

Opalesque Exclusive: The evolution of due diligence, Part 1 - Hedge Fund Appraisal: 'operational risks are certainly the most difficult to apprehend'

Opalesque is the publisher of the Alternative Market Bulletin (www.opalesque.com)

Benedicte Gravrand, Opalesque London:

Some funds of hedge funds (FoHFs) and due diligence (DD) providers have had to review their methodology since the beginning of the credit crunch and the subsequent uncovering of frauds such as Maddof's. Opalesque spoke to several industry players about their approach. Our conversations are presented in a Q&A format - as are DD forms.

The events of 2008 and 2009 served to bolster the risks that many due diligence firms have warned about in the past. Many of the due diligence managers we spoke with cited investor concern over fraud as one of the drivers behind new business. However, they also cautioned investors not to lose sight of many other risks (not to 'fight the last battle' as one manager put it) and expressed ongoing concern with valuations processes, liquidity risks, and counterparty risks. They also stressed the importance of ongoing due diligence. One manager pointed out many hedge funds look very different in 2009 than they did in 2008 and solid, ongoing due diligence processes provide insight to some of the more intangible risks that exist - such as the way managers react during times of crisis.

Gabriel Kurland is the founder of Hedge Fund Appraisal (www.hedgefundappraisal.com), an independent provider of due diligence services to investors in hedge funds based in Geneva. His articles often feature on AMB, and he has also contributed in the production of this series.

*1. What types of **clients** use your services?*

Private banks, family offices, third party marketers. Fund of funds are more reluctant to externalize a service that they are suppose to provide even if a lot of them don't do much.

*2. Do they outsource **all, or part** of the process to you?*

It really depends on the client sophistication. Clients who have some experience in selecting hedge funds and people dedicated to the task usually request us to perform an operational due diligence only. For the other, we do a full due diligence including the review of the strategy, risk management, quantitative analysis ... The operational issues linked to hedge funds are not well known and analysts usually do not have any experience in the way you have to research and identify those operational risks.

*3. What are your **areas of focus** within due diligence?*

We are covering all areas of due diligence from the background check to the full due diligence. Our particularity is that we are totally independent our only client is the end investor. We will never be paid by the investment manager.

Starting in early 2008, the strong demand from client for operational due diligence drove us more into that space and we developed a specific process to cover those risks.

*4. Has the **financial crisis impacted** any specific areas of due diligence?*

The financial crisis has revealed that hedge funds were not only exposed to investment risks but that operational risks were as much dangerous. The surprise came not only to investors but also some fund managers were taken off guard as revealed by the numerous funds that are now caught in the Lehman Brother bankruptcy. Today analysts have to ask questions about counterparty risk, liquidity management, financing solutions, asset protection, valuation...

The other area of due diligence highlighted by the crisis has been the liquidity mismatch between funds' terms and their underlying investments. Investors have push to get liquidity into strategies that were by essence illiquid, investors have been collecting those strategies' liquidity premium for some time until suddenly their investment was locked in.

*5. What do you consider to be the **most complex risk** to analyze in hedge fund due diligence?*

The operational risks are certainly the most difficult to apprehend for several reasons. First, operational risks are difficult to understand and often tight to complex regulations. Following the collapse of Lehman Brothers, all the CFOs realized that they had to take steps to better protect their funds assets. The problem is that the protecting effects of the different regulations become clear only when they are tested. Therefore each fund has implemented solutions according to their understanding, or their advisers understanding, of the laws and of the custodian agreements they have put in place. The different solutions implemented are multiple. Second, the analysis of operational risk requires the collection of information from the fund's service providers (administrators, prime brokers, auditors...).

The issue is that those companies see the fund but not the investors as being their clients and they also want to protect themselves legally and resource wise. The results is that the level of cooperation analyst can get is very variable and the effort to get to the information is usually very intense. Third, operational risks are multiple. The good news is that technology can today provide satisfactory solutions to some of those risks but unfortunately access is still limited to the larger funds due to the cost. Multiple prime brokerage and the new trend for managed accounts are also bringing along new risks like orders allocation, client fair treatments ...

*6. How do you go about **evaluating** this?*

At hedge fund appraisal, the cornerstone of our due diligence is the collection of information from independent parties through a set of questionnaires we have developed specific to each of the fund's service providers (administrator, prime broker, custodian, futures/clearing brokers, auditors, independent directors).

The second important aspect of our process is the adaptation of our process according to the strategy implemented. We will not require the same level of sophistication from a long/short equity than from a CTA. Our experience allow us to concentrate on the risks specific to each strategy and to give some flexibility to our process. The third block is the visit to the investment manager office. A visit has to be well prepared in advance to be efficient. Depending on the size and sophistication of the investment manager operation we can spend between one and two days reviewing their processes.

*7. Are hedge fund investment risks the **same** that they were two years ago?*

The risks are the same, only the environment is different.

*8. What are the **challenges going forward** for the practice of due diligence?*

Access to information and transparency. Hedge Fund managers have realized that in order to get back investors confidence they will have to open up to more scrutiny. Unfortunately, good resolutions are very often short lived and we already see bad habits coming back.