

FOCUS ON

DUE DILIGENCE

With investor scrutiny at its highest levels, funds and managers are having to do more to disprove their prospective clients' doubts. Christopher J. Addy of Castle Hall Alternatives explains the current climate of due diligence procedures



Christopher J. Addy CA CFA

is the president and chief executive officer of Castle Hall Alternatives. Chris is one of the hedge fund industry's most experienced due diligence practitioners, having completed more than 1,000 due diligence reviews.

Q HFMWEEK (HFM): WHAT HAVE YOU FOUND TO BE THE BEST METHODS OF MEETING HEIGHTENED LEVELS OF DUE DILIGENCE?

A CHRISTOPHER J. ADDY (CA): Clearly, investor sentiment towards operational due diligence changed dramatically in the aftermath of the Madoff fraud. All investors now conduct a baseline of due diligence, either in-house or with the help of external specialists such as Castle Hall. However, due diligence practices evolve and should always be forward looking: good due diligence shouldn't be like airport security, always over-reacting to every problem. Overall, the key to effective due diligence is to consider, both objectively and subjectively, the aggregate business risk of each manager. Indeed, we feel 'business risk due diligence' is a better term for the process, as investors should think very broadly about the business strengths and weaknesses of each manager's organisation. This extends the scope of due diligence significantly beyond the fine detail of operations and accounting.

Q HFM: THE REGULATORY CLIMATE HAS INTENSIFIED – HOW HAS THIS AFFECTED THE ROLE OF SERVICE PROVIDERS?

A CA: We are moving to the next stage of the regulatory process. While politicians in the US have passed Dodd Frank, and Europe has issued the Alternative Investment Fund Managers Directive, everyone now has to figure out how these extremely broad pieces of legislation will be implemented. On the US side, we also have the new Form PF and Fatca tax avoidance legislation, and the new Ucits IV rules in Europe. Against this background, service providers will face both new challenges and opportunities. Fund administrators will be impacted heavily by new demands to gather and manipulate data, but this new environment also requires better compliance support, impacts technology and may require new fund structuring and legal solutions.

Q HFM: HOW HAVE INVESTORS RESPONDED TO YOUR DUE DILIGENCE SERVICE OFFERING?

A CA: From inception, Castle Hall has offered a due diligence solution which focuses only on operational (or should I say business) risk, and offered our services only to investors and not managers. This un-conflicted

model has great appeal to investors. Looking forward, we are also about to conclude due diligence on our 1,000th individual fund, which creates the experience across funds of all sizes, strategies and locations which is critical for allocators.

Q HFM: HOW IMPORTANT IS DUE DILIGENCE IN YOUR RANGE OF SERVICES PROVIDED?

A CA: That's an easy question – it's all we do. We don't run money or build portfolios, so we never have to grapple with whether to approve a fund which has great performance but weak operations. This helps us be objective and reassures investors that we offer a process and viewpoint which is aligned with their interests.

Q HFM: WHAT ARE INVESTORS MOST CONCERNED WITH WHEN CARRYING OUT DUE DILIGENCE? HOW DO YOU SUCCESSFULLY TARGET THIS?

A CA: I'm showing my age if I say I started my career with my first job as an auditor more than 20 years ago. That initial training, though, taught me that any investment company only has two core risks, existence and valuation. If you can become comfortable that a fund does own what it says it owns, and that portfolio assets are worth what the fund says they are worth, you have answered the two questions of primary concern for investors. Obviously,

“ WE SEE NEW INTEREST TO EXPAND OPERATIONAL DUE DILIGENCE BEYOND HEDGE FUNDS ”

CHRISTOPHER J. ADDY

asking those questions can be a lot easier than answering them, but focus on custody controls and counterparty risks, together with a very detailed examination of valuation policies at both manager and administrator, are critical.

Q HFM: WHAT CAN YOU SEE THE NEXT 12 MONTHS HOLDING FOR DUE DILIGENCE AND HOW IT IS CARRIED OUT?

A CA: Due diligence continues to evolve. As a challenge, we are disappointed by a new trend for some fund administrators to try to reduce due diligence transparency. It obviously affects independence if an administrator will only answer due diligence questions in writing – with those responses vetted and pre-approved by the manager. As a development, we see significant progress in the area of corporate governance, with both investors and directors working to increase the quality of governance oversight. Finally, as an opportunity, we see new interest to expand operational due diligence beyond hedge funds. An increasing number of institutional investors are beginning to subject their private equity managers to similar ODD scrutiny. This can only help enhance business standards across the alternative investment industry as a whole. ■