DUE DILIGENCE – WINNING OVER THE INVESTOR

CAPITAL IS INCREASINGLY HARD TO COME BY FOR FUNDS, ESPECIALLY WITH THE UNCERTAINTY SURROUNDING HEDGE FUNDS STILL RESTING HEAVY ON INVESTORS' MINDS. **JASON CHOLEWA**, OF **ALPS**, DISCUSSES THE QUALIFICATIONS A FUND NEEDS TO MEET TO PASS THE ALL-IMPORTANT DUE DILIGENCE STAGE

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After the financial crisis, a vacuum of new capital investments in alternative products left the industry in a precarious state. Uncertainty in the market and economy combined with the shock of unexpected gates and lock-ups left investors weary of the seemingly infallible hedge fund product. New and emerging managers struggled to find any institution interested in placing capital in a pooled investment vehicle.

Fortunately we've seen a reversal in this sentiment. As investors become more comfortable and find hedge funds to be invaluable parts of their portfolios, capital is once again returning to the industry. While the vast majority of that capital is being placed with large, established investment advisors, a growing amount is being allocated to emerging managers. Competition for that capital can be fierce and as a result, allocators have increased their scrutiny during the due diligence process. So the logical question arises: what key elements does an emerging manager need to abide by in order to attract this scarce capital?

The first and potentially easiest pitfall to avoid is to ensure everyone in the firm has a consistent story. Time and again we've heard tales of well-performing portfolio managers explaining the strategy, investment style, and even the structure and vision of the company in complete contrast to the chief financial officer, business development professional, or some other forward facing executive. This kind of inconsistent story is an immediate red flag for an allocator. It creates confusion for the investor and instills a sentiment that one or more key individuals are either incompetent, or that there is a general culture of miscommunication. Regardless of the cause, any one of these reasons will usually cause an investor to become uncomfortable with making an allocation.

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Another major concern for allocators is scalability. The investors have to ask themselves what will happen to the portfolio composition if a large allocation is placed. If the current positions and trades made within the portfolio would be different were the fund to be three, four or even five times the size, then there could be a problem. This is concerning for allocators because it indicates there may be style drift as the fund grows. If the allocator thinks they are making an investment in a small-cap equity fund, they don't want this strategy to significantly drift to a mid-cap equity fund, since that may be the only place a fund of this larger size can find any opportunities to generate alpha.

SERVICE PROVIDERS

Engaging the appropriate service providers is crucial when presenting the investment vehicle to potential allocators. The fund's service providers need to be reputable, have expertise in the investment strategy being used, and maintain independence.

These firms should have reasonable name recognition. If the fund is being serviced by an unknown administrator or a relatively small accounting firm, allocators may have some concerns as to the expertise of the service provider and possibly the firm's sustainability. With that said, being well known is not in itself sufficient for an allocator to 'check the box' these days. Even if the firm is well known, lacking the expertise in the specific fund strategy could be equally harmful. A law firm that focuses on fund creation of fairly standard long/short equity funds may not be the best firm to engage with if the fund is going to be heavily investing in real estate.

One area of focus during the due diligence process that has been consistent over the past few years is the mechanics of back office support. Allocators want to find a robust process in place, which has appropriate checks and balances. The relationship between the manager, administrator, and prime broker or custodian, and how the information is flowing is a key point of interest for the allocator. During the due diligence process, the investor wants to ensure there is a proper reconciliation between the broker's execution of trades and what the manager thinks should have been executed. There tends to be a preference among allocators to have a third party (the administrator) conduct that reconciliation. In the past, or currently with much smaller funds, the chief financial officer (CFO) may conduct that reconciliation and the administrator may not be given access to the trade orders, instead only receiving trade information directly from the prime broker. This kind of setup may have been acceptable several years ago and may be suitable for small non-institutional funds today, but as those funds grow, the dynamics of this process need to change.

In a similar vein, it is important for the manager to mirror or shadow the books of the administrator. Blindly accepting the NAV issued by the service provider is, for obvious reasons, frowned upon. The degree of the shadow accounting can greatly vary. Some managers choose to engage a second back office service provider to shadow the primary administrator. Other managers have teams in place that perform this function internally. Whatever method is selected, the outcome allocators want to see is a robust process where the manager can accurately and timely detect errors. A cursory review of the NAV by the CFO will not likely be found sufficient during the due diligence process.

Allocators will look for the administrator to have a dedicated pricing team as well as a current SSAE 16 (formally SAS 70), which in short, attests the controls of the organisation are sufficient. These are easy 'check the box' qualifications the administrator should bear, which helps reduce back office questions during the due diligence process.

Avoiding conflicts of interest and maintaining service provider independence is extremely important to allocators as well. Some examples of independence issues can be as blatant as a manager who makes a direct investment in their administrator, to something as seemingly harmless as a familial connection to the engaged accounting firm. It is critical that these conflicts be addressed in a reasonable manner. It may not be necessary to find a new accounting firm, but a simple solution where the family member avoids all assurance/tax work on the manager's products could be an acceptable solution.

Counterparty risk is a hot topic as well. With investment bank collapses like Lehman Brothers and continued uncertainty in the financial health of various firms around the globe, spreading the fund's assets across multiple prime brokers/custodians is a sought after approach to mitigate this risk. Allocators may be uncomfortable with seeing all the fund's eggs in one basket. Although it is appealing to some managers to concentrate assets in order to get better financing terms, this economic payoff is usually viewed as shortsighted by allocators.

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THE INVESTMENT MANAGEMENT COMPANY IS A BUSINESS

The last point that tends to be missed by many managers is that the investment management company is a business that needs to be sustainable. Allocators want to ensure that the revenue raised through management fees can adequately cover daily company expenses including infrastructure, costs, and personnel. If the financials of the business are unhealthy, it can almost be a guarantee that institutional investors will have a hard time committing to an investment in any of the products. In summary, performance is not the only factor that will attract institutional money. The manager needs to have a concise and consistent message backed by a sound infrastructure with quality service providers. Both the investment strategy and the management company need to be sustainable entities that can be viewed from an allocator's perspective as a long term investment. Following these principles will allow a manager to attract and retain institutional investment from a due diligence perspective. ■