
# Preparing for the operational due diligence visit: A hedge fund's guide

In light of the recent Madoff scandal, hedge fund investors have placed an increased importance on performing detailed operational due diligence reviews. Now more than ever in order to receive new capital allocations and stave off redemptions from nervous investors, hedge funds must be able to highlight the strength of their operations. There are a few key steps a hedge fund can take to ensure that they are adequately prepared for an operational due diligence review:

## Understand your investor

Different types of investors may have different reasons for performing operational due diligence. Some well resourced hedge fund allocation organizations may wish to understand the nuts and bolts of a hedge funds operations in extreme detail. Others may want to ensure that there are no major weaknesses in a hedge funds operational infrastructure but they may not have the knowledge or resources to thoroughly vet all this risks completely. Still other investors may be extremely sensitive to certain operational risk factors, such as valuation or counterparty risk, and may conduct more detailed reviews of only these areas. Without taking the time to understand the goals and resources of each particular investor when performing an operational due diligence review, many hedge funds falter by either providing too much or too little relevant information to investors.

## Be Prepared

According to a recent study conducted by Corgentum Consulting, in the pre-Madoff environment approximately 85% of the operational information collected by large institutional investors focused on the same operational factors. In the course of an operational due diligence review different investors will likely inquire about the same key operational areas such as trading, valuation, service providers and compliance policies. If a hedge fund has taken steps to prepare detailed information for investors regarding these key issues then it will often increase the efficiency of the operational due diligence process for both parties. Hedge funds must also be prepared to both discuss and demonstrate the implementation of these descriptions during an on-site visit.

## Be Consistent

One of the biggest reasons hedge funds perform poorly on operational due diligence reviews is due to a lack of consistency. This inconsistency can come in several forms such as in a fund's written documentation (i.e. – offering memorandum or marketing materials) or between written materials and statements made by a hedge fund's operational professionals. Such conflicting information may cause investors to raise questions concerning the stability, connectivity and oversight within a hedge fund's organization. Avoiding such inconsistencies is a crucial part to the success of any operational due diligence review.

## Conclusion

In order to succeed in the post-Madoff environment hedge funds must take the management of operational risks seriously. Furthermore, they must be prepared for the increased costs and resource demands investors will place. Now more than ever, hedge funds which are prepared for these increasingly rigorous due diligence reviews and which make the processes as seamless as possible for investors will be the most successful at not only attracting but retaining capital from increasingly risk sensitive investors.

## For More Information

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