

# CASTLE HALL ALTERNATIVES



The New Standard of  
**OPERATIONAL DUE DILIGENCE**

Five principles to guide best practice

## ABOUT CASTLE HALL ALTERNATIVES

Castle Hall is the hedge fund industry's leading provider of operational due diligence. Our clients include institutions, fund of funds, endowments and family offices who rely on Castle Hall to evaluate whether hedge fund managers meet operational best practice. Our shared goal is to avoid the penalty of uncompensated operational risk, or "Risk Without Reward".

The founding principle of Castle Hall's business is independence. We do not manage assets, perform investment analysis or recommend funds based on investment performance. We therefore avoid any "investment versus operations" conflict: irrespective of the investment case, we provide an objective assessment of each fund's operational quality.

Unlike many consulting firms, Castle Hall has also chosen not to sell services to hedge fund managers. We do not audit hedge funds, provide valuation services, act as a compliance consultant or sell legal advice. As such, Castle Hall is never faced with the conflict of performing due diligence on its own work. Instead, we are proud to offer a unique, unconflicted model which directly aligns our interests with our clients.

Castle Hall's team brings together more than 30 years of operational due diligence experience, representing significantly more than 1,000 due diligence reviews. This unrivaled experience provides the knowledge base which underpins each Castle Hall operational assessment.

## THE NEW STANDARD OF OPERATIONAL DUE DILIGENCE

Five principles to guide best practice

As the dust from the global financial crisis begins to settle, investors realize that the entire business of managing money has changed. This is especially the case for the hedge fund industry, which, humbled by poor returns, an inability to return investors' money and an outbreak of "Ponzimania", faces a new and tougher reality.

After the events of recent months, investors are beginning to re-examine their current and potential relationships with hedge fund managers. Many aspects of hedge fund investing are under review, from the "2 and 20" fee structure, to side-pockets and lock-ups, to transparency and the age-old argument of funds versus managed accounts. There is also an overdue discussion of regulatory oversight in the wake of Madoff and other frauds.

The common theme across many of these issues is that they are driven by hedge funds' operational and business risks, not investment strategy and performance. For hedge fund investors, therefore, one of the key lessons of the financial crisis is that the evaluation of operational risk is now vital, not optional. Operational due diligence can no longer simply be ignored or treated as an afterthought once the investment decision has been made: investors must carefully investigate the operational quality of each and every manager in their portfolios.

In October 2008, Castle Hall Alternatives published its first White Paper, Hedge Fund Investing in a New World. We asked a number of questions, including whether 2 and 20 was fundamentally flawed, whether funds needed better corporate governance, whether there was an "expectations gap" in the administration industry and whether fund offering documents should protect the manager or the investor. With the luxury of hindsight, it seems as if these issues resonate even more: the fine print of fund offering documents, for example, suddenly became significant when investors found they couldn't access their money due to gates, NAV suspensions and fund restructurings.

In our latest report we take these themes a step further, setting out five core principles which will guide the "New Standard" of operational due diligence. What will this entail, and how can investors successfully navigate the new hedge fund landscape?

## THE THREE RULES OF DUE DILIGENCE INDEPENDENCE, INDEPENDENCE AND INDEPENDENCE

Madoff, together with WG Trading Co., Nadel and an unfortunate list of smaller “blow ups” has shone a new light on hedge fund fraud. This is not to say that all hedge funds are fraudsters: indeed, it is hard to find evidence that fraud is any more prevalent in hedge funds than in other areas of the asset management industry. What is true is that, during the hedge fund “bubble”, many managers enjoyed only capital inflows and never had net redemptions. The reversal of fortune as investors asked for their money back has revealed that some firms were simply running Ponzi schemes.

The lingering question – particularly in the case of Madoff – is why multiple, reputable investors seem to be caught in each big fraud. We are the first to admit that no due diligence process can be infallible: a fraudster who is able to maintain a sham investment strategy over a sustained period is probably a very good liar, and it is certainly possible to fool, in the old adage, some of the people all of the time. Nonetheless, the flood of recent frauds has created an uneasy sense that the gatekeepers tasked with due diligence have not always done the job they were paid to do.

The insurmountable problem is independence, and specifically the conflict between investment returns and operational risk. It is self-evident that asset managers need to generate performance, as it is performance which allows the payment of incentive fees, and it is performance which attracts (and retains) client capital. The role of the investment team, therefore, is to find funds which will generate good returns, as good returns drive the very survival of the business.

Compared to investment analysis, the role of operational due diligence is completely contrary: put simply, it is our job 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 the potential operational problems?

This conflict means that it’s suddenly critical to conduct due diligence... on the due diligence. When evaluating an in-house due diligence program, investors need to determine if the operational due diligence process is meaningful or whether it is actually nothing more than a marketing story. Is there even an operational due diligence process in place? If there is, is there a separate operational due diligence team, or is the work completed by investment analysts (paid based on investment performance)? Does the operational due diligence team have a veto – can they say no? If they can, have any managers actually failed the due diligence process? Have any funds ever been removed from the portfolio because of operational deterioration?

Investors must also dig deep to understand how the asset manager’s due diligence process works in practice. How many people are on the due diligence team (full time, not an inflated number of part time “equivalents” or a “resource network” of ad hoc consultants)? Is that number sufficient, given the number of funds under review? Are the members of the operational due diligence team experienced and knowledgeable, of equivalent seniority and stature as the investment professionals – or are they junior analysts? When does the operational due diligence process begin – is it only after the CIO has already committed to invest? Does the due diligence team visit all funds, and are all of those visits completed before investment? Does the due diligence team look at each specific fund, or do they simply “pass” the manager? Thereafter, how often does the operational due diligence team update its work?

In our view, the investment process should be clearly segregated from operational analysis. In this way, the operational due diligence team can focus solely on its role as a watchdog, remaining agnostic as to performance and strategy. The New Standard of due diligence, therefore, will require independence, experience, and proof that operational analysis has an impact on portfolio decisions.



## DUE DILIGENCE IS JUST AS IMPORTANT ON THE BIGGEST AND THE BEST

Madoff was an astonishing fraud, not only in terms of the sums involved but also for the number of years over which the fraud was sustained. Madoff was, quite simply, a criminal who took advantage of a perfect confluence of circumstances – he conducted his crime in an industry which not only had colossal sums of money, but was also prepared to accept that certain managers did not have to explain anything about what they were doing.

The lesson for investors is obvious: irrespective of the manager in question, it is emphatically necessary to complete robust, detailed due diligence. It will no longer be possible for any investor to have a "list B" of certain managers who, because of tenure, reputation or length of personal relationship, are allowed to provide less information.

This new reality will have a number of implications for the hedge fund industry. One is that all managers – even large and successful ones - will need to provide a new degree of operational transparency. This will require a marked change in attitude for some firms who, to date, have been happy to push back on investor requests for better information.

Madoff should also remind us that every Ponzi scheme exploits a fatal flaw in investors' psychology: investors always seem to 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.

## OPERATIONAL DUE DILIGENCE IS ABOUT MORE THAN OPERATIONS

Traditional due diligence has 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). To be effective, operational due diligence needs to consider much more than the "nuts and bolts" of accounting and reconciliation. The New Standard of due diligence will require investors to think broadly about the overall quality of each manager's business, including each firm's culture and operational philosophy. This is unavoidably subjective, is often difficult and requires much more experience – yet is vital if investors are to have a true understanding of the risks of each manager in their portfolio.

At Castle Hall, our due diligence process is divided into four areas: the management company, the fund itself, the service providers and finally the operational controls and procedures. Due diligence issues may be individual and specific, or they may be a combination of observations across different areas.

In each due diligence review, Castle Hall carefully examines core accounting controls. Issues considered include the trade cycle (authorization, execution, confirmation, settlement and reconciliation); custody, prime broker and counterparty arrangements; and valuation. Equally, however, we look at broader business risks such as financial viability, growth, and the manager's business plan for new products and new personnel. We examine, for example, insider investment and the alignment of interests between the investment professionals and external shareholders. We are also concerned by "softer" issues such as excessive staff turnover and the caliber and experience of the CFO and back office team.

In our view, the purpose of an effective operational due diligence review is not to complete a mini forensic audit focused only on checking reconciliations. Rather, an experienced due diligence team can provide a far more valuable evaluation of the manager's entire business. It is the business which is the structure within which a manager can generate attractive returns: without a strong business, managers will fail to deliver optimal performance.

## DUE DILIGENCE REQUIRES JUDGEMENT, NOT A SCORECARD

When applying the New Standard of due diligence, investors will need to apply judgement, not a simple scorecard, to assess operational risk. Every review presents a different “balance sheet” of operational strengths and weaknesses and, for every list of 100 standard questions, most funds seem to have a 101st - if not a 151st – issue to consider. While some due diligence practitioners 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 spurious back office costs to the fund in addition to the management fee; perhaps the firm’s compliance procedures spend more time on justifying exceptions than on enforcing rules; perhaps the manager has gone above and beyond to ensure that the fund’s offering documents allow flexibility “in the sole discretion of the investment manager”.

Individually, these issues may not be overly significant, but, collectively, can help investors understand how each manager views its business and its relationship with investors. These insights can be especially useful in times of stress, as how a manager behaves when times are good is usually the best sign of what will happen when times are bad. One of the lessons of the recent crisis is that managers who were unduly impatient and unhelpful in 2006 and 2007 were, quite consistently, those firms who appeared to protect themselves ahead of their investors at the end of 2008.

## ONGOING DUE DILIGENCE IS VITAL YOU DON'T ONLY CHECK ON THE WAY IN

One of the biggest errors in operational due diligence is to review a manager only at the time of initial investment. Once a fund has “passed” due diligence, investment teams have often been quick to assume that all operational issues have been resolved and that, once a fund is in the portfolio, only performance matters.

When applying the New Standard of due diligence, systematic, ongoing due diligence is as important as the initial review. Once more, events of recent months have demonstrated how quickly the operational rules can change, particularly during the crisis of gates and restructurings. Going forward, many managers face entirely new business challenges due to new regulations, redemption pressure and no opportunity to earn incentive fees if they are under their high water marks. How these managers will run their businesses to navigate the coming 12-24 months is just as important as their investment thesis.

Even when times are more stable, ongoing due diligence is essential. 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. Some managers will always be at the leading edge, while others will fall behind their peers and competitors. Funds also update their offering documents, change service providers such as the administrator, and have turnover in key roles such as the CFO and COO. Each of these events must be evaluated on a timely basis.

A final change relates to accounting standards. To date, much of the discussion related to the new fair value standard, FAS 157, has focused on the valuation methods used by underlying managers. There has been less emphasis, so far at least, on the fact that many fund of funds and institutional investors are themselves subject to FAS 157. When preparing their own financial statements, investors must now demonstrate to their auditors that they understand the valuation process applied by each underlying fund. This can become a significant challenge when funds hold harder to value securities, especially as different managers may use different valuation procedures for similar instrument types. Current audit guidance, therefore, now requires that investors evaluate – and potentially challenge - each manager’s pricing process as part of the internal controls which underpin each year’s financial statements. Without a thorough, ongoing due diligence process, investors will find it increasingly difficult to conduct their own audits.

## CONCLUSION

We continue to have great confidence in both the validity and the resilience of the hedge fund industry. Despite recent poor returns and an unfortunate wave of frauds, the majority of hedge funds do what they advertise: provide uncorrelated returns in varying types of market conditions. After the decline of broader equity markets, institutions have an ever greater need for diversification, and hedge funds will invariably be an asset class that can provide it.

What will fundamentally change is the way in which investors allocate to hedge funds. The financial crisis has reminded us all that, at its heart, hedge fund investing is not easy. Funds are often small, private companies, yet trade high volumes of sophisticated and hard to price securities. This is not a one size fits all industry and hedge funds are not an investment where there is a short cut to hard work and experience.

Going forward, investors will be more conscious of both the importance of operational risk and the need to conduct effective and vigilant operational due diligence – in practice as well as on paper. Future due diligence will be independent, will be consistently applied and regularly updated and will place a premium on judgment and experience. This is the New Standard.



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