Doing the due diligence detective work

Ask the questions and then trust your gut instinct, say the authors of Greenwich Roundtable White Paper

By Niki Natarajan

As more and more investors are thinking that investing directly will save them money, few stop to consider the true value of their investment of time and energy: is it really worth it? Funds of hedge funds continue to get bad press but what few of the nay sayers fail to recognise is that what the good ones offer just in terms of due diligence — if you were to break it down into cost per hour — would be a bargain.

Eighteen months ago professional due diligence was estimated to cost between $50,000 and $100,000 per manager, and now that more and more time is being spent on due diligence and follow up due diligence post the initial investments, these costs are unlikely to fall.

There is an alarming trend, however, which some of the best fund of hedge funds managers are starting to find; namely that investors are starting to lean on their funds of funds to provide outsourced due diligence. Some of the larger investors are also taking advantage of the recent market turbulence to add to their list of requirements that these funds of funds also negotiate lower fees among underlying managers for their direct allocations.

This might look like a smart use of their funds of funds resources, "more bang for my buck," as one investor says, but it is a short term game. Funds of funds will work for money they get paid for, and are unlikely to invest unnecessary effort where they are being squeezed. When the cycle comes full circle: namely that the big hedge funds grow so big that their fail to perform; it will be those that invested in deep due diligence and have the skill set to discover the gems that will win the performance fee game.

Illustration: Shonagh Rae

But for those that are electing to invest directly and not take undue advantage of their fund of hedge funds providers, the latest Greenwich Roundtable on Best Practices in Alternative Investments focuses on what due diligence questions to ask. While it reads well for a novice investor, any experienced due diligence expert will tell you it is just the tip of the iceberg in terms of the questions to ask and procedures to follow. But it does a good job to show that due diligence is not easy and requires a lot of time and effort (on an ongoing basis) that most give credit for.

Few remember that funds of funds when paid as discretionary managers take responsibility for their decisions and their businesses live or die by their due diligence. For now the trend to lean on existing funds of funds to provide due diligence for direct allocations is a short-term game, given that a funds of funds will focus on business that is paying them proper fees.

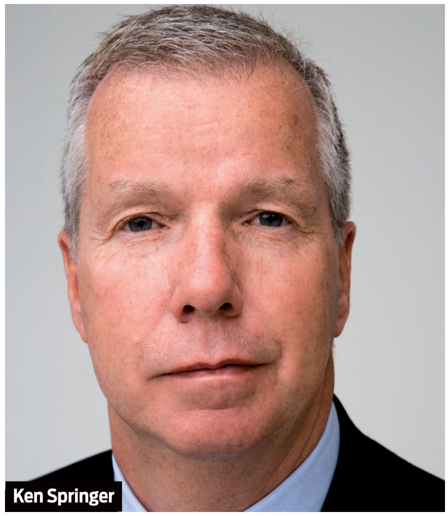
The Greenwich paper reflects the thinking of a diverse group of 15 contributors, including Ed Barksdale of Federal Street Partners and chairman of the Greenwich education committee, Brijesh Jeevarathnam of Commonfund Capital, who gave inside information on illiquid investing, Jennifer Keeney of Tatanka Asset Management, who drafted the sections on operational due diligence and Ray Gustin of Drake Capital Advisors, who gave valuable insights into hedge funds.

The white paper has been written entirely from the standpoint of the investor — any investor — to help them understand complex investments and to identify the best alternative managers. Crowded investments, performance, lack of recognised service providers, fees and liquidity are just some of the areas investors are spotting as 'red flags', according to the Greenwich Roundtable, which has been edited by Rusty Olson, former director of pension investments for Eastman Kodak Company.

Other red flags are overly consistent performance, fees that are excessive in relation to a manager's skill or track record, no cohesive business plan, highly volatile returns and no independent risk management function as well as liberal gate provisions and lack of fee incentive alignment.

Madoff was the catalyst for a number of events in what is now often called the post-Madoff era. Firstly, due diligence has been a growing area of interest among investors and with it the level of detail required by investors and their investigations are growing in scope.

Secondly, many investors, largely the funds of funds such as EIM, are upping their due diligence game. EIM, which has had its fair share of headline grabbing investments, including Madoff, has even gone as far as spinning its due diligence out from its risk management division and has recently hired John Ward for the newly created role of head of operational due diligence.


Ken Springer

And thirdly, a number of detective agencies, such as Corporate Resolutions, a New York firm founded by former FBI agent Ken Springer, and Corgentum Consulting, a hedge fund operational due diligence firm, are now increasingly being hired to assist in the process.

A study from Corgentum found that as a result of recent frauds and Ponzi schemes, the Madoff effect has altered the nature and scope of investor due diligence. Corgentum found that in anticipation of stricter hedge fund regulation, funds of hedge funds are focusing the bulk of their due diligence efforts on legal, compliance and regulatory risks.

The focus on frauds such as Madoff are important, but is potentially misleading for investors conducting due diligence. For example, since the Madoff scandal broke, the study shows that the number of funds of hedge funds reviewing cash management policies and controls has increased by almost 60%.

Meanwhile Corporate Resolutions recently expanded its due diligence services to investors and signed on its first pension fund client. The firm, which currently has 20 funds of fund clients, has gone as far as to launch the Ethics Hotline, as a vehicle for hedge fund employees and others to anonymously report illegal or unethical activity to an independent third party.

The advent of such in-depth due diligence does have side effects. The time it takes to do due diligence on managers these days is delaying investments quite considerably. Those new to the hedge fund investing game are starting to find that the good funds are closed by the time they finish their paper work

The whistleblowers hotline is available 24 hours a day and seven days a week. Complaints are ultimately brought to the attention of outside counsel or an outside investor and are jointly vetted by counsel and Corporate Resolutions to assess and properly resolve the issue.

According to Springer, author of *Digging for Disclosure: Tactics for Protecting Your Firm's Assets from Swindlers, Scammers, and Imposters*, hedge funds and their counsel are interested in setting up hotlines as a self-compliance tool available to employees, prime brokers, fund administrators and their accountants to contact the hotline to report anything unethical relating to the fund.

The book itself is a compilation of Corporate Resolution's casework and illustrates why investors need to know more about managers before they ink a deal and what can happen if investigative steps are bypassed. Specific information relating to Madoff and Stanford cases is also used to show how those Ponzi schemes could have been avoided.

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Other areas that have attracted increased attention from investors doing due diligence include transparency in reporting and the role of service providers such as auditors and administrators, according to Corgentum. But less than 2% of funds of funds included in this study considered the independence of a hedge fund's board of directors during the due diligence process.

The Corgentum study also pointed out that the other areas that have been overlooked are information technology infrastructure, personnel turnover and the quality of overall operations management.

Experienced hedge fund managers also often prefer to invest their time in investing rather than answering questions that can easily be answered by a little pre-meeting research, which is another reason why the breadth and scope of the recent Greenwich Roundtable white paper is perfectly timed.

The Greenwich Roundtable, which is a not-for-profit research and educational organisation for investors who allocate capital to alternative investments, has 150 members comprised of mostly institutional and private investors, who collectively control $4.5 trillion in assets.

The high fee structures of hedge funds attract investment managers of all levels of competence and integrity and can give them heightened incentive to take undue risks, or even to cheat, the Greenwich survey found. Firms can fail not only as a result of poor investment performance or fraud, but also for non-investment-related reasons, such as poor risk management, weak operations, compliance gaps, and promising too much liquidity to investors.

The only defence against the dark arts of fraud, lack of integrity, cheating, and cutting corners, is due diligence both before investing and after the investment was made. Madoff could have been prevented if the red flags had been heeded, but the collapse of Amaranth Advisors was about style drift that snowballed out of proportion.

The Greenwich document is divided into five chapters. Chapter one discusses the due diligence process and covers the types of questions, but by no means offering an exhaustive list, an investor should ask when considering any kind of alternative investment programme.

Much of what is said in the Greenwich Roundtable report on due diligence is common sense and what many already do as standard practice, but the alternative industry has been dogged with a lack of transparency and complicated jargon for so long that what is intuitive sensible due diligence research behaviour in, for example, buying a house, seems to have been in the past forgotten when buying hedge funds.

Subsequent chapters provide additional questions tailored to each kind of alternative investment, with chapter two covering due diligence questions on hedge funds; chapter three covers due diligence questions on specific hedge fund strategies; chapter four is on the questions for illiquid strategies such as venture capital, mezzanine capital, natural resource funds, including mining, energy and timber funds; and chapter five is a short chapter on funds of funds, both hedge funds and private equity multi-manager funds.

A number of hedge fund managers already have due diligence questionnaires (DDQs) to help prospective investors, and for those that do not currently have one, the 74-page Greenwich Roundtable white paper is in-depth enough to serve as one.

These days there is no excuse for managers not to be prepared for due diligence questions, or for any investor not to know what to ask or what to look for when they talk to hedge funds as the Alternative Investment Management Association has both a number of guides to sound practices, as well as illustrative due diligence questionnaires on its website.

DDQs typically benefit hedge fund managers in two ways, says the Greenwich report. Firstly they demonstrate to investors that the manager understands their needs and is prepared to answer candidly all the hard questions investors should ask. And secondly it would reduce the time the managers would have to spend with prospective investors by responding to most of their questions before they can ask them.

Kevin Gundle

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To be seen as a serious and knowledgeable investor is important and pre-meeting preparation such as collecting all available information (marketing materials, offering memorandum, subscription agreement, DDQ and published information in the trade press and databases) as well as any recent manager's letter or performance report, is essential says Greenwich.

Like any pre-meeting preparation, the quality of the new information that comes out of the meeting is directly proportional to the quality of the investor's preparatory work, according to Greenwich. Experienced investors often try to gain responses to the additional questions applicable to a particular manager by asking them of the manager in writing prior to the meeting.

Managers receive a large number of investor questionnaires. They cannot be blamed for shunting aside ‘canned questionnaires’, standard forms that an investor may send to all prospective managers, say the authors of the Greenwich report. “To gain the manager's attention, and to let him know that we are serious, we should include only those questions that cannot already be answered from available printed materials. This is a lot of work,” they add.

The authors say that for an investor, the objective should be to receive a written response to their questions. A written response is most valuable because it is far more concrete than the ephemeral spoken word and it is more accurate than whatever notes are taken in conversation. A manager, however, may decline to put his answers in writing. He may be willing to answer them over the phone or even wait until a meeting to respond.

It is possible that the manager may be limiting the amount of time he is willing to spend on matters not directly related to managing his portfolio. Conversely, he may not want to be pinned down on the facts, and if so, it raises a very important question as to why. If the manager offers a telephone response, one way to avoid misunderstandings or misinterpretations is to send the manager a copy of the notes about his verbal responses and ask him if they are correct.

Experienced investors sometimes draft their own summary of the manager's investment approach in 100 to 200 words, using their own words as this helps to focus on what distinguishes this manager from other managers in his category, what is this manager's edge or unique approach? A manager's advance response to questions may lead to follow-up and more probing, qualitative questions, which should form the agenda for the first meeting.

Much of the initial meeting may be with the fund's director of client services, but quality time should also be spent with the chief investment officer or senior portfolio manager. An unwillingness to meet, especially after an in-depth conversation, is an indication that investor may not be important to the manager, or that the manager has something to hide, as was evident in the behaviour of Bernie Madoff towards his many investors.

Following this first exploratory meeting, a good practice is to hold a brainstorming session, to harness the intuitive insights of the team and identify alternative opinions regarding the investment opportunity. Intuition plays a large part of the very first stage of hedge fund research. Indeed, Aurum Fund Management is known to suggest to its analysts to read Malcolm Gladwell's book *Blink*, to understand the power of the first impression.

That said, neither Aurum nor any other firm serious about due diligence can rely just on this. Experience and knowledge is then used to find out what is giving rise to any negative intuitions and only then, if the manager comes up well in the initial meeting, can the process of due diligence really begin.

Reference checking is critical and so too are independent references. “The longer you have been in business — the better access you (should) have to thousands of old PowerPoint presentations and org. charts that give you a good insight as to where people have come from and where they have been," says Kevin Gundle, founding member of Aurum Fund Management. Aurum has even gone as far as having systematised the search function for independent references going back more than 16 years. "Operational due diligence must be manned by 'strong' personalities — who can exercise a veto and where this cannot be overturned by rank," Gundle adds.

Once the decision has been made to go forward then the due diligence work has only just started. The next stage outlined in the Greenwich report is how to look closely at the areas of operational due diligence. That said, even if a manager passed the operational due diligence, putting the fund in the portfolio needs to be about how it fits into the overall portfolio in terms of strategy and risks, all of which have to be assessed before any more work is carried out.

A good way to ensure that all the bases are covered properly is to speak to the relevant people in charge of different functions. The Greenwich authors believe that a very valuable non-verbal clue to a firm's credibility is when one person insists on addressing all topics rather than providing access to the team's individual experts. "If key people are not available to participate in the due diligence process, we should proceed with caution," they add.

Another red flag is everything looking too good to be true. "We can't assume that a sense of comfort with the manager translates into a pristine past," say the Greenwich authors. Was there a disciplinary action, an inconsistency, or a misrepresentation in the manager's CV? Are there details about the manager's personal life that cause concern? These are all questions that need to be addressed.

Even if nothing negative surfaces, gut instinct may still raise red flags. Red flags can often be corroborated or dismissed by interviews and references. Talking to other investors can often help, although the experiences and impressions of others can only be a small part of the pool of information.

A good due diligence exercise needs to triangulate multiple sources of diligence to see if it all adds up. The process should include channel checking, internet searches, and outside investigative reports. There is no substitute for speaking with a wide range of sources who can provide insights from different perspectives, say the Greenwich authors.

It may sound very basic, but as alternative investments are often complex, no-one should invest in anything they cannot understand or that the manager cannot explain in understandable terms. Just as in journalism, there is no such thing as a stupid question (assuming the appropriate homework has been done). Before even considering investments, do the investors feel comfortable with their level of understanding of the strategy and risks? Can they explain it well to others?

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If this all sounds like a cookie-cutter checklist, it can never be just that, says the Greenwich Rountable report. Ultimately, due diligence is an art. Participating in private investment funds is about investing in people rather than in an asset class. It's about uncovering unique skills.

Global economies are dynamic, individual markets that are constantly in flux, and alternative fund organisations are not static. Individuals change over time. They respond differently to evolving situations and incentives. Every organisation and strategy has its own series of investment and operational risks. No due diligence questionnaire can cover all such risks, much less produce a definitive yes-or-no answer to investment opportunities, say the Greenwich authors in conclusion.

Aside from the due diligence questions themselves, the more existential questions are also never ending: How do you balance facts with a gut feeling? How do you balance negative information with the desire to do a deal? Do you feel pressured to make an investment? Is this a "hot" manager? Has enough time been given for due diligence? Does the manager respond patiently and candidly to the continuing questions? Can you trust this manager?

Are there hints of concern about integrity, ego, arrogance, pride, complacency, carelessness, excessive optimism, or personal difficulties? Are you really prepared to be this person's partner? Do you believe the manager is truly committed to the fund and its investors? And assuming the personal investment objectives are the same as the firm you are working for, would you put a similar portion of your personal wealth into this investment?

Ultimately, due diligence is a human exercise. One often needs to judge individuals and organisations based often on limited exposure. "We must discipline ourselves to constantly examine and reexamine our assumptions and conclusions. Then, rather than dismissing the importance of intuition, judgment, and experience, we should embrace their value in financial and operational analysis. Intuition is really a form of common sense, so we should pay attention to our gut feeling," say the Greenwich authors.

In the final analysis, all decisions about investment opportunities are judgment calls. Judgments honed by proper due diligence, however, should not only help to avoid mistakes but also identify opportunities likely to provide superior returns. As Sherlock Holmes said to Dr Watson in *The Sign of Four*, "How often have I said to you that when you have eliminated the impossible, whatever remains, however improbable, must be the truth?"