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PHILEQUITY CORNER

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Due diligence

Are there still investors who make financial decisions based on “hot tips” from friends, insiders or proponents of schemes that are “too good to pass up”? With social media, online investment advice is on the rise, sometimes provided by unlikely celebrity endorsers, usually associated with face cleansers. And there’s always FOMO or the fear of missing out.

Does an investor need to have a more informed approach by exercising “due diligence”?

This is a discipline of good corporate governance, especially imposed on companies listed on the PSE. Due diligence then refers to reasonable steps taken to ensure that transactions, especially with third parties, adhere to internal corporate policies and regulatory requirements.

Corporate governance in the company includes the vetting of the qualifications of key executives, reviewing transactions with related parties, as well as evaluating the sources and uses of borrowed funds.

In our own daily life, we already practice due diligence. When buying medicines from the pharmacy, don’t we check the proper dosage and expiry date? Don’t we also try on a leather jacket before going to the cashier, checking for proper fit and price, as well as how often we will get to use it, even in Baguio? And then we can make an informed decision.

The “wealth management” units in the banking system provides high net worth individuals a portfolio adviser offering information and advice. A menu of options is available depending on the established risk appetite of the investor. Selection of investments then are informed by due diligence.

Hefty profits from an IPO or a tipped stock with business plans but vague cash flow prospects for the coming years can endow the first-time investor with beginner’s luck or its opposite. This is sure to be a learning experience which favors due diligence even in picking well-advertised investments.

Doing away with due diligence can lead to buyer’s remorse. (Why did I get into that portfolio?)

Is there possibly an issue of taking in too much information? Can an ordinary investor assess all the available data on an investment and its prospects?

Should the investor just leave due diligence to an asset management group with an active research unit? Then it is a matter of picking the right company using due diligence again.

An assessment of the right firm requires looking into any conflicts of interest which may affect its investment decisions. A good track record and the size of Assets Under Management (AUM) are good indicators.

For individual stock picks, due diligence is still a necessity. This can include such indicators as market share or profitability, an undervalued price/earnings ratio and a strategy for customer retention and growth.

Industry definitions are no longer as static as they used to be. This is true of traditional companies like media, power generation or property development. An industry metric like market share may need to be redefined.

Companies now have investor relations (IR) units which provide statistics on earnings, major challenges, market share and other financial data. The IR unit is often a part of the finance or communications function.

Stock brokerage's research departments attend quarterly IR briefings as part of their service to their clients. Participating in these sessions can provide insights into the quality of management too in addressing current issues.

News items in the business papers, interviews of the CEO (now sometimes online), and company reports to the stockbrokers provide information on the company's value. The absence of quarterly briefings, delayed releases of financial statements or non-disclosure of audit findings can be warning signs to watch out for.

Can due diligence be overdone?

Can too much information lead to confusion rather than insight? The desire to get all the facts on a stock can lead to "analysis paralysis". How are all these facts related to the investment decision? There will always be some unknown (or unexpected) factors like new players, a changing industry landscape and technology breakthroughs that have not yet impacted the financial performance of companies being monitored.

When is it time to be assured that one has enough information for a judgment call? In any investment, due diligence is obligatory. An informed investor can at least understand the risk he is taking on...and maybe the rewards he can expect.

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