

Has Rigor Mortis Set In On Your Due Diligence?

- The dangers of inflexible operational risk methodologies

When comparing operational due diligence methodologies across different hedge fund allocators consistency of approach is often a key concern. These concerns however, must be counter-balanced with the notion that all hedge funds are not created equal. In order to successfully vet the full entirety of operational risks present at a hedge fund, an investor must sometimes be prepared to add an element of flexibility to their approach. Such flexibility can often lead to covering areas not traditionally addressed in detail during the course of standard methodology reviews. Such flexibility often sheds more light on the operational risks already uncovered during standard methodology reviews. Similarly, flexible approaches tend to allow investors to uncover a series of operational risk factors which were previously not reviewed under standard methodologies. Inflexible operational due diligence approaches, can suffer from a *check-the-box mentality* which can be detrimental to both hedge funds and investors. Furthermore, inflexible operational due diligence approaches are more susceptible to fraud as they are easier to manipulate from the perspective of the fraudster. Investors should seek to have an element of flexibility in their operational due diligence process to design the most appropriate review specifically tailored to meet the needs of each unique hedge fund manager, while at the same time not sacrificing the benefits afforded by having minimum uniform standards in place.

Investors have different operational sensitivities

Different hedge fund investors may have different sensitivities and priorities in regards to the operational riskiness of a hedge fund. So for example, one investor may only place minimal importance on a hedge fund manager's business continuity and disaster recovery plan while this may be of high importance to another investor. An overly rigid operational due diligence methodology overlooks these different investor sensitivities.

Operational risk factor weights vary among hedge fund managers

Operational risk concerns may also vary among different managers. Continuing our example, business continuity and disaster recovery may be of increased importance to a high frequency trading manager than a hedge fund which only executes a few trades a month. Inflexible operational due diligence methodologies often ignore the nuances of different investor operational risk thresholds and the potential increased weight of certain operational risk actors for different managers.

Information overload can dampen investors operational sensitivities

Inflexible operational due diligence methodologies can often yield reports which contain reams of irrelevant information as a result of their boiler-plate *check the box* approaches to operational due diligence. Overloading investors with volumes of such information can result in important details and risk considerations becoming lost. This leaves investors with the problem of searching for an operational risk needle in a haystack of immaterial information. A flexible approach to operational due diligence can assist in mitigating this information overload.

For More Information

Contact:
Jason Scharfman, Managing Partner
scharfman@corgentum.com
corgentum.com



CORGENTUM

20 Fleet Street, Jersey City, NJ 07306
Tel. 201-360-2430