



# Due Diligence Pitfalls

**Big Risks Hiding in Obvious Places**

**By Kelly Westfall, CPA, CFA**



It is true that this list does not include every critical investment risk we try to minimize with planning and due diligence. It does, however, include a “hit list” of sorts, of those key attributes which tend to go unnoticed or are overlooked. Investors diligently focus on investment strategy and holdings and the related risk profiles. They may also screen for and look closely at characteristics such as historical performance, liquidity terms or maybe the age of the fund. But investors can sometimes overlook key factors related to HOW the investment is made.

### What are you getting into?

It's not a secret that active managers are under tremendous pressure to reduce fees and increase the liquidity of their products. Trillions of dollars have been pulled out of actively managed portfolios and reallocated to ETFs; \$130 billion in the first quarter of 2017. It makes sense that issuers are motivated to find ways to wrap strategies, whatever they may be, and market them as the product everybody wants to buy. Still, a leopard cannot change its spots. And a readily active market for illiquid investment assets won't appear because they are in ETF or mutual fund portfolios. There may be a place in your portfolio for actively managed or “alternative” mutual funds or ETFs. But mismatches between investment vehicles and underlying assets change the risk profile of the asset; increasing the chance of fund failure and volatility and changing manager portfolio allocation decisions based on being able

to ensure liquidity. Additionally, these benefits are not free; opportunity losses result.

In general, investment products and vehicles have their own independent set of risks and benefits which are distinct from the underlying assets. Valuations of a fund which is required to value its assets daily, but is holding illiquid assets, are error prone and subject to restatement or worse.

Separately managed accounts are safer, in that the investor is the beneficial owner of the underlying assets; however, they are more burdensome from a “back office” perspective. Private funds such as hedge funds or private equity funds are easy, in that all you see is a monthly or quarterly statement and there is not much to do (because there is not much provided to do anything with). The flip side is that private funds require more due diligence, analysis and monitoring; incorporating not just the funds underlying assets, but

the business operations and the motives and goals of the investment manager as well: Are they raising money for one or more funds? What is the nature of fund distributions – earnings or borrowings? What is the fund holding and how are they valuing the assets? These are complex, time consuming and difficult questions to answer. And, private funds are very expensive. They are also the best vehicle for riskier, illiquid strategies which require a large asset base to be successful; like venture capital. Venture capital returns, however, should exceed those of more liquid, less risky assets (if the due diligence is performed on the front end). Illiquid investments and strategies requiring more complex planning and large asset bases are, without a doubt better suited for a private partnership vehicle.

### **Hidden in Plain Sight**

Buried amongst standard descriptive information, regulatory and contract disclosures also contain protections for investment managers from disgruntled investors as well as regulators. In general, as long as a controversial but strictly legal business practice is disclosed, and investors are informed, investment managers are free to run their businesses however they see fit. The fact that certain disclosures are



presented co-mingled with standard information, on multiple pages of complex technical verbiage, may make some controversial operating practices seem innocuous and provide a false sense of normalcy. When in fact, disclosures include items which should be considered risky. If they were truly harmless, there would be no need to disclose them; thus “warning” investors. These disclosures should be interpreted as warnings to investors and protections to investment managers.

Risks and conflicts of interest are required to be disclosed in regulatory filings, fund documents and investment management agreements. These disclosures can be long, complicated and painful to interpret. But in order to understand the risk profile of the investment, its place in your portfolio and

calculate required return estimates, these risks require analysis. It matters whether or not employees are trading along-side investors; and if so, what are the ramifications of this within the context of the particular investment strategy? Does the Investment Manager have consulting arrangements with companies held in client portfolios? What are your rights as a Limited Partner in a private fund? Are there complex gate, fee or liquidity terms which require interpretation? What are the allowed investments; can the manager buy and sell anything? How about real estate or art or movie production deals? Can the manager sell assets between its various products and clients? These practices are required to be defined in the fund's or investment management company's disclosures.

It may be possible, if the investment is structured as a separately managed account, to address these issues on the front end. Regardless of the vehicle, however, they should not be overlooked.

## **Fee Errors**

Investment performance and performance fee errors are more common than most people think. In fact, they happen regularly; and they can be material. Strangely, they typically tilt in favor of the investment manager -- but not always. Periodic checks and scrutiny of investment manager's performance

calculations, as well as reviews for consistency with stated fee profiles, can reduce expenditures and will help to ensure investment managers are scrutinizing these numbers before reporting them.

It helps if the manager has a robust back office and systems. But systems also sometimes produce erroneous numbers. Additionally, many investment firms have robust systems or hire outside administrators for their fund products, but maintain the books for their separately managed accounts in house, using much less dependable methodologies. Spreadsheets, for example, are famous for their tendency to produce inconsistent data and are fraught with errors. Primarily due to inconsistency amongst, and mistakes made by, those maintaining the data.

## **The Business as a Whole**

It is important to consider the fund complex or investment management company as a whole. Other strategies, products and businesses can expose the organization to a slew of regulatory, cash flow and other risks. Transfers of illiquid assets, buying and selling between funds and/or clients, may be hard to identify (it's important to review disclosures related to these transactions). But understanding these relationships on the front end is a place

to start. Illiquid and highly leveraged strategies can put the company as a whole at risk; or, land them in the press which if nothing else, is a distraction. Asymmetrical bonus agreements, though not as common in the wake of the Citibank debacle in the midst of the financial conflict, can create a situation wherein the investment company is forced to pay out huge amounts of money, despite having incurred significant losses in other parts of the company's business. Not to mention that the investment manager may be distracted by other, more lucrative, areas of focus.

So, it is not enough to rely on the terms of the agreement for your particular investment. It pays to do due diligence on the entity as a whole.

### **Compliance is Only as Good as its Weakest Link**



Regulatory reforms included the requirement of a dedicated Chief Compliance Officer (CCO). However, some firms solved that problem by handing the title to an existing employee without much authority over other employees. Or, the CCO may be responsible for everything from marketing to the back office.

Alternatively, some firms have experienced legal professionals who understand the fear of non-compliance and how regulatory issues can destroy a business. Who the CCO is and the authority they command, is a determinant of not just how robust the investment management firm is; but it is also an indicator of common sense.

### **Common Sense**

In general, taking regulatory risks lightly or relying on “after the fact” checks to ensure laws are being followed is a silly, expensive and time consuming use of resources. Simple fixes on the front end, in the form of preventative controls (rules) over areas exposed to tremendous regulatory risk – such as employee trading – show a recognition of the risk involved and makes the due diligence process less complex for investors. Why any investment manager would put the firm at risk, and/or create a need for manually intensive, error prone and time consuming detective procedures, just so that employees can hold, buy and sell the same assets as their clients, is a mystery. Yes, it may be seen as a promotion of sorts if the employee is willing to buy and own the same securities they are buying for you. But they may also be trying to affect the price, trade ahead, create a sizeable trade or engage in any number of other

nefarious activities; all of which are under tremendous scrutiny by regulators. Violations of securities laws will destroy a business. It helps if the investment manager understands this. So, it is the decisions themselves regarding policy which are relevant, as well as the actual policies.

The End



*Kelly Westfall, CPA, CFA is the Founder of Investment Strategy Consulting LLC and the Co-Founder and General Partner of Archer Avenue Partners. Her expertise includes analysis of equity and alternative asset managers and products, and allocation recommendations as well as other types of specialized investment analysis. She has extensive experience in the United States and Europe conducting due diligence and consulting on portfolio allocations to investment managers, alternative investments, public funds and other complex investment products and advises on their use in the design and implementation of investment strategies.*

*Throughout her career, Kelly has authored published articles and is a regular panel participant and speaker at investment industry events.*



---

ARCHER AVENUE PARTNERS

---