Thinking outside the box- Seven innovative due diligence techniques

The nature of due diligence is changing. The drivers of this change are manifold ranging from the Madoff scandal and current Ponzimonium to recent initiatives by the G-20 and the United States Securities and Exchange Commission to more closely regulate hedge funds. According to Corgentum's research in the pre-Madoff environment approximately 85% of the operational (i.e. – non-investment related) data collected by large hedge fund allocators during the due diligence process was very similar. Clearly this herd due diligence mentality was flawed and did not focus on the enough of the right red flag issues. In order to perform effective due diligence in this new environment investors both large and small need to become creative in redesigning their approach to due diligence. Here are some techniques which may prove beneficial in the new environment:

Talk to your friends

Turn your contact list into a *red flag social network*. When looking at a hedge fund manager for the first time, others may have looked at the same hedge fund previously and can provide insight including reasons they may not invested or redeemed.

Pick up the phone

If a manager says they work with a certain counterparty of service provider do not just confirm relationship but try to have a conversation with the other party. It is often very informative and provides a different perspective than the HF manager will give you.

Make you presence Known

Let the hedge fund manager know that you will be performing on-going monitoring including conference calls, focused reviews and on-site visits if they want to keep your money. Investors must walk a fine (but necessary) line between being overbearing and pushing for transparency

Design a due diligence budget

Investors should have an approximate due diligence budget (of both money and time) for each manager. This will vary by region, strategy etc. but provides a benchmark towards consistent due diligence.

There is no such thing as a stupid question

Do not be afraid to ask any question as part of due diligence process. You may touch on an issue the manager has never dealt with in detail. It is in these types of scenarios hedge funds cannot read from their prepared due diligence scripts – and this can lead to valuable insights of actual practices in place

Know your limits

Due diligence (particularly on operational issues such as legal, compliance, valuation, IT etc.) often requires specialized knowledge which many investors may not possess. In these cases investors should not be hesitant to work with experts that have specialized knowledge.

Put it all together

It is very important not to isolate parts of the due diligence process from each other. Once the entire due diligence process is complete, all data should be reviewed together in their entirety. This often allows investors to connect the dots and ensure that a hedge fund manager is being consistent.

For More Information

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