

# The Onsite Visit's Importance to Completing Institutional-Quality Due Diligence



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## ***Onsite Due Diligence (n.)***

**Onsite Due Diligences prior to and after investing are a minimum requirement for serious alternative investment allocators to reduce the risk of fraud and operational failure in their portfolio.**

### **Summary**

By now, all serious investors in alternative investment funds recognize that it is important to visit managers onsite prior to reaching any investment decisions. Making sure that you walk away from the meeting with more than a re-digested version of the marketing pitch takes preparation, experience, patience and a structured methodology.

The core purpose of the Onsite Due Diligence is to verify and cross-check the information which has been collected and analyzed in advance of the meeting, particularly as it relates to a fund's operations. Additionally, managers should provide increased levels of transparency into their strategy and portfolios during the visit, as many excuses for the confidentiality of information are invalid onsite.

Analysts must be thorough and structured in their approach to the Onsite Due Diligence, with solid preparation and a good understanding of the manager, the fund and the strategy beforehand in order to finish off this crucial portion of the investment analysis. Failing to do so can end up not only wasting everyone's time, but leaving the investor exposed to a wide number of risks that can materialize in unexpected draw-downs or a complete loss of capital in the future.

## Preparation is Everything

The Onsite Due Diligence offers investors the **opportunity to verify and challenge the assertions** which the manager has made **regarding all aspects of their operations**.

Even though analysts are on the managers “home turf”, the **analysts must take over as the agenda-setters**. They must be completely prepared in order to take advantage of this. Only through meticulous preparation are they prepared to get the manager off of their marketing pitch, and ask the hard-hitting questions. The manager knows many of the most critical risks to his funds and operations himself. The trick to the Onsite Due Diligence is to get them to reveal them.

Preparation means:

- Having a complete understanding of the fund’s strategy well ahead of time
- Obtaining a complete, independently-verified understanding of the fund’s legal structure and operational partners
- Having a good overview of the core management team, as well as all key investment professionals
- Ensuring that the meeting is scheduled with all key team members available

This preparation should come together to produce **a unique, structured protocol for each fund visited**. This protocol is the primary tool which enables analysts to fully leverage their agenda-setting role and return from a visit with a clear, complete opinion of the fund’s operational risks.



## What does the Manager Think about the Onsite Due Diligence?

### ***“This is the end game”***

- Whether the visiting analysts are from an independent due diligence provider or from the investor’s own team, the manager knows they are close to landing an investment.
- Re-emphasizing the fund’s strategy and opportunity set can distract unprepared analysts from key operational weaknesses.
- Operational weaknesses can be show-stoppers.

### ***“We have done this before”***

- One will rarely be the first team going onsite with the manager to put them under an operational microscope.
- Nearly every manager has failed other investors’ due diligence processes before, and will prepare themselves to not trip up again.

### ***“In terms of transparency, I will only go so far”***

- These guys are either the potential investors, or are going to be reporting to them. Cooperate where I can, politely refuse where I must.
- Previously used excuses for not producing documents in electronic form are invalid onsite.
- The responsiveness and increased transparency of the manager are linked to two aspects
  - 1) Professionalism and preparedness of the due diligence analysts
  - 2) Opportunity cost of losing the potential investment which warranted the Onsite Due Diligence

The analyst must be able to identify weak spots and not get swallowed up in the manager’s pitch. Central to this process is their ***ability to identify the limit that the manager has set for his transparency and push it forward.***

If the analysts are not in strong command of the fund, the management team and the investment strategy beforehand, they risk becoming trapped in the standard operational presentation. ***The manager will do his best to sell his organization*** and land a new investor, and are typically well-versed in basic operational standards to lead investors away from the problem areas of their company.

Understanding the perspective of the manager, his experience and his goals, it is crucial to ***take command of the meeting in order to conduct a proper analysis!***

## Topics for Assessment During the Onsite Due Diligence

Given information gathered and analysis conducted beforehand, the Onsite Due Diligence is the best opportunity to verify processes to make sure that things function in the way they have been portrayed.

Through preparation, analyst teams must be prepared to ask questions and gain a detailed understanding of a wide range of topics within a limited time-frame. These include (in no particular order):

- Legal & Compliance
- Human Resources
- Investment Process
- Cash Management
- Risk Management
- IT, Trading Systems and Infrastructure
- Organization
- Professionalism
- Accounting, Shadow Bookkeeping
- Service Providers & Counterparties
- And more...











With regard to each of these topics, it is crucial that analysts are able to ***interview members of the manager's team independently***. Taking the individuals responsible for tasks to their workplace with a **“show me” attitude** can begin to find the holes in the manager's story that merit further lines of questioning.

By having conducted a structured, **methodical analysis in advance**, the onsite team can target those weak spots to get the manager to unknowingly reveal contradictions, weaknesses and key areas of operational risk of their organization.













If the manager identifies team member X as a key trader in their DDQ, X better know the trading procedure like the back of his hand! Having the teams in place to feed off each other, cover each others incorrect statements is a recipe for an incomplete analysis in the very best case.

### Sample Findings as a Result of the Onsite Due Diligence







The following is a table of several experiences which we have had in conducting onsite due diligence where the manager has been tripped up to reveal certain weaknesses in their fund and operations.

Manager Representation	Onsite Due Diligence Findings
No soft-dollar agreements.	The manager has pre-defined limits to channel orders to various brokers in order to obtain free research and invitations to various conferences, presentations and road shows.  
Analysts can not initiate trades without approval by investment committee.	Analysts can initiate trades so long as there is no veto from the investment committee.  
We have a compliance manual, which can be supplied during Onsite Due Diligence.	No compliance manual can be produced for a casual look through, suggesting it in fact, does not exist.  
All potential trades are extracted from Bloomberg to Excel on a weekly basis. Access to several back-ups is in place.	In the event that Bloomberg stops functioning, there is, in fact no back-up in place.  
All crucial files are stored on central servers, which are housed in a fire-safe room, backed up every night, and stored offsite.	Inspection of server room shows that the server room is actually a standard closet, and back-up tape does not appear to have been removed for months. Furthermore, the active spreadsheet used for portfolio management was stored on the desktop of one employee, rather than on the server.  

**More Sample Findings...**

Manager Representation	Onsite Due Diligence Findings
<p>HF Manager described his two “only” types of trades he enters into and reassures onsite that he only does those two types.</p>	<p>When requesting to review the portfolio onsite it appears that 2 of the 10 largest portfolio holdings were actually invested via a third undisclosed type with private companies instead of the claimed 100% in public companies.</p> <p> </p>
<p>All trades must be approved by the investment committee, as well as by the senior risk officer.</p>	<p>Senior partner in practice places trades on his own. The senior risk officer only monitors risk exposures ex-post, after the positions are already open.</p> <p> </p>
<p>Quarterly disaster recovery tests are performed.</p>	<p>When interviewing the responsible person for the IT infrastructure, we learned that over the last 9 months, no disaster recovery tests were performed.</p> <p> </p>
<p>The fund is independently administered by XYZ Fund Administration, Ltd., Bermuda</p>	<p>The management company sub-lets and share’s its primary office space to the fund administrator’s London branch.</p> <p> </p>
<p>The management company was founded in 2006, and remains fully independent and owned by the three founding partners.</p>	<p>There is a second asset management company’s name written on the door, mailbox and ringer. It turns out that two of the partners are still actively managing funds which have run into trouble in the same strategy.</p> <p> </p>
<p>The team is made up of 10 investment professionals.</p>	<p>Manager claims in advance that it will be difficult to see all members of the team. Upon arrival, there are only 4 individuals in the office, and three empty desks do not appear to have been used in months.</p> <p> </p>

And some specific to Funds of Funds...

Manager Representation	Onsite Due Diligence Findings	
<p>“Every meeting that we have with a prospective or current manager is written up in form of structured reports”.</p>	<p>When we asked for the complete set of due diligence reports, no written reports on the underlying funds existed. All due diligence reports were performed by analysts at the portfolio manager’s former employer and have so far not been reproduced.</p>	
<p>The COO has final decision on areas of operational risk and right to veto any potential investment.</p>	<p>When interviewing the COO onsite, we learned that he once had concerns with a self-administered fund and he advised not to invest before administration is done independently. In fact, his veto right was not valid as the portfolio manager has invested before the administration issue was resolved.</p>	
<p>The investment team avoids CTA’s because it is difficult to understand how they make money.</p>	<p>A look at the fund of fund’s underlying positions onsite revealed that the manager had exposure to quantitative trend followers. When interviewing the portfolio manager we learned that he seems to be in close relation with the manager of this trend following fund.</p>	
<p>“We use a third-party provider for due diligence”.</p>	<p>When interviewing the CIO onsite, we learned that the contract with the third-party provider has been terminated and so far was not renewed.</p>	
<p>The manager defines its biggest non-market risks to be underlying manager fraud and counterparty risks.</p>	<p>During our Onsite Due Diligence we were told that the manager neither verifies assets or wire controls independently with banks and brokers nor does he review any of the service provider agreements.</p>	
<p>“We mitigate tail risks through rigorous risk management and dynamic hedging, as appropriate.”</p>	<p>In fact, the manager confirmed onsite that there is no hedging in place due to the complex nature of his holdings which make it impossible to define offsetting positions.</p>	

## Summary – Conducting Professional Onsite Due Diligence

Onsite due diligence can reveal crucial pieces of information about a manager that may lead an informed investor to turn away or at least re-think a potential allocation.

**Misleading information which was communicated before the Onsite Due Diligence tends to hide key areas of operational risk.** Furthermore, the fact that the manager has misrepresented or misled the potential investor prior to the Onsite Due Diligence is, in itself, a yellow flag at best.

***“Contradictory information tends to hide key areas of operational risk”***

In this age of increasing transparency, it is up to investors and their due diligence specialists to challenge managers to provide the information they require to make an informed investment decision. A well-structured Onsite Due Diligence is a crucial portion of that process.

Although obvious red-flags may not pop-up on every manager directly during the onsite, trained analysts almost always find areas where the manager can make improvements. For individual investors, advisors, and fund of funds managers, a complete and thorough due diligence process with a structured Onsite Due Diligence are invaluable important steps before and after investing in any alternative investment strategy.

Only then can an investor say that they truly have completed their “due diligence” for their shareholders, stakeholders and themselves.

# Do Diligence



A word cloud of various due diligence factors. The words are arranged in a roughly rectangular shape, with 'Fraud' and 'Liquidity' being the largest. Other prominent words include 'Operational Risk', 'Valuation Policies', 'Risk Management', 'Background Investigation', 'Conflicts of Interest', 'Legal', 'Regulation', 'Leverage', 'Counterparty Risk', 'Fund Structure', 'Compliance', 'Disaster Recovery', 'Hidden Fees', 'Redemption Terms', 'Strategy Drift', 'Signature Rights', 'Key People', 'Audit Review', and 'Investigation'.

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