ADDEPAR

Investment memos and decision-making

Translating better memos into stronger returns

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1. Welcome

Investment memos are the foundation of most investment processes: they condense large amounts of diligence, expertise and analysis into a single document that leads to an investment decision. Despite their ubiquity and importance, there's practically no published research in either academia or industry on best practices in crafting or using investment memos.[1]

Many institutions consider their investment memos to be highly confidential documents that draw upon their firm's 'secret sauce' (investment strategy). As such, many investment professionals — including Addepar clients — are in the dark regarding how their peers write and use them. There's widespread curiosity surrounding what investors *should* be doing with investment memos, relative to what they're actually doing.

This Addepar research brief (ARB) addresses that uncertainty by shedding light on the typical content, quality and functions of both pre- and post-investment memos. Our findings illustrate new methods and processes in the crafting and use of memos. We conclude that memos aren't merely paperwork; they can enhance investors' performance by meaningfully improving investment processes.

2. NTK

Here are the key takeaways you need to know (NTK) from this brief.

[1] Google Scholar has zero peer-reviewed journal articles on investment memos as of March 2023.

- **Pervasive:** 97% of the professional investors we surveyed have a formal investment memo template and process, and 78% of their firms require a memo approval before making any investment.
- **Key sections:** We observed a standard set of memo sections (see 4. Context, below). The most important among these are: deal description, risk factors, team bios and deal terms.
- **Memo process:** We identified a standard process for memo construction and usage, and this includes screening, writing, critiquing, rating, approving, storing, learning and improving.
- **Friction-filled:** Many investors perceive the process of writing memos to be arduous and friction-filled, which can have ramifications for the quality of memos and how they're used once an investment has been made.

In light of these findings, please see the ARB-itrage section for our synthesis of what goals seem prudent for all investors to consider.

3. Significance

Nearly all professional investment organizations write investment memos. These memos can be informal documents for internal investment officers or formal documents that emerge from well-defined processes, which are ultimately reviewed by investment committees and boards of directors. In all cases, the memos capture the information, expectations and logic behind specific investments. They serve as valuable windows into the inner workings of an organization's decision-making by including the following:

- **Investment logic:** Most professional investment firms require documentation of the process and inputs that lead to an investment decision. This 'investment logic' is memorialized in memos.
- **Investment assumptions**: Memos are time-stamped artifacts that offer some unique insights into the thinking and assumptions that an investor relied on to make a specific investment. The assumptions, in particular, are valuable, and should be tracked over time in case they change.
- **Investment processes**: Memos shed light on decision-making and execution, from risk management and due diligence to portfolio construction and even deal

sourcing. Hence, memos can serve as diagnostic tools for bettering a wide array of organizational processes.

4. Context

Although the process-flow for investment memos varies across organizations, the goal of writing memos is essentially to aid concrete investment decisions associated with specific, actionable opportunities. Ultimately, the purpose of any memo is to prime an eventual yes/no decision about the particular opportunity that's the subject of the memo.[2] Such opportunities are generally deal-based and often concern a new investment in an external fund or a direct investment in a company or asset. (They may also be written on new in-house investment pursuits, but these are less common.)[3]

Memos are typically written by a firm's internal investment experts, but — depending on the nature of a firm's resources — may also be written by external investment consultants. At private firms, the audience of investment memos typically consists of chief investment officers and members of the investment committee. At public firms (e.g., state pensions), the target audience is generally board members.

From our close study of investors (both for this ARB and in years of prior work), we've found that many memos have the same prototypical structure. They generally include sections that describe the:

- Proposed investment
- People involved (both internally and externally)
- Prospective deal terms
- Associated risks
- Performance benchmarks
- An opportunity's fit within the investor's broader strategy or portfolio

Some memos deviate from this basic structure, and those deviations are usually due to either: 1) a particular investment being novel enough to warrant a unique memo format; or

[2] As such, memos are primarily pre-investment resources. They are often accompanied by additional documents that capture the post-investment performance of opportunities that were ultimately pursued. It's worth noting that many investors don't track the performance of opportunities on which they 'took a pass' after writing a memo; doing so creates a loss of information on relative performance, as well as ways in which decision processes could be improved.

[3] Ultimately, memos are usually just one piece in an investment's 'case file,' which might additionally include performance analyses, meeting notes, consultant reports, records of diligence with fund managers and reference calls.

2) an investor having an idiosyncratic approval process for new investments. Yet, by and large, most memos conform to the structure above while often including additional sections that support an investor's own decision-making process.

Regardless of their precise structure, most memos that we've encountered address three major topics, which we break down as follows: opportunity, fit and process.

The opportunity: This topic provides the key information about the candidate investment. The following subsections will often be included:

- ***Deal specifics:*** Memos will often start with the following: asset classification (e.g., first-time buyout fund, commercial real estate, cryptocurrency fund); the size of the opportunity; mode of participation (e.g., via an external fund or direct investment in an individual company or private/public asset); and footprint (e.g., definitions of what the opportunity consists of or excludes).
- ***Historical context:*** Background on the opportunity and biographical information about its key people (e.g., executives, founders, board members and other relevant folks who might affect the opportunity's success or failure).
- ***Valuation:*** An assessment of the opportunity's current value. These valuations are (ideally) a combination of internal analyses and independent appraisals. It's common for them to include sensitivity studies (e.g., by analyzing comparable companies, when the opportunity is itself a company).
- ***Geography:*** Information and statistics about the geographies in which the fund, company or project is headquartered and operates, with special attention devoted to local regulations and risks (e.g., threats of military conflicts or human rights concerns).
- ***Track record:*** Past performance of the company or project on a range of relevant criteria, such as risk-adjusted returns, returns according to fund vintages or investment strategy, or peer benchmarks.
- ***Terms:*** Analysis of fees and costs (both one-time and recurring) that are likely to be incurred if a proposed investment is made. Terms may also include an array of deal features associated with a specific opportunity (e.g., clawback provisions in a private equity stake).

Portfolio fit: Next, portfolio fit considers the candidate investment in the context of the fund's goals and current needs, such as an assessment of the role an investment would play within a fund's broader portfolio, including its impact on diversification and the exposures being pursued. The following subsections will often be included:

- ***Investment logic:*** This is the overarching rationale for why an opportunity may be attractive to the investor. The logic tends to emphasize supportive forces that could drive the opportunity's upside potential and rationale for inclusion in the fund's portfolio (e.g., rapidly growing industry, market inefficiency or underserved consumer needs).
- ***Relevant risks:*** A list of relevant risks associated with the opportunity, along with any mitigating factors (or lack thereof). Relevant risks may include: reputation, technology disruption, political or geopolitical risks.
- ***Projections:*** Detailed expectations for future performance, typically presented as a spectrum of scenarios (e.g., upside, base and downside cases) or sensitivity analysis. These projections often include multiple levels of composition (e.g., expected profits being derived from forecasted revenues and expenses) and derivation (for example: revenues being linked to relevant economic variables or costs being tied to labor and commodity prices). Projections are often accompanied by explanations of the presumed relationships between expected performance and key drivers of that performance (such as market size).[4]
- ***Assumptions:*** These are explanations of the forecasted quantities that 'drive' performance projections. For example, if the opportunity is a direct investment in a widget manufacturer, assumed drivers of performance would be the future demand for widgets or the manufacturer's borrowing costs for financing construction of a new widget-making facility. These explanations generally include some justification of reliability, given that forecasts may come from various sources (e.g., the CEO of the widget manufacturer or a renowned professor on widget science).
- ***Benchmark:*** Identification of one or more standards for judging the relative performance of the opportunity, both historically and in the future. Examples of benchmarks might include performance of the S&P 500 or the performance

[4] The future behavior of such drivers usually depends on various assumptions, which are often justified separately.

threshold for top-quartile funds of an applicable type. This section might provide analysis and valid low-cost index alternatives.

- ***Structure alignment:*** An assessment of positive and negative incentives faced by all parties in a given opportunity, as well as any adverse incentives acting as mitigants. For example, an analysis might be included of the risk that a hedge fund manager might manipulate valuations of portfolio companies.

- ***ESG:*** Statement of any portfolio-level requirements around sustainability (such as carbon net zero by a particular year), as well as ESG performance attributes of the opportunity and any associated liabilities.

Due diligence list: Investment memos can also document the work an investor must complete prior to making an investment. Often, allocators will make investment decisions as part of a 'procurement process' that dictates what items must be collected and reported before a decision can be made. This aspect of the process ensures that key rules and regulations have been properly observed. The following elements are often considered:

- ***Sourcing pathway:*** Information on the provenance of the opportunity — i.e., how an opportunity reached a given stage of consideration, via a traceable succession of brokers, bankers, professional networks or consultants.[5]

- ***Internal 'deal team':*** A list of the investor's own employees who have either sourced or worked on the opportunity. This may include in-house lawyers who handled due diligence and helped structure the opportunity.

- ***External consultants:*** A statement from any technical experts, which includes their opinions on various aspects of the opportunity. (For instance, if the opportunity is a stake in a startup biotech company, an assessment of the company's intellectual property might be undertaken by an expert with specialized knowledge.)

- ***Checks:*** Background checks on key individuals within a company or project, identifying the firm that conducted the check.

[5] The sourcing topic effectively tackles the question, "Why are we seeing this deal?" For many investors, the provenance of an opportunity matters for one (or more) of several reasons. First, it can be indicative of quality: a deal recommended by a trusted source may automatically deserve more attention. Second, it can help expose whether any deal participants have adverse incentives. Third, it can help pinpoint sources of additional information — to ultimately reach a decision on the opportunity in question.

- ***Follow-ups:*** A memo should define the terms under which a decision would be reviewed or reversed as part of a risk exposure summary.

- ***Author conflicts:*** As one of our interviewees noted, "Authors have the ability to put their thumb on the scale (consciously or subconsciously) by de-emphasizing or omitting certain details." As such, it's important to provide authors the opportunity to detail potential conflicts or share additional information related to their function in the process. For example, external consultants will have different incentives and potentially be influenced by these when deciding what to include and/or emphasize than members of the internal staff might. Conversely, if senior staff have full editorial control and are compensated on investment returns, they may be incentivized to spend less time documenting opportunities once they are convinced it won't be a fit. In addition, junior staff whose work product is aimed at senior staff who control promotions or compensation are likely to respond to an entirely different set of incentives than senior staff. As a result, not all memos will be created equal in terms of detail or rigor.

5. Approach

A key aim of our research is to reveal how professional investors use investment memos in their decision-making. To gain these insights, we fielded a survey in partnership with the Stanford Initiative in Long-Term Investing in June 2022 about investment memos, the audience of which included Addepar clients as well as some contacts within our broader investment community. The 54 responding organizations spanned a broad range of types and geographies (details on these characteristics appear in the appendix).

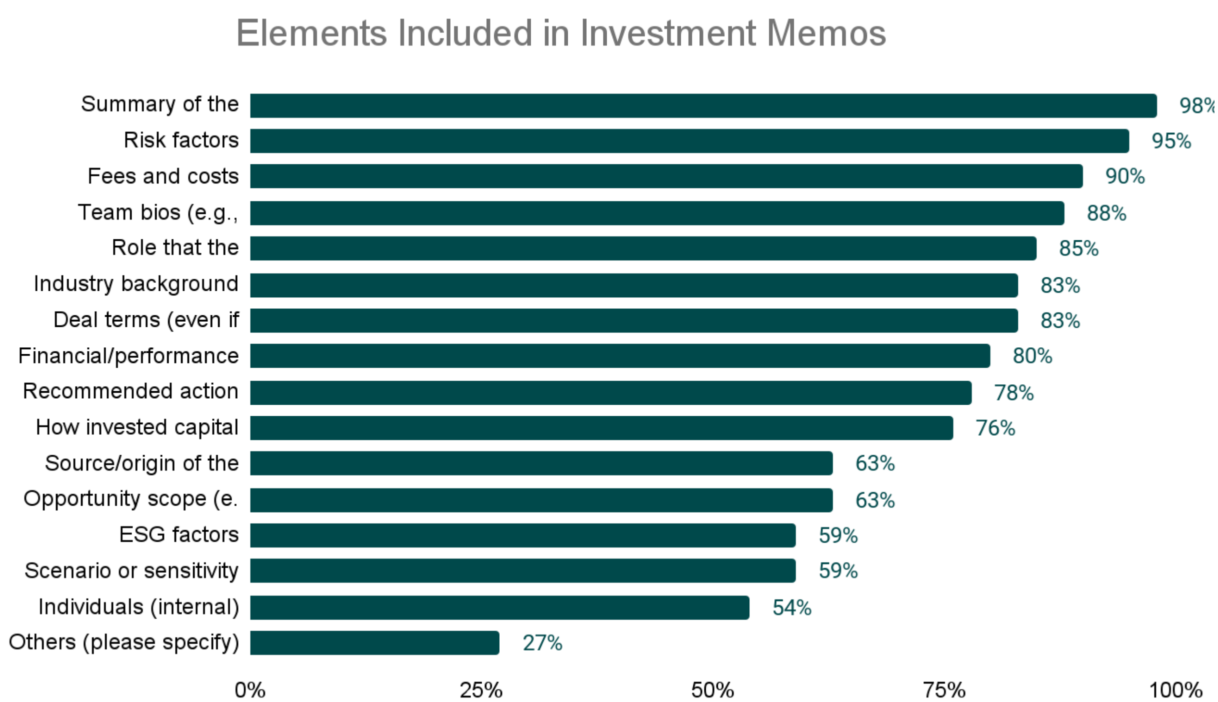
To augment our findings in that survey, we completed six case studies in October 2022 on four pension funds, an endowment and a multi-family office. These case studies entailed in-depth, 60-minute interviews with professionals responsible for investment memo processes at their respective firms.[6]

6. Findings

[6] In accordance with case study and ethnographic methodologies, we've chosen to anonymize these findings.

Our survey revealed that the vast majority (97%) of professional investors employ investment memos as a means of making investment decisions. And of those organizations that use memos, 78% make memo completion and review a requirement before an investment can be made. The majority of firms (86%) also stated that they use standard templates for memos — that is, an investor will use the same 'starter' template for all memos.[7]

The survey also discovered that many investors use the same basic sections in their memos. Topping the list were: summary of the opportunity (98%), risk factors (95%), fees and costs (90%), team bios (88%) and the role that the deal plays within the overall investment portfolio (85%). The figure below depicts the popularity of these sections relative to other fields.



We also uncovered similarities in the processes investors use for writing, approving and subsequent (i.e., post-investment) use of memos. These similarities are synthesized in the diagram below.

[7] It's vital to note that this template is practically never the same for any two investors who might use one.

Investment Memo Process

Pre-production

- Screening

Production

- Writing
- Critiquing
- Rating

Post-production

- Approving (go/no go)
- Storing
- Learning
- Improving

Screening: It's standard to have a gated approval process for investment memos. This first gate represents an initial draft of the investment memo and is intended to avoid wasted time and effort by the deal team. It distills the investment thesis, the context for the opportunity, and an assessment of portfolio fit and a list of the key pros (returns) and cons (risks). The required topics and authors are often defined during this screening stage.

Writing: After initial screening, a team of experts — internal or external — completes the memo's key sections, using a memo template usually built as a PowerPoint or Word document. The time frame from initial concept to completed final memo can be as quick as two weeks (assuming it's a continuation deal with an existing firm/strategy for which all new data is easily accessible) or as long as a year. On average, we heard that it takes a team two months to complete the entire investment memo writing and review process.

Critiquing: Some organizations bring in 'red teams,' which are internal investment teams assembled specifically to critique an opportunity and poke holes in the logic. The objective is to stress-test the opportunity to develop a deeper understanding of unexplored risks or to uncover new problems. If the deal is within infrastructure, for example, then the team may enlist the help of a non-team member who works in the same sector but in a different geography. This critique (in summary or full) is often included within the memo's discussion of key risk factors or as an appendix.

Rating: Some of the firms we interviewed also use scoring mechanisms to assess opportunities relative to similar ones within a strategy type (e.g., a real estate fund raising capital would be compared to peer real estate funds). In other cases, opportunities are assessed on a total portfolio basis. In these instances, the authors may consult a broader set of stakeholders and include capital market assumptions for a range of asset classes. (See our brief on capital market assumptions and portfolio construction.)

Whatever the case, most raters are asked to assign numerical scores to the following three components:

- The opportunity (e.g., the investment itself in terms of the team, time and risks)
- The terms (e.g., the fees, level of transparency and level of control)
- The fit (i.e., does it solve problems for portfolio diversification, and so on)

In order for a candidate investment opportunity to advance, a minimum score equivalent to 6/10 or 7/10 is usually needed. (Unsurprisingly, this varies by investment firm.)

Approving: After all diligence has been completed, the final investment memos typically are sent for approval with critiques and ratings appended. They are approved or rejected by a person or committee with the appropriate and relevant delegated authorities. In some cases, a head of an asset class might be able to independently approve a transaction (depending on size). In other cases, the final approval might go all the way to a board of directors. Some memos require signatures of a single party, whereas others have no signature lines at all (approvals are noted in committee minutes).

Storing: Once approved, investors tend to keep the memo in a place where it can be easily referenced. There seems to be significant diversity in how firms store their investment memos. Some use less tech-centric solutions, such as simply maintaining digital folders of PowerPoint presentations; others use more sophisticated solutions (e.g., research management systems, such as Dynamo).

Learning: We asked our interviewees whether they have structured processes for ex-post analysis of memos. The majority do not, which is noteworthy in that it reveals how much value is not being captured in current memo processes. That said, some firms still succeed at learning from their memos. Some anonymized examples of these learnings include:

- ***Two-part evaluation:*** Firm #1 consistently employs a two-part process for evaluating past memos. The first part is the ‘postmortem’ that occurs within one month of each deal and entails a discussion of what was learned, what went well, what went badly and what might be done differently to be more successful the next time. The second part occurs within 12–18 months and is a more in-depth audit of each deal to reassess its risks and evaluate whether its performance proved adequate, relative to the initial investment thesis.

- ***Annual team offsite postmortem:*** Firm #2 does a postmortem of its investment memos and process at an annual team offsite. This is an effort to understand opportunities for continuous process improvement. It's also intended to identify whether any observed success is due to "being right" or simply "being lucky," as well as to unearth whether unexpected/unwanted outcomes were due to "previously known risks" or to "something we missed."

- ***Revisiting memos on per-manager basis:*** Firm #3 evaluates memos when considering additional opportunities by the same manager. The firm revisits past memos and focuses on initial strategy and concerns (including how the latter were addressed), performance versus expectations, and notes any major shifts that need to be taken into account for subsequent projects (i.e., changes in key personnel or a firm's strategy).

Improving: Beyond this process, we also asked our respondents how they might enhance the process for investment memos. This is what we learned:

- ***Improve tracking:*** Increase the speed of creating investment memos or of updating key data. The latter is especially relevant for evergreen investments that require regular maintenance of metrics such as performance.

- ***Reduce resources:*** Investors frequently cite the 'pain' involved in writing these memos, which we interpret as the time and resources needed to write an 'approvable' memo.[8] Some felt this could be achieved by established word count limits and tables of contents that encourage authors to create memos that are concise, digestible and actionable — with minimal uncertainty as to what's expected.

- ***Improve automation:*** The writing of memos could be automated by populating required fields with outputs from other systems — perhaps even with the assistance of generative AI — leaving the memo writer to handle only the higher-order functions of analysis and recommendations.

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[8] Interviewees consistently identified the process of writing memos as being arduous and friction-filled. This carries potential consequences for the overall quality and future usefulness of memos (e.g., as sources of insight after an investment decision is made).

- ***Track assumptions:*** If applicable, implement assumption tracking after an investment is made. For example, if interest rates are a key assumption, then if they were to change meaningfully, a red flag would be sent to the original deal team.

Before closing this section, it's useful to note an additional finding from our case studies that did not fit neatly above. We found the governance and oversight of memos to be idiosyncratic, owing to the respective firms' histories, natures, mandates and shareholders. For example, in one case we found investment memos were written by external consultants for non-expert trustees — a process that could represent a failure of governance should consultants not be properly credentialed or their work couldn't be independently validated. In another case, the memos were written by in-house experts for a management investment committee. Both of these findings represent potentially improvable areas for investors in the memo writing/use process.

7. The ARB-itrage

The professional investors we studied are all strong performers among their peer groups. Although investment memos aren't the sole ingredient to their success, it's safe to assume that solid memos — and the processes for crafting them — are clear enablers of that success. Prior to our work here, there were very few established facts about investment memos 'in the wild.' From what we've learned so far, the following goals seem prudent for all investors:

- **Consistent quality**: High-quality memos are those that yield investment choices that are well-informed and made with confidence. The key to that quality appears to lie in clear standards for what every memo should contain (as well as clarity on *why* that content is relevant to end decisions).[9]

- **Process integrity**: Investors need a transparent, well-governed workflow for completing memos. Integrity of these processes is required not only to guarantee that there are no skipped steps or undue exceptions in memo content, but also to ensure that the completion of memos is efficient. Any given memo represents the investment of significant time on behalf of an investor — time which can translate

[9] The best memos are rarely composed from scratch; instead, they conform to well-designed templates that help guide deal teams into asking the right questions, conducting the right analysis and adopting the right perspective on the fit of an opportunity as a whole.

into a drag on performance if improperly spent (given how costly the time of investment professionals is, in general).

- **Persistent usefulness**: Investors aren't extracting enough value from their memos *after* the point at which an investment decision is taken. Any single memo is a rich repository of information that's potentially applicable to future decisions, whether these decisions are about improving internal processes or informing future portfolio actions. Memo templates (and supporting governance) unlock their future value by making them easily searchable and able to be analyzed.[10]

8. Coda

The vast majority of investment organizations are using investment memos to summarize the key details of investment opportunities in the context of their broader portfolios. Based on our findings, those involved in the investment memo process find it to be arduous yet necessary. In an effort to streamline their respective processes, all have created templatized reports that they continue to refine to better meet the needs of the memo authors and readers.

This ARB was intended to provide you with an overview of the 'white belt' essentials regarding the elements and processes involved in both writing and using investment memos. In a future ARB on the subject, we may explore themes that are more 'black belt' in nature. In our research, we heard the recurring theme of the need for greater efficiency regarding memos — at all phases of their development (pre-production, production and post-production). As a result, we may dive deeper into a range of memo-related technologies that top firms are employing to drive outperformance. Such technologies expedite the aggregation of the array of inputs required in standard memo templates, facilitate the writing process and support superior ex-post analysis of a firm's overall investment process, as well as performance of individual investment opportunities.

[10] Given the pace at which analytical technology (in specific, that for natural-language processing) is advancing, designing memos for subsequent use as part of organizational knowledge bases is a worthwhile consideration, now or in the near future.

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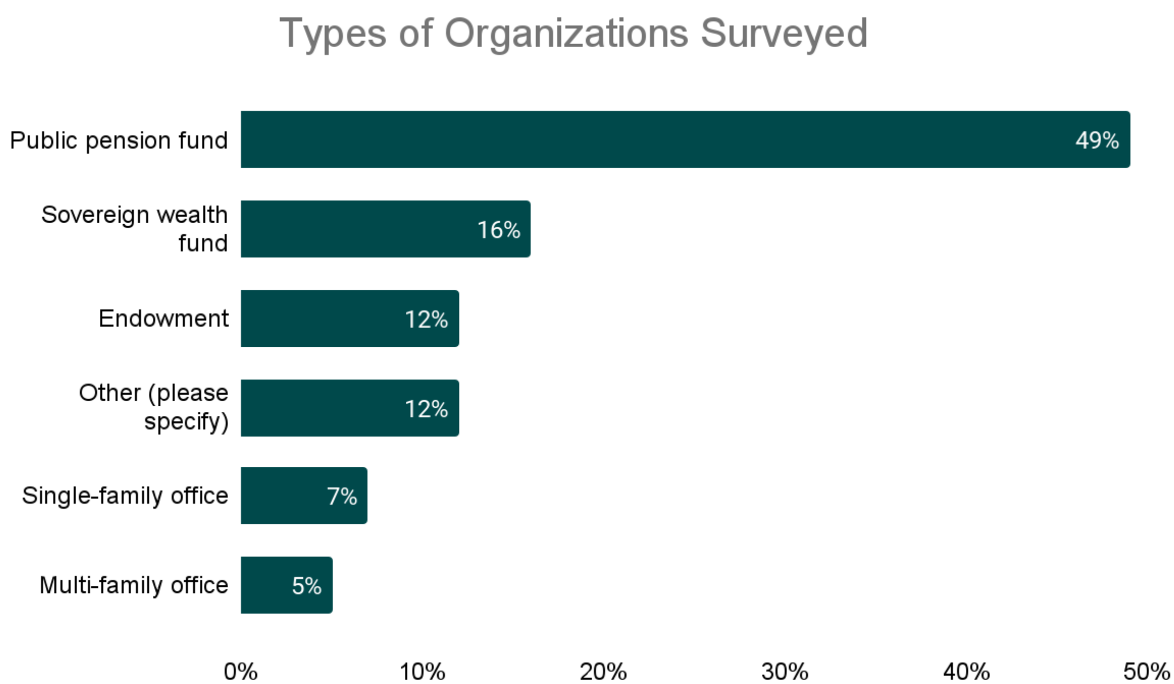
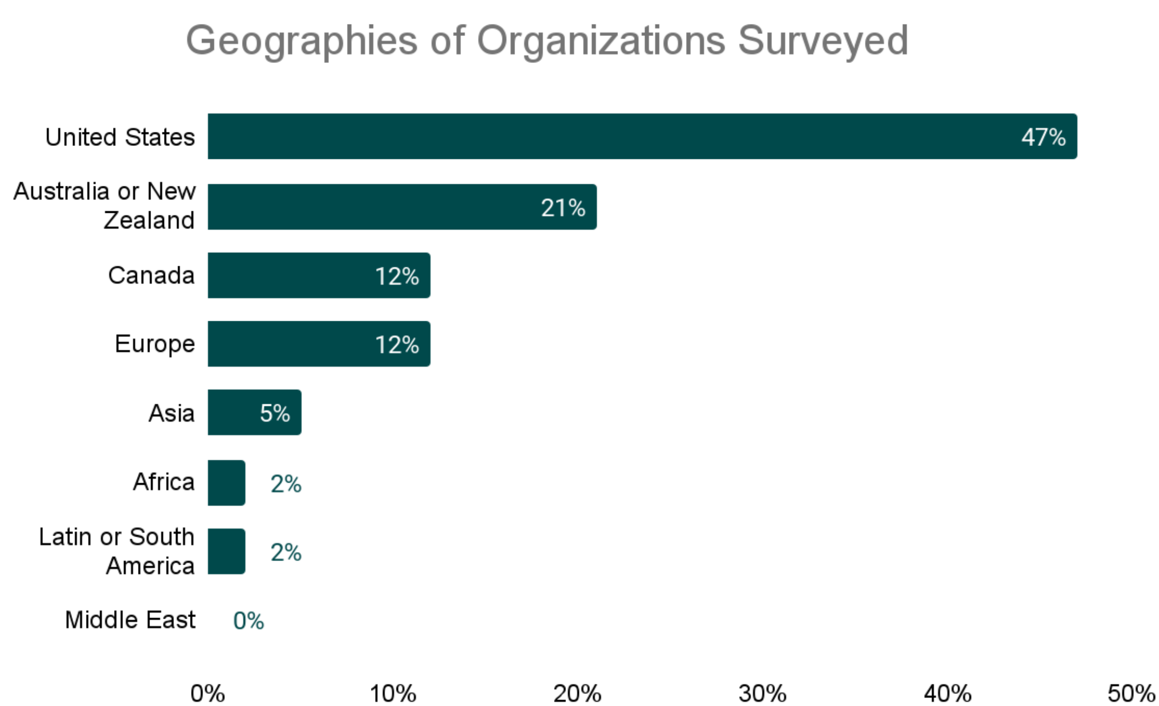
Appendix


Types of Organizations Surveyed
Public pension fund
49%
Sovereign wealth fund
16%
Endowment
12%
Other (please specify)
12%
Single-family office
7%
Multi-family office
5%
0%
10%
20%
30%
40%
50%


Geographies of Organizations Surveyed
United States
47%
Australia or New Zealand
21%
Canada
12%
Europe
12%
Asia
5%
Africa
2%
Latin or South America
2%
Middle East
0%
0%
10%
20%
30%
40%
50%

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