PRESERVER PARTNERS

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Three Steps to Improving Operational Due Diligence

The investment research process for private investments at Preserver Partners is bifurcated into investment due diligence and operational due diligence. The investment due diligence process primarily focuses on a potential investment's risk/return profile, how a strategy may fit within the Preserver portfolio, market trends, etc. Preserver Partners defines 'operational due diligence' as the assessment and analysis of a potential investment's firm and/or fund operational risks. Examples of operational risk factors are compliance processes, valuation policies, information technology infrastructure, business continuity and disaster recovery planning, cash management controls, and quality of third-party service providers such as fund administrators and auditors.

While operational due diligence may have always played a role in managers' investment research process, it was not until the infamous Bernie Madoff Ponzi scheme in 2008-09 that operational risk research/analysis began receiving greater emphasis by investment managers and regulators. The U.S. Securities and Exchange Commission is citing more operational topics such as cybersecurity and compliance policies in their exam priorities.

It is important to thoroughly understand the operational processes and procedures of a firm and fund before making an investment. Alternative investments typically have less liquidity. If an unsatisfactory operational due diligence analysis is completed after an investment is made, redeeming the capital investment can be time-consuming and, in some cases, negatively impact returns.

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Three of the most simple, yet meaningful steps in operational due diligence is to 1) Read the material you have requested, 2) Converse with operations and compliance professionals at the investment firm, and 3) Verify primary third-party service providers.

Reading the requested material may sound obvious, but simply having the documentation is not enough. For example, how do you know that a compliance manual contains robust policies and procedures that are relevant to the firm in question if you do not read through the material? Furthermore, if the manual is not robust or relevant enough, what guidance do employees have on the firm's standards and procedures? Requesting a copy of the compliance manual is not unusual (it is a standard practice at Preserver) however, many managers prefer not to send it electronically and instead have their manuals viewed on-site. This is perfectly acceptable and in fact, often helpful to have associates there to answer questions as they arise.

Investment research teams often consume the majority of the discussion during the research calls as well as site visits. It is equally important for operational due diligence professionals to ask questions and to meet separately with the operations personnel for conversation if necessary. For example, a back-office associate will have a more detailed and clearer response as to how trades are confirmed and reconciled than a portfolio manager will.

Lastly, verifying relationships with primary third-party providers typically takes no more than a 10-minute phone call, yet can reveal an incredible amount of insight into the processes, procedures, and communications of the firm. And most obviously – that the business relationship even exists.

Focusing on these three simple steps can elevate any operational due diligence research process and provide an added layer of confidence to the final investment decision.