OPERATIONAL DUE DILIGENCE

Avoiding pitfalls and adding operational alpha to emerging manager investments

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Introduction

Since the 2008 financial crisis, operational due diligence professionals have experienced better access to and transparency from hedge fund managers. However, some established managers have yet to adapt to the new world, and often emerging managers are overly focused on cost saving measures. It is critical for emerging managers to deploy enough human and operational capital in building a robust, institutional business. We work collaboratively with our managers to understand their needs whilst guiding them on best practices. Managers who work proactively with investors will not only strengthen their own organisation, but also enhance their chances of raising capital. To build trust early with a manager, full transparency is paramount to investors.

In this paper, we explore some of the pitfalls which can be avoided and how operational alpha can be created across hedge fund managers. We will start the discussion with a focus on emerging managers and how some key concepts can optimise their chances of success. We will then review some of the innovative trends which have gained traction with emerging managers. Finally, we will examine some recurring operational challenges we continue to encounter in the hedge fund industry.

Section 1 – Emerging Managers

APPOINTING THE RIGHT BUSINESS TEAM ON DAY ONE

A manager launching with less than USD 100m will have a limited budget to hire a seasoned operational team with proper backup in place. Having said that, it is essential to have a dedicated, experienced COO on day one to construct infrastructure, establish appropriate processes and supervise operations across the wider business. Unfortunately, this is not always the case. We still encounter managers who opt for a cost effective solution, such as appointing a junior COO or in some extreme cases splitting the function across different partners. We are a strong advocate of appointing a resourceful, experienced COO who is dedicated to the growth of the business. It is important to highlight that the COO may not have previously worked with the investment team. A crucial part of the operational due diligence consists of assessing whether this person is the right personality fit and will have sufficient authority to operate independently from the CIO. It is our preference for a COO to have an equity or shadow participation interest, as it demonstrates that the founding partners take the function seriously and are willing to empower the COO.

We look for businesses which are adequately resourced. It is important that the COO is, at least, seconded by an operations analyst to provide sufficient redundancy coverage and to maintain a clear segregation of duties with the investment team. As part of our onsite visits, any operations backup staff should be able to demonstrate their ability to provide redundancy coverage across back office and valuation functions.

The value that an experienced, independent COO brings to an emerging manager is sometimes underestimated

ENSURE THE RIGHT ALIGNMENT OF INTERESTS

The correct alignment of interests between founding partners, staff and investors works to everyone's benefit. Before investing we require that founding investment partners invests a substantial portion of their liquid net worth in the fund.

We still meet managers with no deferral mechanisms in place. This is less of a cause of concern when the principals have significant amounts of their personal liquid net wealth in the funds and firm equity. We like managers who have implemented mandatory investment plans, whereby portfolio managers and senior operations staff receive a portion of their discretionary bonus in deferred compensation. Most have implemented a threshold above which the deferral kicks in. Such deferrals are usually reinvested in the funds.

It is of note that some managers are not against a deferral mechanism per se, but appreciate that there are tax complications and younger members of staff have greater liquidity requirements.

We would rather have managers implementing equity participation schemes and shadow equity for senior staff as ultimately, we like to see ownership spread across the firm to ensure alignment.

Strong alignment of interests demonstrates manager belief in the opportunity set, assists with talent retention and reduces staff turnover

Section 1 – Emerging Managers

INTERNALISING THE COMPLIANCE FUNCTION

Some emerging managers do not fully internalise the compliance function on day one. Instead, they rely heavily on their compliance consultants to ensure that an appropriate compliance infrastructure is in place. It is worth noting the prevalence of the outsourced CCO function as the norm in certain jurisdictions. To ensure a proper culture of compliance exists within a firm, we always encourage managers to have compliance internally monitored alongside the ongoing onsite reviews performed by compliance consultants. We would suggest that the COO is made responsible for overseeing regulatory and compliance matters. We have encountered some managers who were not even reviewing the reports prepared by their own compliance consultants. We will also determine at what stage of growth the firm should consider the appointment of a dedicated CCO. Typical compliance enhancements we recommend include tightening personal account dealing policies (particularly for managers trading public equity), formalising policies into a compliance manual, conducting training, performing bi-annual attestations, formalising their conflict register and better documenting expert network usage.

Cost saving on compliance is a mistake in an increasingly complex regulatory terrain

MISCONCEPTIONS ON CAPITAL RAISING

It is common for an emerging manager to not have hired a dedicated marketer on day one. They may take the view that a good track record will sell; they might not want the investment team to be distracted with road shows; they place reliance on the cap intro teams of their prime brokers. As it takes much longer to secure capital from new allocators, it is important that the marketing function is fulfilled on day one. It takes time to build up new relationships with prospective investors, not to mention creating a list of prospects and ensuring all marketing activities are in compliance with the relevant jurisdictional requirements. New investors will scrutinise the quality of the client base and the level of diversification. Investors do not like a client base that is too concentrated, raising the prospect of liquidity risk.

A marketer should be a key resource on day one

Section 2 – Innovative Trends With Emerging Managers

OUTSOURCING

Outsourcing back and middle office functions is a trend which is accelerating amongst emerging managers. Assuming first class service is provided and the manager conducts proper oversight, we are generally comfortable with such arrangements. Having said that, it is not uncommon to encounter a manager who places over-reliance on the service providers for back and middle office functions. Ultimately, prospective investors will form an opinion on the manager based on the quality of any outsourced providers retained. We still notice a lack of full three way reconciliations between the manager, administrator and prime brokers. We encourage managers to internalise these functions as much as possible and implement shadow bookkeeping at the master fund level from day one, minimising aged breaks, breaches, trade errors and settlement issues.

Conducting proper oversight of outsourced functions is critical

REGULATORY HOSTING PLATFORMS

Some managers are looking for an authorised representative to accelerate launch, ahead of obtaining their own regulatory investment management license. It is critical to conduct proper due diligence on such regulatory hosting platforms to ensure adequate oversight and controls are in place. We take the view that this set up should only be temporary and we would expect the manager to have full oversight of risk management from day one.

Ultimately, investors expect that the manager retains oversight of any hosted regulatory solutions

SHARED OFFICE SPACE

We have come across managers sharing their office space with another company in order to save costs. This type of arrangement is not our preference. To prevent any preferential access to a fund's investment activity or business information as a result of such proximity, we want to ensure the following: a proper information barrier is in place between the two legal entities, they do not share the same systems, they follow a clean desk policy and conduct compliance training with their staff. We also recommend that the room where trader and research analysts sit is secured and not accessible without a secure pass. We will work with the manager to define at what stage of growth they should consider having their own office space.

When an office is shared, ensure appropriate compliance policies and procedures are in place to prevent any breaches

Section 2 – Innovative Trends With Emerging Managers

CAREFULLY SELECT AND DIVERSIFY COUNTERPARTIES

A number of managers still prime with one prime broker at launch. Typically, this is due to the manager not being big enough to sign up a second relationship, or preferring to concentrate their business to obtain better financing terms. This tendency is reversing the post-2008 trend when we saw multi-primed funds becoming the norm. There is counterparty risk inherent in the single PB model. We recommend that such managers appoint a second prime broker when they reach a certain AUM trigger, which allows them to negotiate better terms for such agreement.

Some managers are still over-reliant on their legal counsels to conduct ISDA negotiations on their behalf. Typically, this is because they do not have strong internal know-how. These skills need to be brought in-house as AUM grows in the future. There are also dedicated providers, expert in trading agreements negotiations, who can advise independently from a manager's legal counsel.

We are still meeting larger managers with unfavourable ISDA terms, such as tight NAV draw-down parameters that could trigger a termination event. Third party trading agreements should be renegotiated once AUM reaches a certain size to put the fund on better terms.

On-boarding the right quality counterparty at different stages of growth is critical for the stability and financing of the business

Section 3 – Recurring Operational Challenges

TRUST BUT VERIFY

Despite all the effort to ensure that the information collected is accurate and verified onsite, we continue to discover undisclosed information when we conduct reference and background checks, such as inaccurate biographies or undisclosed conflicts of interests from the principals. The importance of transparency towards investors cannot be overstated. An open, proactive approach to investor relations and due diligence will inform the investor's opinion of a manager's integrity.

Transparent and proactive approach help building trust

INAPPROPRIATE LANGUAGE IN FUND OFFERING DOCUMENTS

Many fund prospectuses include boiler plate language inappropriate for the strategy or contain wide-ranging rights to provide enhanced flexibility. Emerging managers should be wary of passively accepting prospectus language from their counsel, as early stage institutional investors will inevitably push back on this. This results in amendments to the prospectus at additional fund costs and can delay the due diligence process. Some of the main changes we have successfully implemented include the removal of preferential liquidity rights, adding a key person event notification, narrowing expenses language, tightening the investment objective, defining voting rights to shareholders, tailoring side pocket and SPV language to be appropriate for the strategy, softening the redemption in specie language and ensuring management fees are charged in arrears.

Some more established managers are less willing to make such amendments to fund documents. In such cases, a side letter is often required to help mitigate risks and add protection to future investments. We generally require most favoured nation clause, capacity rights, key man provisions and certain notification rights. Where appropriate, we like to see side letter provisions incorporated into the prospectus to ensure equal treatment for all investors.

We encourage managers to update the Fund documents at least annually to ensure that they have incorporated all the relevant alterations and regulatory changes, and that all information provided is accurate with no misrepresentations.

Managers should always critically consider their offering documents from the perspective of investors. Side letters are often disregarded by managers but it is sometimes the only way to move forward with an investment

Section 3 – Recurring Operational Challenges

PROPER GOVERNANCE IS NOT USUALLY ADOPTED

An independent, qualified board is crucial for the protection of investors. We have a strong preference for independent corporate governance to be empowered throughout the fund structure.

Despite best practice recommendations, we still see a number of funds without a majority of independent directors, creating potential governance issues. We also encounter managers who have not made any improvements since 2008, with board meetings taking place as infrequently as once a year and retaining independent directors with limited capacity to properly perform their fiduciary duties. We ensure our approved funds take corporate governance very seriously.

We would at least expect that an advisory board is created at launch when a master fund is structured as a Cayman limited partnership and controlled by the affiliated general partner. An advisory board mitigates some independence risks. As a result, when we are not a day one investor, we often have to negotiate that an advisory board is created at the master fund which mirrors the right composition of the existing offshore feeder board. By doing so, the fund governance will be enhanced and limit the occasions when the controller of the general partner can make unilateral decisions on key terms. Such decisions include suspending the fund, establishing reserves, making material changes to the Limited Partnership Agreement and valuation issues among others.

Suboptimal governance is often observed, with established managers sometimes unwilling to adapt to the new world

PRICING TO BE ROBUSTLY DOCUMENTED

Some managers have poorly written valuation policies. We recommend that managers create a formal valuation policy which explicitly describes the valuation process and pricing sources. We also push for the establishment of a valuation committee to be created in case of any pricing disputes. We prefer such a committee to be in place prior to any issues, rather than one having to be formed to deal with a specific case, as this can delay NAV publication.

Transparency reports generated independently by the administrator are increasingly being adopted by managers. Such reports assist investors to monitor illiquid assets and verify that pricing has been independently sourced. It is of note that ASC 820 / FAS 157 categorisation within transparency reports is often provided by the manager and therefore lacks independence. It is important to ensure that such categorisation is pre-agreed between the administrator and the manager. This breakdown should also be harmonised between the transparency report and the disclosure in the audited financial statements.

As part of the review of the audited financial statements we like to see a schedule of investments disclosed. We would encourage more funds to disclose this information as this is valuable to investors, despite the fact that the inclusion of a schedule of investments is not compulsory under IFRS.

Pricing transparency is critical to better understand if there is any style drift

Section 3 – Recurring Operational Challenges

UNUSUAL FUND EXPENSES

Some fund's offering documents still allow for additional expenses to be charged to the fund. These include research, marketing, systems and data. We believe these costs should be borne by the management company. As a result, some non-trading expense ratios are still on the high end compared to the industry standard. We try to establish expense caps on funds to mitigate any unusual expenses being charged back to the fund. In our experience, second generation of managers are more cognisant of our concerns as opposed to established managers.

Where outsourcing is used, investors should also pay attention as to whether or not this cost is borne by the funds or the manager. Where such costs are borne by the fund, this can further increase the rationale for an expense cap. We have experienced funds passing-through expenses from the management company. We take extra care to analyse the pass through expenses breakdown to ensure it is reasonable. It is also important to scrutinise the set up costs. We have come across a number of situations where expenses were off market.

We like the initiative from a US-based manager that decided not to charge expenses to the fund when they reached a certain level of assets under management.

Expense caps give more control to an investor, especially when the PPM expense language is broad

CASH CONTROLS ACROSS THE FIRM

Cash controls at the fund level have generally improved since the financial crisis. At the management company level, a dual signatory culture is not always in place. We would always recommend dual authorisation to release cash beyond a determined threshold. If this is made impossible given the size of an organisation, we prefer to have at least an oversight from one non-investment staff member.

Misconduct can take place at the management company level and proper oversight of cash movements will reduce this risk

SELECT THE RIGHT FRONT TO BACK SYSTEM ON DAY ONE

It is striking that some managers still rely on Excel instead of investing in an Order Management System (OMS) and Portfolio Management System (PMS). In such occasions, we have recommended that they install a fully integrated OMS / PMS solution to automate their operations and improve the oversight of service providers. We also ask that managers perform full trade, cash and position reconciliations in-house. We want to see that there is documentation of trade instruction between different members of the investment team. The OMS will help ensure there is robust documentation of trading limits, pre-trade compliance and trade allocation.

Proper operational oversight is limited when one relies exclusively on Excel spreadsheets. Being an early adopter of the right OMS and PMS will save time and reduce operational and compliance risks

Section 3 – Recurring Operational Challenges

CYBER SECURITY AND TESTING

A number of emerging managers are too complacent on cyber threats and assume that they are not big enough to conduct penetration and phishing tests. We feel that this approach can cause significant risk to their businesses and we encourage them to reconsider their IT security. We expect a written information security policy that is tailored to the manager's own environment. Managers should have a response and escalation process in place should they be subject to a cyber-attack, rather than trying to establish this during an attack. The most important element of any cyber security policy is staff training and education. We encourage all our managers to make cyber security training mandatory on at least an annual basis. Training is particularly effective when provided in conjunction with a phishing test.

We will check onsite that all expected business continuity tests have been performed and documented. We will review the logs to understand better any deficiencies that were identified and the corrective measures managers plan to implement.

Staff training and education is the central pillar of cyber security resilience. Testing schedules of both cyber security and business continuity programmes should be adopted from day one

Conclusion

It is undoubtedly a challenging time to start a new hedge fund business. It is essential for emerging managers to build a sustainable, robust business from day one. Managers and investors alike must recognise and adapt to new trends across the industry. Whilst progress has been made across the hedge fund landscape, there are still numerous instances of operational deficiencies which could easily be improved. Operational due diligence is not just focused on the operational set up of an organisation. In essence it focuses on how the business is run and whether the principals can be trusted to manage the firm for the benefit of investors, and not just themselves.

The operational environment of hedge fund managers is constantly evolving. As businesses which are subject to investor flows, staff turnover, changing ownership, counterparty management and new regulations, it is absolutely key for investors to monitor all their allocations with hedge funds.

In this paper we have listed various deficiencies we have encountered during our operational due diligence process. These observations are of course generic and exceptions may be relevant (strategy specific considerations, for example). Some pitfalls have resulted in the rejection of a manager. Of over 130 underlying managers and funds proposed for investment since Tages inception in 2011, approximately 20 have been discarded due to shortcomings on integrity, staffing, operational issues, litigation and regulatory concerns. More frequently, however, we work collaboratively with managers to add operational alpha prior to investment. In all instances, transparency is essential in building trust with investors. Whilst the institutional quality of hedge funds has increased since 2008, investors must remain vigilant when conducting operational due diligence.

Our next paper will discuss the impact and cost benefit of MiFID II on our universe of approved managers. We aim to publish it in Q4 2018.

IMPORTANT INFORMATION

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