

# Product Due Diligence –

**Key Points to Consider** *Dave Paterson CFA, Paterson & Associates*

*Following the popularity of his presentation, "Minimizing Risk to Maximize Returns: Product Due Diligence" at the Toronto Fall Summit on Nov. 1 & 2, 2006, we asked Dave Paterson to write a guest article for this issue of The Independent so that all our members could take advantage of his tips on product due diligence.*

The MFDA has essentially demanded that advisors incorporate some level of due diligence in their practice as part of their regulation notice MR-0048, "Know Your Product". But beyond being told that you must conduct due diligence, it also makes good business sense. By following a consistent, systematic, and well documented process, you gain a thorough understanding of the product, its offering company, the risks, expected return, and expected costs. Only once you understand these issues can you properly assess whether the product is a worthy investment for your clients. Additionally, by documenting your process you will be in a more defensible position in the event that there is a complaint lodged against you either by a client or a regulatory body.

Due diligence is a multi-step process and depending on the product, it may be a simple process, or it may be more

involved. For example, when looking at a new mutual fund offering from one of the major companies, your due diligence can be relatively quick. It may involve a read of the prospectus and a review of the fund's manager. This is because with a simplified prospectus offering, there are a number of regulated features such as disclosure, reporting requirements, and investment restrictions.

However, when looking at exempt products, such as those offered by Offering Memorandum, the amount of due diligence required is much greater. This is because products offered by Offering Memorandum do not have the same regulated reporting and disclosure requirements as a simplified prospectus product. Therefore the transparency at various levels is much lower than a traditional mutual fund, increasing the potential risks, and increasing the amount of due diligence required before committing any client funds to the product.

A key step in the due diligence process involves a detailed review of the company offering the product. Here, you're looking to confirm basic information about the company including years in business, assets under administration, and the quality of management. You may also want to do a quick search to see if the company or any members of the management team have been involved in any industry scandal or lawsuit.

The next step is a thorough review of the details of the product. Pay particular attention to the investment objectives and the manager, including relevant track record, investment process, including sell discipline and any restrictions (such as permitted investments, leveraging or short selling), that govern the management of the product. Next, take a look at the fees that are charged, and how they compare to similar products. Ideally they should be in line or lower than comparable products. Ask yourself at this point: given the manager, the investment process and level of fees, does the investment objective seem achievable?

Other points to consider include:

- are they using external, name brand custodians, trustees, and auditors?
- is a liquid secondary market available?
- is any performance quoted actual returns, net of fees?

Once you have completed your review of both the company and the product, the risks of the investment should become much clearer. It's a good idea to list all of the risks of this investment in your due diligence file. Beyond the traditional investment risks, other risks to be aware of include:

- business risk
- operational risk
- transparency risk
- liquidity risk

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See "Diligence", pg. 5

*"Diligence", cont'd from pg. 4*

The final stage is determining investor suitability. Traditional mutual funds make this step relatively simple since it is listed in the prospectus. However, for exempt products this task is left to the advisor. Using all of the information gathered you must determine the types of investors for whom the product is best suited. As well, it's wise to determine the maximum portfolio weighting for different investor profiles.

At first glance, due diligence appears to be quite burdensome. The reality is that it is not as bad as it seems. For most traditional mutual funds, the process is quite simple and involves little more than a review of the fund's prospectus and the manager.

For exempt products, the process is more involved, however, thanks to MR-0048, a lot of the heavy lifting should be done for you through your dealer's product review process. Still, advisors must do a minimum level of due diligence in order to satisfy their obligations under the regulation.

By using the points addressed in this article as your starting point, you will be well on your way to having a strong foundation for a due diligence process which should result in helping you to identify those products that may be of concern.

Paterson & Associates is an independent consulting firm providing mutual fund and hedge fund research, product due diligence, and portfolio optimization services. You can download a copy of Dave's 'Due Diligence Checklist' on our website at [http://www.ifbc.ca/to\\_summit.php](http://www.ifbc.ca/to_summit.php)