# Chapter 31: Due Diligence of Fund Managers

## Demonstrate knowledge of due diligence evidence and organization

* Identify evidence for and organization of a due diligence process

Def **due** **diligence**: viewed as the initial phase of building a relationship with a fund manager; a crucial task that investors should do to select a manager

Due diligence includes 7 parts: structure, strategy, administrative, (investment) performance, risk, legal, and references

One shall not confuse completion of this 7-item checklist as risk mitigation

## Demonstrate knowledge of the three questions critical to understanding the nature of a manager’s investment program

The answers to these 3 questions are critical to understanding the nature of fund manager’s investment program:

1. What is investment objective of the fund?
2. What is the investment process of fund manager?
3. What is the nature and source of any value added by fund manager?

* Define and describe due diligence processes related to investigation of investment objectives of hedge funds

The investment objective of a fund specifies the goals, nature and strategies of fund’s investment program. The first question regarding fund manager’s investment objective can in turn be broken down into 3 questions:

1. In which markets and assets does the fund manager invest?
2. What is the fund manager’s general investment strategy?
3. What is the fund manager’s benchmark, if any?

* Define and describe due diligence processes related to investigation of investment processes of hedge funds

The investment process of a fund comprises the methods the fund uses to formulate, execute and monitor investment decisions

Def **investment process risk**: potential loss from failure to properly execute the stated investment strategy

Def **key personnel clause**: provision that allows investors to withdraw their assets from the fund, immediately and without penalty, when the identified key personnel are no longer making investment decisions for the fund

* Define and describe due diligence processes related to investigation of how hedge fund managers add value

The final fundamental question related to developing an initial understanding of an investment program regards an explanation of how and why the manager is able to generate attractive returns

This section focuses on two questions

1. What enables a manager to identify alpha?
2. What reasons are there to believe that alpha will persist?

* Describe and contrast information gathering and information filtering

There are 2 primary information-based explanations for superior investment performance in competitive markets based on information

1. Information gathering (or searching): indicates the ability of manager to create access to information or have access to better information than do other managers => superior NOT in analyzing information but in developing a superior information set => the advantage is a proprietary information set accumulated over time
2. Information filtering (analyzing): have superior skill in filtering and analyzing information. Def information filtering is the fund manager’s ability to use data available to others but to be better able to glean tradable insights from it. For example, quant manager having access to same information set, but better algorithms to extract more value

The investor cannot rely on historical fund performance data as a means of selecting good managers over bad managers => more reliable method for ascertaining the potential for alpha is rigorous and thoughtful analysis

## Demonstrate knowledge of the due diligence of hedge fund structures

* Describe the main issues related to the review of a fund’s organization

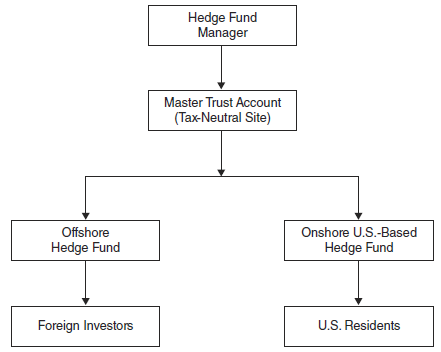
Def **master** **trust**: legal structure used to invest the assets of both onshore investors and offshore investors in a consistent if not identical manner, so that both funds share the benefit of fund manager’s insights.

Def **feeder** **fund**: legal structure through which investors have access to the investment performance of master trust

Onshore and offshore investors use separate feeder funds to access the master trust, where investors benefit from separation of funds of tax consequences

* Discuss the master trust account structure, and recognize its uses by hedge funds

The purpose of master trust is tax neutrality, not evasion. For example, in Bermuda, MT pay only a corporate licensing fee, not corporate income tax => ensures no tax consequences to fund investors at MT level, but based on tax rate at investor’s country of domicile



* Explain the importance of reviewing fund managers’ organizational structures. Discuss separation of duties and how organizational charts can be used to evaluate it

Typical questions related to organization of fund manager

1. Where is fund manager located?
2. Are there any satellite offices?
3. Where is nearest office to the investor?

An organization chart of personnel is mandatory, with particular attention to separation of duties

Of special importance is CFO, who is typically investor’s most important link with fund manager after an investment is made => make sure CFO has strong background in accounting for investments, preferably including a major professional accounting designation

Investors should also determine which senior managers are in charge of trading, information systems, marketing, risk management and research, and analyse this information accordingly

Ownership structure of fund manager must be documented => imperative to know who owns company that advises the fund, whether it is an external party, active employees, or some combination of two

Finally, important to understand the compensation structure and incentives of each key employee

* Recognize the importance of reviewing and documenting regulatory registrations

If fund manager is registered with SEC or UK FCA, Investor should ascertain the date of the original registration and whether there are any civil, criminal, or administrative actions outstanding against the fund manager => also manager’s local jurisdiction and ensure manager is current with appropriate authorities

* Describe evaluation and documentation of outside service providers, including the auditor, attorneys, and the prime broker

The investor should identify the fund manager’s outside auditor, legal counsel, and prime broker, and independently verify their suitability if they are not well known with solid reputations => positive sign if fund is employing reputable service providers with substantial experience in the business.

Def **league** **table**: a listing of organizations that ranks organizations by size, volume, or other indicators of activity.

1. Auditor: obtain fund’s latest annual audited financial statements. In addition, auditor is a good source of information regarding fund manager’s accounting system and operations
2. Attorneys: investors should speak to fund manager’s compliance manager or internal or external counsel for 3 reasons: a) counsel is responsible for keeping current all regulatory registrations of fund manager; b) counsel can inform investor of any civil, criminal, or admin actions that might be pending against fund manager; c) investor negotiates documentation and other issues with attorneys when making an investment with fund manager
3. Prime Broker: investor to contact fund’s prime broker to assess strength of relationship: anything happened in past could happen in future

## Demonstrate knowledge of the strategic review of fund managers in the due diligence process

* Explain the importance of understanding the markets and securities in which a manager invests

1. Types of securities where the fund manager invests. The purpose of due diligence is not to legally bind the fund manager but to document the types of securities necessary to effect the investment strategy
2. Investor should also pay attention to extent fund manager invests in derivative securities
3. Particular concerns include short selling and extent to which fund manager may short volatility

* Discuss the issues related to benchmarking of fund returns

Establishing a benchmark for fund managers is one of most challenging issues facing an analyst

1. Manager skill cannot be adequately captured by a passive securities benchmark => return on skills are often uncorrelated when better opportunities to implement skill-based strategies occur in stressed markets
2. Manager risk exposures NOT explained well by return of a passive index => different investment strategy + use derivative instruments with nonlinear payout functions

Def **fund** **style** **index** is a collection of fund managers with similar strategy to fund manager in question can be used as benchmark

If fund manager does not believe that any index is appropriate as a benchmark, then a hurdle rate should be established => hurdle rates are most appropriate for absolute return fund managers

* Describe key considerations in the analysis of managers’ competitive advantages and sources of investment ideas

Competitive advantages, or equivalent to ask what makes fund manager’s process more attractive than other managers.

Note: specialization alone does not represent a competitive advantage

Using skill to better forecast merger outcomes is a possible source of attractive returns

* Describe key considerations in the review of managers’ current portfolio positions

Investors should ascertain the fund’s current long and short exposures, determine the amount of cash held by fund, and decide whether it is appropriate

1. Too much cash => investment stuck in neutral or waiting for attractive investment opportunities
2. Too little cash => potential liquidity issues

A final question that investors should ask: how the current portfolio has been positioned in light of current market conditions => reveal insight into how manager view the current financial market + anticipated investment strategy going forward

* Describe key considerations in the review of the source of investment ideas

Investor should determine under which market conditions the fund manager’s ideas work best and opportunities for manager’s strategy are most available

* Discuss investment strategy capacity in the context of evaluating structural risk

The ability to generate alpha is tightly linked to issue of capacity. For example, if targets small sectors of economy, manager must not have too many assets under management

Too much money chasing a limited-capacity investment idea moves the price of the security away from the investor, cutting into the alpha that might have otherwise come from the idea

## Demonstrate knowledge of the administrative review of funds

* Discuss the importance of due diligence on the ethical and legal history of fund employees

First, a history of civil or criminal actions filed against one of the fund manager’s principals provides a valuable insight into that principal’s character

Second, lawsuits are distracting => such problems can distract a principal from the fund

* Discuss the reasons for review of employee turnover

First, good fund managers know their competitive advantage and how to exploit it; this is often the people employed by the fund manager. A stable workforce may be one of the keys to maintaining an advantage, both from the perspective of continuing to find exploitable investment ideas and in keeping current ideas from disseminating to competitors via former employees

Second, turnover is distracting => it takes time, money, and even emotional effort to replace talent

Third, high employee turnover may indicate volatile leadership

* Discuss the ideal organization of investor relations

Ideally, the fund manager should designate a primary contact person. This representative handles issues regarding performance reporting, subscriptions and redemptions, increased investment, and meetings

* Describe the importance of business continuity management

The fund manager should have a disaster recovery plan if a natural or other disaster shuts down trading and investment operations

## Demonstrate knowledge of the procedure for conducting a performance review of a fund manager in the due diligence process

Two critical decisions are when the performance review should be executed and how much weight past performance should be given

* Describe the behavioral biases that can interfere with performance analysis

Def **confirmation** **bias**: an analyst tends to falsely interpret information as supporting previous beliefs or preferences

Def **herd** **behavior**: extent to which people are overly eager to adopt beliefs that conform to those of their peers

Def **bias** **blind** **spot**: people’s tendency to underestimate the extent to which they possess biases

The bottom line for bias: if material flaws are uncovered in analysis of manager’s strategy, structure, or administration, then due diligence process should cease before evaluating performance

* Identify and discuss three important questions to ask regarding all assets controlled by the fund manager

1. How long has the fund manager been actively managing each current and previous fund?
2. Have the manager’s performance results been consistent over time and across funds?
3. How do the investment strategies of the funds compare and contrast?

For funds, 5 years is generally sufficient to qualify as a long-term track record

* Discuss the analysis of drawdowns

Drawdowns should be analyzed in the context of the fund’s strategy, the fund’s leverage, and the performance of market indices

For example, large drawdowns in a market-neutral fund may indicate a lapse of fund manager skill. Drawdowns in directional fund strategies may simply indicate market risk

In addition to size of drawdowns, investor should examine how long it took for fund manager to recoup losses

* Identify and discuss the five issues related to the use of past data to predict future performance

1. **Accuracy**: Expectation bias is synonymous with confirmation bias and is a tendency to overweight those findings that most agree with one’s prior beliefs
2. **Representativeness**: representative of fund’s total experience vs cherry-picking/selection bias
3. **Stationarity**: past results likely to predict future results? In high past performance should be expected to attract competition and eventually dilute profit opportunities rather than persist through a stationary return-generating process
4. **Gaming**: fund performance gamed?
5. **Appropriateness**: performance measures used appropriate for underlying investments and strategies?

* Describe how the analysis of returns can be impacted by the investment horizon

Risk management analysis and systems based on short-term annualized volatilities (e.g., daily data) may substantially understate risk over longer time periods

The possibility of large directional movements over months or even years may have been underweighted because of a focus on volatility computations based on short time intervals

* Discuss issues related to subscriptions, redemptions, and volatility of assets under management

Large redemption from investment pools can have an impact on fund performance; rising subscriptions to a fund can also be a source of drag on fund performance

1. May take time to get invested in less liquid ideas, cash may be a drag on portfolio return
2. Subscriptions result in transaction costs that are typically borne by all investors as new money is invested

For redemptions, the fund manager must sell securities to fund the withdrawals => transaction costs are incurred and typically borne by all investors unless specifically charged to investor requiring redemption

* Describe considerations in the review of the asset manager’s process for pricing securities in a portfolio

One of the biggest issues with fund performance measurement, operational risk management, and fee computation is how the fund manager values securities in fund’s portfolio => prompt and proper portfolio pricing can help signals risk and problems before losses escalate

if a manager can delay revealing a large loss, the manager retains the chance of recouping the loss and preserving that compensation

To reduce opportunities to manipulate prices, external pricing services are often used to value positions held by a fund, especially funds holding illiquid assets

Fund managers are believed to be able to earn consistent abnormal returns for securities with greater complexity and less liquidity

FASB in US defines 3 types, or levels, of determining fair asset values using GAAP

1. Level 1 assets: assets valued based on unadjusted market price quote from actively traded market of identical assets
2. Level 2 assets: based valued based on nonactive market price quotes, active market price quotes for similar assets, or non-quoted values based on observable inputs that can be corroborated
3. Level 3 assets: valued substantially on basis of unobservable inputs

Internal valuations should always be supported by following:

1. Use of knowledgeable but disinterested party in performing valuation
2. Documentation and justification for valuation methodology
3. Documentation of all inputs and assumptions
4. Review, if not approval, of final value by yet another knowledgeable, independent party

## Demonstrate knowledge of the procedure for conducting a portfolio risk review of a fund manager in the due diligence process.

* Identify and discuss three important risk management questions

1) What are the types and levels of risk involved in the fund manager’s strategy?

2) What risks are measured, monitored, and managed?

3) How are risks measured, monitored, and managed?

* Describe and apply the role of leverage in determining the total risk of a fund

Leverage is a crucial determinant of risk. The fund with a leverage factor or ratio of L (L = Assets/Equity) has short-run returns that have L times the volatility of its assets

Def N-sigma event: event that is N standard deviation from mean

* Discuss the role of the chief risk officer (CRO)

The chief risk officer (CRO) oversees the fund manager’s program for identifying, measuring, monitoring, and managing risk

## Demonstrate knowledge of the procedure for conducting a legal review of a fund manager in the due diligence process

* Discuss considerations in the review of the fund structure

Most in LP, as LP can provide a liability shield for investor

Def limited liability shield or financial firewall: legal construct that prevent creditors from pursuing restitution from investors or other participants involved in an economic activity beyond the amount of capital contributed

Separate accounts do not typically offer limited liability to investor => more risk associated with this type of investment => investors responsible for losses beyond their investment to cover losses from use of margin or use of derivative

* Discuss considerations in the review of the fund fees

Fee structure: typically quarterly, but could be annually or semi-annually; clawback provision?

* Discuss considerations in the review of the lockup and redemption provisions, including gates and hard and soft lockup periods

Lockup periods provide 2 benefits:

1. Give fund manager time to implement investment strategy
2. Withdrawals of capital by one LP can disadvantage remaining partners through transaction costs borne by fund

Def hard lockup period: withdrawals are contractually not allowed for entire duration of lockup period

Def soft lockup period: may allow to withdraw capital from fund before expiration of lockup period, but only after payment of a redemption fee (1% to 5%). The redemption fee serves 2 purposes

1. Discourage investors from causing liquidity disruptions by leaving the fund
2. Allows fund manger to recoup some of cost associated with liquidating a portion of fund portfolio to redeem shares or to make up for drag on performance from a cash balance

* Discuss considerations in the review of the subscription amount

The subscription amount is quite high for 2 reasons

1. Fund may be using a safe harbor provision that limits number of investors
2. Higher capital commitments help ensure that only sophisticated investors with a large net worth subscribe in the fund

Some fund has a max subscription amount => single investor becomes too large relative to other investors in the fund, so that redemptions from one very large investor won’t intensify or create accurate liquidity problems

* Discuss the role of the advisory committee

Advisory committees serve as a source of objective input for fund managers; composed of representatives from fund and investors in the fund; may provide advisory advice on valuation of particular investments, especially illiquid investments

## Demonstrate knowledge of the procedure for conducting reference checks on service providers and other fund investors

* Discuss the process of conducting reference checks on service providers

With respect to the prime broker, the investor should inquire directly with regard to financing arrangements, the size and frequency of margin calls, and whether any calls have not been met

* Identify key questions to ask when conducting reference checks on other investors

1. Have the financial reports been timely?
2. Have the reports been easy to understand?
3. Has the fund manager responded effectively to questions about such topics as financial performance?
4. Has the fund manager done what was promised, such as maintaining the investment strategy?
5. What concerns does the current investor have regarding the fund manager or the fund’s performance?
6. Would the current client invest more money with the fund manager?

## Demonstrate knowledge of the procedure for measuring operational risk.

* Discuss the role of the omega score in measuring operational risk

1. a diversified portfolio of at least 40 funds provides reasonable diversification against operational risk
2. Investors should conduct an informed operational due diligence examination that takes into consideration the relative importance of the main risk factors affecting funds in general.
3. When investors assess the operational risk of funds properly, the information can be valuable in developing a more accurate return and risk profile for the fund

Def **omega**-**score**: measure of future risk that is computed as a function of fund’s age, size, past performance, volatility, and fee structure

* Discuss the cost of fund manager due diligence

Fund due diligence is expensive, in terms of both money and time spent; effective due diligence of funds in selection of fund managers can generate alpha for investor’s portfolio