance of the investments in your portfolio – “operational risk.”

¹ Basel Committee on Banking Supervision, Principles for the Sound Management of Operational Risk, footnote no. 5, June 2011. (<https://www.bis.org/publ/bcbs195.pdf>)

OPERATIONAL DUE DILIGENCE

WHY YOU NEED AN EXPERT

Many institutional investors realize that operational due diligence should be an integral part of their investment manager selection process but do not have the ability to do it themselves. An effective operational due diligence program requires sufficient staffing with broad ranging skills and experience that may be beyond the resources and knowledge base of the typical institutional investor.

Further, keeping up with the continuing advances in technology and regulation around the globe are principal components of operational due diligence and can be daunting:

- *Information security* – The Equifax data breach of 2018 and other similar cases within and outside the financial services industry have bolstered the concerns of investors as to how investment managers are protecting their proprietary and personally identifiable data. Determining whether an investment manager has adopted procedures to successfully navigate the impact of a data breach should be a priority for all institutional investors — as most experts believe that it is not “if” but “when” such an incident will happen.
- *Evolving regulation* – From the continued roll-out of rules stemming from the Dodd-Frank Wall Street Reform law to the EU’s Markets in Financial Instruments Directive (MiFID), global financial regulation is always changing and expanding. Institutional investors need to be able to discern that an investment manager has kept pace with the regulatory environment.

OPERATIONAL DUE DILIGENCE AT NORTHERN TRUST

At Northern Trust, operational due diligence is a critical part of our holistic investment manager due diligence process. Importantly, it is performed independently from investment due diligence, making it a standalone input.

Northern Trust’s operational due diligence process is designed to achieve four principal objectives.

- Fulfill the duty of care owed to clients.
- Meet all regulatory requirements.
- Adhere to contractual obligations.
- Identify, assess, and mitigate risk to its clients and, by extension, to Northern Trust itself.

WRITTEN ASSESSMENT TOPICS

We offer unique solutions – our standard written assessments are comprehensive and can be tailored.



OPERATIONAL DUE DILIGENCE

Northern Trust's operational due diligence program covers investment managers of varying sizes and locations, and both traditional and alternative investment products:

- Traditional equity & fixed income
- Hedge funds
- Private equity & venture capital
- Private debt & bank loans
- Infrastructure
- Natural resources
- Funds of funds
- Transition managers

Since the inception of our program, we have performed more than 1,000 operational due diligence reviews. More importantly, our process is ongoing, and entails regular follow up communications and onsite visits, certifications and resolution of issues. Northern Trust's operational due diligence professionals have a specialized skillset that has been obtained through years of industry and direct operational due diligence experience.

CONCLUSION

Northern Trust's operational due diligence program's primary focus is understanding and mitigating unwarranted operational risk to your portfolio. It is one of the many benefits of working with investment managers on Northern Trust's platform.

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Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments, so they can confidently realize their long-term objectives.

Entrusted with more than \$950 billion¹ of assets, we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy. That's why we combine robust capital markets research, expert portfolio constructions and comprehensive risk management to craft innovative and efficient solutions that deliver targeted investment outcomes.

As engaged contributors to our communities, we consider it a great privilege to serve our investors and our communities with integrity, respect, and transparency.

¹Assets under management were \$955.7 billion as of March 31, 2019.