
New Fund Investment: Diligence For A New Era

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In Neuberger Berman's 2011 Strategy Outlook, the firm studied 288 emerging hedge fund managers. The study found that performance since 2002 showed emerging managers annualized +9.49%, versus the +7.61% achieved by emerged managers during the same time. "Based on this analysis, the emerging manager's trend of outperformance seems clear," says the report, published by the firm's fund of hedge funds team. While this study makes a strong case that smaller funds tend to outperform their larger counterparts, numerous barriers to entry exist for the manager who is just starting out.

The start-up costs of launching an institutional hedge fund business are deterring some market participants from starting their own businesses. A new regulatory climate, coupled with increasingly demanding investors, is driving up the costs surrounding compliance, infrastructure, service providers and other necessities. Further, consultants, fund of funds, pensions, and endowments have a bias towards larger funds to mitigate headline risk, preserve jobs, and lure client capital. No one ever got

fired for buying IBM. Money usually follows efforts for smaller managers. All of these conditions pose significant challenges for the entrepreneurial hedge fund manager – so many emerging managers continue to market towards the high-net-worth investor and family offices that tend to have a broader range of risk tolerances.

While this hidden alpha can be a positive for many high-net-worth and family office investors, the truth is that investing in smaller managers poses a few unique and potentially complex challenges. After discovering the right manager with a compelling strategy, there might be risk lurking around the corner. In the post-Madoff world, investors must perform proper operational due diligence prior to any investment. Whether the investor's goal is capital preservation or capital creation, he or she would benefit from a few practical tips to ensure meaningful due diligence and risk mitigation.

1. Check Backgrounds.

Confirming a manager's education, employment history and other resume data

is essential. Also, investors must determine whether the manager has been involved in any undisclosed legal or regulatory matters. Learning about a manager's behavioral patterns, conflicts of interest or outside business interests helps to protect the investment. This kind of background check is an ongoing process that should continue throughout the relationship.

2. Review Documents.

Investors need to read all relevant documents - including legal documents, marketing materials, audited financial statements and the due diligence questionnaire – before allocating to any manager. These documents explain the manager's strategy and investment philosophy, and they reveal important details about the general partners' powers and authorities. It also illustrates the investor's rights. Note discrepancies between documents, which may confuse the real risks.

3. Visit The Site.

Commit to an in-person meeting with the manager at his or her office – and make sure his or her team is present. During this meeting, obtain a profile of the manager's

culture, clarify discrepancies and verify procedures stated by the manager. At the end of the site visit, the investor should assess his or her instincts before proceeding with the relationship.

4. Reconcile and Verify.

Investors should confirm the Fund's net asset value. Obtain the Fund's assets from the manager and then verify that number with both the Fund's administrator and the Fund's counterparties, who usually include: prime brokers, cash custodians, and OTC counterparties. Three-way reconciliations may not result in 100% asset verification, but it may exceed some predetermined threshold. Also, seek confirmation from the administrator of the manager's investment into the Fund in question. Investors need to confirm that the manager has "skin" in the fund.

5. Confirm Relationships and Functions.

Before investing, confirm all significant service provider relationships and their specific functions to the Fund/Firm. Also, if a hedge fund has changed service providers, an inquiry should be made to the specific provider to gain understanding of why the change occurred. Providers that must be confirmed include auditors, administrators, prime brokers, cash custodians, valuation agents, technology providers, directors and compliance agents.

6. Check References.

Check all references the manager provides, and go one step further by obtaining independent references from current and former investors, former employees, and former colleagues of the hedge fund manager and key employees. Keep in mind all managers only provide positive references. These conversations will provide the investor with a range of opinions that can be used to draw new conclusions.

Every hedge fund business is different, but the following structure and philosophy should be shared by all trustworthy managers:

1. Appropriate Staffing.

A manager that has hired a knowledgeable CFO, COO or Controller has taken an important measure to separate duties within the firm. Among other benefits, this allows the hedge fund manager to focus his time and energy on portfolio management.

2. Reputable Service Providers.

Managers should work with a reputable auditor whose practice is well-versed in the hedge fund business.

An independent administrator is a service provider who keeps official books and records and allows the fund manager to improve controls and mitigate certain risks. The administrator should also verify the valuation of portfolio assets on a regular basis. By having the proper support to maintain the fund's books and records, investors will grow even more confident that proper oversight is in place and that the underlying fund's NAV is accurate.

3. Sophisticated Technology.

New managers who invest resources in information technology early-on offer better internal controls. Front to back office systems provide for better streamlined operations by ensuring straight through processing which can only be achieved through proper technology. Top-quality IT systems quickly pay off in the form of greater efficiency and productivity.

4. Documented Procedures and Business Plan.

Managers should demonstrate a forward-thinking approach by developing a detailed expansion plan. The plan should set forth a strategy to bring on additional hires as assets grow and new products are offered. Also, new managers should identify their business' break-even point and be able to prove to potential investors that they can handle additional costs.

5. Business Transparency.

New managers have a lot to prove and "slick talk" is no longer sufficient. Investors should be encouraged to ask questions and get comfortable with the organization, people and systems. For example, managers should proactively invite investors to view the following systems: portfolio management, risk management, order management, and accounting. Investors would be wise to monitor the following processes themselves: compliance manual, operations manual, valuation policies, disaster recovery plan, and

a master list of key ISDA terms. Investors are demanding 100% transparency, and managers can stand out from the pack by demonstrating openness and accessibility.

6. Compliance Culture

Under the Dodd-Frank Act, hedge fund investment managers with over \$25m in assets under management will be required to register with either their state or the SEC by July 21, 2011. Emerging managers must comply and would be wise to establish a "culture of compliance" at their firm. This can be accomplished by hiring a qualified Chief Compliance Officer or outsourcing the function to an experienced compliance company. These actions will help win over even the most skeptical investors.

Study after study confirms that "emerging managers" continue to outperform more mature, larger and established hedge funds. As the regulatory and infrastructure costs of doing business rise, the smaller hedge funds will have trouble launching and remaining open. High-net-worth individuals and family offices can capture the additional alpha from emerging managers as long as they navigate these waters carefully. This prudent approach highlights the need for proper operational due diligence. There are many new managers who are superb at investing but don't have much experience running a business or marketing their own enterprise. By conducting thorough due diligence, family offices can invest in these new managers and have a chance at making significant returns while mitigating the risks.

About the Contributors



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Duff & Phelps' ORDD practice provides investors with an independent third party assessment of their hedge fund managers' operating policies and procedures. More information is available at http://www.duffandphelps.com/services/alternative_asset/Pages/OperationalRiskDueDiligence.aspx.

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