



Opalesque Exclusive: The evolution of due diligence, Part 9 - SwissAnalytics: it is impossible to properly analyze operations without solid understanding of fund strategy

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Andrew Perry: Andrew Perry is a director at alternative investment risk specialists SwissAnalytics, based out of Zurich. With several decades of combined single-manager and fund of funds management experience, SwissAnalytics is now wholly dedicated to delivering superior qualitative and quantitative alternative investment research to a broad range of alternative investment allocators.

1. What types of clients use your services?

Our clients range from family offices to funds of funds and larger institutional banks.

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

Everyone investing in alternatives has some portion of the due diligence process that is kept in-house, and we stress the importance of this to our clients. They can neither outsource their fiduciary duties nor their professional responsibility to their stakeholders and investors.

That being said, our clients leverage our experience, tested processes and independence to augment their alternative investment analysis. Independence is particularly important, as conflicts often exist between selection teams (typically more senior) and the due diligence teams at many institutions.

We are sensitive to these factors, identify where we can add the most value and take on various roles in the allocation process while maintaining that independence.

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

We consider ourselves to be risk management partners in a broad sense. Our approach to due diligence is thus built around the goal of identifying non-traditional risks which can lead to significant losses of capital. Key to this is the distinction between compensated and uncompensated risks.

In our opinion, it is impossible to properly analyze operations or have an opinion about best practices without having a solid understanding of the fund strategy. In the same way, the business risk of the manager is closely tied in with their fund strategies' exposure to market risks, and there are many integrated factors with cross-relationships.

We thus focus on *doing* diligence, not cutting any corners and avoid relying upon assumptions or the manager's own selling points at all costs. If we can't get comfortable with or independently verify risk factors, managers will lose our confidence and that will be reflected in our analysis.

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

It didn't impact our work per se, rather justified our rationale for being so picky and broad in our analysis. In that regard, several risks were highlighted by the crisis through their materialization, and we have seen both our clients and the managers we analyze highlighting risk mitigation in these risk factors *du jour*.

Counterparty risks and re-hypothecation, for instance, became hot topics since the Lehman collapse. Also, outsourced functions such as fund administration have always been critical for serious investors, but since Mr. M revealed his ponzi scheme, properly thorough examination of the associated risks has become en vogue. Liquidity mismatch is another risk factor which widely materialized through suspensions, gates, side-pockets, and subsequently frustrated investors.



We have always highlighted investor concentration risk and liquidity mismatches in our work. Unfortunately, in bull markets where funds were attracting new assets, investors tended to take many of these issues lightly. We put a lot of time in defining and identifying a wide range of risks, unfortunately, many investors hadn't taken many of these too seriously until it was too late.

There are other risks that either did not materialize as significantly during the crises, or were watered down by other headline risks. Many investors may not be properly scrutinizing these other areas. Succession plans, incentive structures, IT and disaster recovery and signature rights are some of these areas which the crisis did not significantly highlight, which remain crucial parts of proper due diligence.

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

The business risks of hedge funds are extremely complex, and can only be properly assessed as an aggregate of diverse, individual risk factors. Some of these sub-risk factors include estimated past and future profitability of the fund/management company, conflicts of interest, weaknesses in legal set-up, fund operations, execution, IT, disaster recovery, the fund strategy's risks, liquidity mismatches and investor concentration, among others. These can all look great in a manager's own due diligence questionnaire, but independent verification and cross-checking their ascertainment is another matter entirely.

6. How do you go about evaluating this?

Honestly, it takes a bit of healthy, professional cynicism along with a "divide and conquer" approach. Managers know the strengths and weaknesses of their business very well, and are accustomed to "selling it" to investors and due diligence teams. Our entire process is designed to get managers off of their marketing pitch and produce evidence that their business is a stable, sustainable foundation for their funds' long-term success.

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

The risks have always been there, it's just that many hidden risks finally materialized in a big way since about mid-2007.

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

The challenge in alternative due diligence will be to stay ahead of the industry and stay on top of the latest tricks and trends, especially with regards to fund structure and strategy. For instance, the growing use of UCITS funds and the accompanying compliance risks and the increased frequency of managed accounts and managed account "platforms" push due diligence experts to constantly keep informed and have a clear opinion on best practices and risks. Even though the industry took a step and a half backwards in 07-08, it remains nimble and dynamic, requiring due diligence professionals to keep ahead of the curve and avoid overlooking the key risks which will lead to the next blow-up, fraud, disorderly liquidation or lengthy legal dispute.