The New Era of Manager Due Diligence

Globally, growth in alternative assets outpaced that of traditional asset classes by nearly seven times during the five years prior to 2011, according to a 2012 study by McKinsey & Company (p. 1). The appetite for alternatives is expected to continue as investors seek absolute returns, diversification, lower volatility, and fixed-income substitutes in an environment characterized by ultra-low interest rates and high downside risk. “Alternatives offer a different kind of return stream,” says Steve McMenamin, Executive Director of the Greenwich Roundtable, a not-for-profit research and educational organization composed of approximately 150 alternative asset investors. “Alternative managers go through the marketplace with a finer tooth comb to generate higher returns with different kinds of strategies, different kinds of assets.”

The definition of the alternative asset space has expanded to include asset subclasses, such as infrastructure, timber and farmland, and global tactical asset allocation, in addition to the traditional four—real estate, private equity and venture capital, hedge funds, and commodity futures. As alternative investments continue to gain presence in institutional portfolios, retail investors have also taken note. Since 2005, retail alternative assets and strategies have grown by 21% a year (McKinsey & Company 2012, pp. 9–10). The mainstreaming of alternative assets presents challenges for traditional and alternative consultants as well as investors on both ends of the spectrum. Sophisticated investment strategies, leverage, illiquid assets, and increased risk of loss call for a set of due diligence principles different from the principles that guided traditional due diligence.

ASSIGN MORE WEIGHT TO OPERATIONAL DUE DILIGENCE

A significant challenge to consultants and plan sponsors is the complexity that alternative assets add to the due diligence process. Sophisticated strategies require sophisticated processes. A fund’s operations should be researched as thoroughly as its investment strategy. “Operational due diligence is more important than ever because of the complexity of these investments,” says McMenamin. “There is also a lot of business risk. Investors need to make sure that the business has the systems and the safeguards in place to prevent accidents from happening.” Leverage, liquidity, and valuations must be analyzed and understood. Among the thousands of hedge funds, relatively few fail, yet failures do occur each year. Of 22 hedge fund failures analyzed by the Greenwich Roundtable, most were the result of excess leverage and illiquidity. Investors should know what kind of leverage is being used, the amount of leverage, and—of key importance—the sustainability of the leverage, particularly when combined with less-liquid assets. “Leverage and illiquidity can be high-octane dynamite in a portfolio,” says McMenamin. Interviewing pricing services and other vendors is also recommended. Of the six fund failures that were the result of fraud, interviewing service providers would have raised a red flag for five of the funds (Greenwich Roundtable Education Committee 2012, p. 5). The absence of an independent valuation service is certainly a red flag.

Due diligence should extend to the managers themselves, as in traditional due diligence, but a more rigorous approach is called for beyond simply interviewing...
managers at their offices. Background checks, both formal and informal, should be performed on key personnel. Interviewing previous coworkers, for example, can provide far more insight into a manager’s character than an investor can hope to gain from a sales presentation, particularly from a “beauty contest,” as the practice of having a selection of potential managers make well-crafted sales pitches is often called. Channel checks, internet searches, and private investigative reports can all provide valuable information about a manager.

As alternatives move into the mainstream, the due diligence process for alternative investments has become more formalized and more rigorous. Traditional consultants and plan sponsors may find the process overwhelming, whereas alternative investors may find formalization of due diligence constraining. Although formal processes provide investors with more safeguards and information, they can come with a downside in alternative investing. “Complexity in due diligence has driven many investors to large, mega firms, potentially at the expense of alpha,” says Edgar W. Barksdale, Jr., a member of the Greenwich Roundtable who has been engaged in manager due diligence for more than 40 years. Barksdale was one of the founders of Callan Associates, a cofounder of Rogers, Casey and Barksdale (now Segal Rogerscasey), and past president and CEO of Northern Trust Global Advisors. Today, he is principal and CEO of Federal Street Partners, LLC. “One of the reasons many institutional investors invest with very large firms is because due diligence has become so complicated that it can be overwhelming for investors,” Barksdale says. “But as a firm becomes very large, and assets become more concentrated in a small number of very large firms, it becomes more difficult to have meaningful positions in companies, particularly for hedge funds that want to short positions.”

Investors who find that due diligence is beyond their resources can hire firms that specialize in manager and fund due diligence. Investors who take on the challenge themselves will find that economies of scale eventually materialize, both in costs—which can be substantial—and through familiarity with the markets and industry contacts.

APPLY TRADITIONAL TOOLS SPARINGLY

Sophisticated investment strategies often bring higher rewards, yet they can have hidden risks and greater opportunities for failure. “A challenge in due diligence is spending enough time to understand a fund’s or investment’s strategy and risks. This requires a lot of judgment on the part of the investor because it is very hard to reduce the risks of hedge funds, for example, to valid statistical measures,” says Barksdale. Barksdale notes that as alternative assets become mainstream, investors tend to apply the same tools to them that are applied to stock and bond investments. Most of those tools, however, were designed for traditional long-only strategies. When analyzing alternative investment strategies, Barksdale says, more weight should be given to judgment about the managers themselves and less weight to traditional statistical analysis. “Standard deviation and the Sharpe ratio are more useful for information than for basing hiring decisions on, though they may be useful in excluding managers. If a manager has had a very high standard deviation, that’s probably going to continue,” he advises, “but that is probably not the case for future returns.”

One of the issues with applying conventional risk measures to alternative assets is that risk for conventional assets has traditionally been defined as volatility. Volatility is often hard to measure for alternatives assets. Prices are frequently not observable and must be estimated, resulting in smoother return series. Measures based on volatility rely on the assumption that returns are normally distributed, an unrealistic assumption for alternative assets (as well as for many traditional assets). Downside volatility measures, such as semivariance (the standard deviation of below-mean returns) or shortfall risk (the probability of falling short of a target return), may be more informative. Still, volatility measures can provide useful red flags. A sudden or persistent change in volatility might indicate strategy drift or an aggressive increase in risk taking. Unusually low volatility may be a symptom of stale or unrealistic pricing, or fraud.

Volatility is one definition of risk; for alternative investors, loss of capital is another. Drawdown measures are often favored by hedge fund investors. The ratio of a manager’s annual rate of return to the manager’s largest drawdown is a particularly useful risk-adjusted measure for analyzing managers with more volatile strategies. Leverage, another component of risk, can be used to amplify risk or dampen volatility. Like volatility, the manager’s historical average, minimum, and maximum leverage levels should be analyzed for changing trends as well as for whether the amount and type of leverage is appropriate for the market and the strategy. Risk-based leverage measures can also be used. In general, statistics
are most informative when they are used as the basis for questioning what is happening with a fund or strategy and considering the likelihood of that trend continuing.

**RECOGNIZE THE ISSUES IN FORECASTING AND EVALUATING RETURNS**

Estimating expected returns is the foundation of traditional investing, but using historical returns to project future returns is even more problematic for alternative assets than it is for traditional assets. Most alternative asset classes lack valuation indicators that serve as reference points for richness or cheapness. Historical returns for many alternatives, particularly hedge funds and private equity, are often misleading because of survivorship and other reporting biases. Risk premiums for alternative investments have also been shown to change significantly over time. Moreover, forecasting returns requires estimating a premium for the illiquidity of an asset class, a notoriously difficult task. Although some rules of thumb can be used—private equity, for instance, is typically assigned a premium of 500 bps over public equities—estimating an alternative asset’s return generally requires judgment rather than a reliance on quantitative models. McMenamin says no hard and fast rule exists to judge whether an investor is getting paid enough of a premium for illiquidity. “You have to ask, am I going to be paid more for this illiquid structure or investment than I can get in the marketplace?” he says. “We might say, for example, we think—not we expect—we think this strategy, this market, this manager, may deliver 10–15%.”

In addition, there is no guarantee that an investor will actually be compensated for taking liquidity risk. In one example, the Kauffman Foundation analyzed their investments in 100 venture capital funds over a 20-year period and found that 78% of the funds did not compensate them for the long-term illiquid nature of the investments; 62% of the funds underperformed public markets. A rule of thumb offered by the Greenwich Roundtable is that investors should stay with liquid investments unless an illiquid investment is expected to have a materially higher risk-adjusted return.

The ultimate goal of projecting returns is to allocate assets in a portfolio in such a way that an investor’s return is maximized within his or her risk constraints. The traditional approach to asset allocation is based on determining an investor’s efficient frontier through mean–variance optimization (MVO). MVO is derived by assigning expected returns to equities and bonds based on an analysis of their historical returns, standard deviations, and covariances. The model assumes a portfolio can be freely rebalanced. Illiquidity, high transaction costs, and inability to buy or sell easily make alternative assets unsuitable for traditional MVO. The high expected returns often ascribed to illiquid assets and artificially smoothed volatility lead to very high allocations of alternative assets in MVO models. Although models have been developed to address these issues with alternative assets, the outputs are only as good as the inputs and assumptions. Monte Carlo simulation can be a more useful alternative. McMenamin cautions against relying on models to predict outcomes because doing so leads investors into a false sense of certainty about what the future might bring.

When evaluating actual returns, investors must be prepared to deal with imperfect benchmarks, or none at all. Although many hedge fund indices have been developed, they are affected by survivorship bias and voluntary reporting, as well as other issues. Grouping hedge funds by strategy is difficult, and sometimes meaningless, because of complicated structures and shifting risk exposures. Private equity indices do not exist, although performance is typically evaluated against a spread over publicly traded equities. Moreover, private equity investors will not know their true return until the investment is exited years later. Until then, they will receive return estimates, which can be subject to accounting interpretation and calculated in various ways. Indices for other alternative assets are also subject to lack of observable transaction prices or are not representative of investment opportunities and associated costs.

**COLLECT “PICASSOS”**

One of the best principles in the new era of manager due diligence, says McMenamin, is to collect quality managers when they become available. Reaching a private equity target allocation, for example, may take years but investors should be prepared to wait. Spreads between top managers and median or bottom managers can be so large that it is better to forgo investing in an asset class until a quality manager becomes available rather than “fill a bucket” with a mediocre manager, according to the Greenwich Roundtable. In the past, McMenamin says, a mediocre manager would do no harm, but today, a mediocre manager can get wiped out, especially a venture capital or leveraged hedge.
fund manager. “Alternatives are an access class, so truly good-quality managers—those who are return manufacturers and not asset gatherers—will try to limit their assets under management,” he says. “And so when they become available and they have some spare capacity, that is the time to hire them. The notion of collecting quality managers is like collecting Picassos. Not all Picassos are for sale all the time.”

**KNOW WHEN TO OVERDIVERSIFY**

Another modern-era principle is that hedge fund investments and strategies should be spread among many managers. Among equity managers, overdiversification or hyperdiversification is often viewed as reducing consultant career risk rather than equity risk, but the opposite is true for hedge funds. “Hedge fund investors need to be broadly diversified, more diversified than most investors think,” says Barksdale. “There is much less transparency than in traditional investments, so investors really don’t know what they own.” For example, a 20% allocation to hedge funds within a large institutional portfolio should be allocated among 10–20 managers, he says, whereas a similar weighting in a traditional equity portfolio might warrant no more than 3–5 managers. “The greater the number of managers, the more an investor has reduced the risk of catastrophic failure by one of the managers,” advises Barksdale, “though much more monitoring is required.”

**MONITOR MANAGERS MORE OFTEN AND MORE CLOSELY**

Finally, in the modern era of manager due diligence, the due diligence process does not actually end. Traditionally, once a manager was hired, consultants and investors would receive monthly or quarterly performance and holdings reports and meet with the manager periodically. Alternative investment managers should be closely monitored on an ongoing basis. “Manager monitoring is just as important as the due diligence that is done before the investment is made in that manager,” says McMenamin. “And monitoring should be continuous, ongoing, and regular because things do change.”

For very active managers, such as hedge funds, reporting should be more frequent and more detailed—weekly performance reports, for example, as well as monthly statistics on volatility and leverage. Because these managers are so active and strategies and holdings are often not transparent, a greater emphasis should be placed on understanding the manager’s short-term activity and returns rather than the traditional longer-term focus on returns. Investors should also analyze the manager’s liquidity on a regular basis because liquidity changes as markets change. If a fund’s return is aberrant in some way—either better or worse than one would expect—Barksdale advises picking up the phone and calling the manager to find out what he or she is doing differently.

Red flags to note include a change in vendors, such as the manager’s auditor or valuation agent, and offerings of new types of funds or strategies. High fees for assets under management provide an incentive for managers to raise more capital, which may overwhelm a strategy or asset class’s ability to absorb the capital. Managers should focus on the business of investing and not become distracted, says Barksdale. “If they become distracted—managing the business, tweaking the strategy to accommodate more assets, or offering an array of new products—it is time to move on to other opportunities.”

**CONCLUSION**

As alternative investments become more mainstream, manager due diligence should incorporate a set of principles that reflect the differences between these and traditional investments. Using traditional analytical tools to evaluate alternative investments will lead to underestimating risk and overestimating returns. Investing in alternative assets requires a greater reliance on judgment over statistics, more detailed and thorough due diligence and manager monitoring, the patience to invest only with high-quality managers, and the ability to know when traditional practices do not apply.

Some traditional due diligence principles still hold true in the modern era of manager assessment, however. Placing less weight on historical returns and more weight on future expectations is one of them. Barksdale says investors would make better manager selection decisions if they undertook a comprehensive evaluation of the manager before seeing historical return statistics because intuition and judgment is easily blinded by strong historical performance. Another tried-and-true principle that still holds: Investment strategies that are too complex, that are beyond the understanding of an investor, should be avoided.
REFERENCES


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