



# Six Principles of Operational Due Diligence

Hedge funds have progressively moved into the mainstream of institutional investing.



Christopher J. Addy, CA, CFA  
President and CEO



Hedge funds have progressively moved into the mainstream of institutional investing. While, even ten years ago, hedge funds were still largely the “secret club of the super rich”, sophisticated investors such as pension funds, sovereign wealth funds and large endowments now embrace the absolute return and diversification benefits available from hedge funds. Retail investors are also exposed to hedge funds as never before: many corporate pension schemes have added hedge fund exposure, and, more generally, the movements of both stock and bond markets are now heavily influenced by hedge fund investment decisions and capital flows.

Since the 2008 market crisis – thanks in part to Bernie Madoff, Lehman and numerous funds gating and suspending redemptions – operational due diligence has become much more significant to the hedge fund selection process. While performance and strategy remain central to every decision to allocate to a fund, investors, large and small, must also ensure that they have selected a manager with sufficient controls and infrastructure to safeguard assets.

In practice, a number of issues combine to make hedge funds unduly exposed to operational risk. At their heart, hedge funds are a paradox: while they may trade large volumes of extremely complex securities, most hedge funds have fewer than 50 staff. As a result, investors cannot rely on the depth of resources – or deep pockets – which can be taken for granted at a major asset management institution. Moreover, many hedge fund managers, while skilled traders, may not be effective business managers (many fund managers launch their own firms to escape the “bureaucracy” of an investment bank). Finally – despite all the talk of “institutionalization” and best practices - there remains a lack of standard procedures in the hedge fund industry. Operational practices vary widely from fund to fund, particularly in critical areas such as valuation and administrator oversight.

Each year, Castle Hall visits several hundred hedge funds worldwide to conduct operational due diligence reviews on behalf of the firm’s clients. Based on this experience, we have highlighted six principles which can guide the development of an effective due diligence program.



## 1 Operational Due Diligence is About More Than Operations

Many investors have traditionally viewed operational due diligence only as a defense against fraud and other catastrophic loss. Due diligence procedures have, therefore, tended to focus narrowly on accounting controls and procedures – if due diligence is conducted by an accountant – or legal terms and conditions, when due diligence is conducted by a lawyer.

While any due diligence review will consider the risk of a “blow up”, effective due diligence provides a much broader insight into the overall quality of each manager’s business, including each firm’s culture and operational philosophy. Indeed, “business risk” due diligence is probably a more helpful description than a more limited “operational” due diligence framework.

Managers who fail to make an appropriate investment in people, systems and other infrastructure will unavoidably fail to deliver optimal performance. The purpose of operational due diligence, therefore, is as much to assess the risk of a drag on performance due to a poorly run business as it is to identify outright fraud.

## 2 Due Diligence Requires Judgment, not a Scorecard

Judgment is critical in the due diligence process. There is an enormous variety of hedge fund operating models across different strategies and jurisdictions, meaning that the typical hedge fund structure is far from one size fits all. While it is tempting to use a rigid, predefined list of criteria to determine an overall “score”, effective due diligence must combine a consistent process with subjective opinion.

In our experience, yellow flags and warning signs are as likely to be subjective impressions as they are objective facts. Perhaps a manager is a little too aggressive to pass through research or back office costs to the fund in addition to the management fee, or perhaps the firm’s compliance procedures spend more time on justifying exceptions than on enforcing rules. Individually, these issues may not be overly significant, but, collectively, can be important signals to help investors understand how each manager views its business and its relationship with investors.

The attitude of the manager during the due diligence process can also give valuable insights. At one extreme, some managers may view due diligence as a mundane necessity, adopting a “seen it all before” attitude when answering investor questions. At the other, we very consistently find that, the more capable the CFO, the more quickly he or she will ask for feedback and suggestions as to how controls and procedures could be improved. A commitment to continuously improve the hedge fund organization sends a strongly positive signal.

## 3 Ongoing Due Diligence is Vital

In the past, many investors completed an operational due diligence only at the time of initial investment. Once a fund “passed” due diligence, investment teams often assumed that all operational issues had been resolved and that, once in the portfolio, only performance mattered.

In practice, systematic, ongoing due diligence is as important as the initial review.

Every hedge fund faces a constant challenge to keep up with new trading technology, adapt for new instrument types, and match the ongoing evolution of industry best practices. Funds also update their offering documents, change service providers and have turnover in key roles such as the CFO and COO. Each of these events must be evaluated on a timely basis.

## 4 Be Prepared to Ask Tough Questions – Even When Making Money

With the benefit of hindsight, the colossal fraud perpetrated by Bernie Madoff was astonishing in terms of both the sums involved and for the number of years over which the fraud was sustained. Madoff was, unfortunately, able to take advantage of a perfect confluence of circumstances – he conducted his crime in an industry which not only had enormous sums of money, but was also prepared to accept that certain managers didn’t have to explain what they were doing.

The Madoff case reminds us that every Ponzi scheme exploits a fatal flaw in investors’ psychology: investors always have less appetite to ask tough questions when they are making money. Madoff and his lesser imitators show just how important it is to focus on strong performers as much as the laggards on the “watch list”. It is precisely the fact that a fund has reported great returns that could be the clearest sign that all is not well.

## 5 If It Looks Too Good To Be True – It Probably Is

Some investors are more skilled than others, and some managers do have better resources and infrastructure. No-one, however, has discovered the secret of alchemy. Despite investors’ enduring optimism, it is simply not possible to design an investment strategy which, over time and under all investment environments, will always generate consistent, positive returns. Investors should be conscious that a high proportion of hedge funds which did turn out to be frauds offered some combination of unreasonably high returns, unreasonably low volatility, or a minimum, guaranteed return.

## 6 Be Prepared to Say No

Our final comment is perhaps the most obvious but, all too frequently, can be one of the most difficult. Very few allocators can truly remove emotion and the “human element” from investment decision making. Sometimes, the effort expended in researching a new fund can create almost unstoppable momentum to get the fund approved and into the portfolio. There can also be strong peer pressure to take scarce capacity in well-regarded funds: after all, the argument goes, if everyone else has already invested, musn’t the fund be safe?

Allocators should also be conscious of the need for independence between the investment and operational teams. Investment analysts must, of course, find funds which will generate good returns, and are typically compensated based directly on fund performance. The role of operational due diligence, however, is different: at the most basic level, it is to worry about what can go wrong. This creates an unavoidable trade-off – what happens if a fund has strong performance, but is operationally weak? At what point is there an incentive to “pass” the fund, irrespective of potential operational problems?

In our view, a consistent and comprehensive due diligence process allows better investment decisions. With detailed due diligence, investors can be better informed to reject those funds which do have deficient operational controls, and can have more confidence to invest with those firms who genuinely do have a top tier business infrastructure. \*

*Christopher Addy, CA, CFA, is the President and Chief Executive Officer of Castle Hall Alternatives. Castle Hall provides operational due diligence services to institutional investors, fund of funds, endowments and banks worldwide from offices in Montréal and Halifax.*