

THE LONG VIEW

JOEL PRESS

on the growth of operational due diligence – and how it could work better



“OPERATIONAL DUE DILIGENCE IS NO LONGER A CASE OF ‘KICKING THE TIRES’. TECHNIQUES AND REPORTS HAVE EVOLVED – BUT THE PROCESS COULD WORK BETTER”

The growth of operational due diligence since 2008 is a symptom of the increasingly institutional profile of the average hedge fund investor. Allocators are spending more time on the process than ever before, and sets of common standards such as Albourne’s OPERA – Open Protocol Enabling Risk Aggregation – are emerging. All of this is to be welcomed: institutional money is sticky, and well-researched investments are projected to have a longer life-span.

Operational due diligence is no longer a case of ‘kicking the tires’. Techniques and reports have evolved and the onus is on managers to meet often sophisticated standards before an institutional investor will commit capital. But the process could work better.

First, the ‘tick-box’ model generally favoured within the industry is, in my view, not robust enough. Such an approach cannot be relied upon to get to the heart of issues, particularly as there is frequently

a gulf of experience between those asking the questions and those answering. Due diligence covers a broad range of industry issues, and those asking the first question frequently don’t have the depth of understanding or practical savvy to know what the next question should be.

Can a checklist really be relied upon to deal with issues arising from the valuation of Level three assets? Does the person asking the question really understand those assets, the risks associated with them, their volatility and risk profile? Associated with such issues are settlement and counterparty risks that no checklist could really deal with. A clipboard and a set of questions are never enough; but knowledge can be.

If the process was more focused on the very complex and mundane, it would provide far more important information to the investor and they would be better-placed to decide whether it is acceptable to invest. Having said that, if we could cre-

ate a universal approach, we would have better due diligence and less time would be spent on it by investors and managers. I have a contact whose firm had seven due diligence visits, each from different investment groups, in the space of a week. All required access to key staff and systems, time and effort which could have been saved if there was a more singular approach.

What is needed is a universal set of standards the whole industry can get behind. This may seem an odd statement in the world of OPERA, Albourne’s risk reporting guidelines, which have gained some industry traction. But it is clear those guidelines will not work for all investors as they stand today, and many don’t think they go far enough.

The problem is that everyone thinks their approach to due diligence is the best one. While there is competition in the worlds of administration and auditing, reports provided by the mainstream firms in those industries carry weight. But a due diligence report produced by one investor may well fail to satisfy another investor, who would prefer to employ their own approach and criteria. As mentioned before, this leads to widespread duplication even though the investors’ goals are, ultimately, aligned.

Operational due diligence is being taken increasingly seriously and that is a positive development. The potential adoption of the OPERA standards as a condition for hedge funds to receive investment from Australia’s \$1.5trn superannuation market demonstrates its ever-bigger industry role. It also shows that trusted benchmarks are a possibility. But there is some way to go until a set of standards emerges the whole industry unites behind. The true test of this will be when operational due diligence reports produced for investors are trusted more or less equally by all. ■

JOEL PRESS is the founder of Press Management

THE WEEK IN QUOTES

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Albourne Partners CEO Simon Ruddick reacts to the backing for the OPERA reporting standards from Australia’s financial regulator

“WHAT WE TRY TO DO IS DIVERSIFY IN AS MANY WAYS AS POSSIBLE”

CTA industry pioneer Toby Gabel on his short-term trading style

“PEOPLE TALK ABOUT ASIAN MACRO A LOT BUT THERE ARE NOT THAT MANY DEDICATED ASIAN MACRO FUNDS OUT THERE”

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