



CORGENTUM

## Hedge Fund Due Diligence Gold? - The Olympic Connection

The world is currently focused on the 2012 Summer Olympic Games. This athletic spectacle had us thinking of the similarities between the Olympics and operational due diligence. In certain Olympic team sports such as basketball, all that matters is the final score - that is what determines who will be standing on the medal podium. In other sports however, such as archery and judo, the technical details matter. In these sports the way in which an athlete performs, not only whether they hit the target or not, determines their overall score.

Investors tend to approach operational due diligence on hedge funds and private equity funds in much the same ways. Some investors take a cumulative or macro view approach to evaluating the overall operational risk in a fund manager. These investors tend to forgo the minutia of the operational details for the overall big picture. Much like Olympic basketball, what matters to them is the so-called final score. For these investors most managers start with a passing grade and points are deducted for deficiencies. These investors are focused primarily on answering the question of whether or not there are any deal killer type operational deficiencies in place.

Another group of investors approach operational due diligence from the bottom up. For these investors, operational points are earned rather than deducted from a starting high score. Under this approach investors are focused on assessing not only whether or not a manager has what could be considered operational weaknesses, but also on assessing the overall quality of the firm's operations. This approach is more diagnostic in nature. It requires not only more investor knowledge of operational practices, but also more work on the investor's part to delve into the details of each operational practice.

To illustrate the differences in approaches, consider, are you the type of investor that asks generally about a fund's relationship with its administrator or do you delve into the details? For example, do you ask if the fund manager ever visits the administrators' offices or conducts daily cash and position reconciliations? Do you know how to evaluate the answers to these questions?

### Conclusion

By focusing on the details of creating a bottom-up operational profile of each operational area of a fund manager, investors can make more informed risk assessments. When performing operational due diligence, many investors run the risk of losing focus of important operational details in lieu of big picture, broad stroke risk assessments. While the ultimate conclusion of the overall operational riskiness of a fund manager is crucial to asset allocation, such considerations should not outweigh the required operational due diligence research necessary to draw an informed conclusion. Without such hard work investors may be left with the bronze medal instead of the gold.

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