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Performing Due Diligence on Alternative Investment Managers

By Scott D. Welch, CIMA®

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When investing with alternative investment managers, it is critical to remember that the qualitative analysis is, often, more important than the quantitative analysis. Performance numbers speak for themselves, with two important caveats: (1) beware of backtests—you will almost never see a bad one—i.e., insist on evaluating only live performance; and (2) be cautious when comparing individual fund performances with publicly available benchmarks.

Most hedge fund benchmarks comprise an aggregation and an averaging of self-reporting individual managers, compared with public index performances in traditional strategies. But there can be wide discrepancies in how different funds are managed relative to make-up of the other managers categorized in the same way. And the benchmarks themselves can be subject to survivorship bias, i.e., poorly performing funds stop reporting their numbers and drop out of the benchmark, or inclusion bias, i.e., where funds that are doing well and are successfully raising capital don't bother to report.

Hedge funds and limited partnerships (LPs) in general have come a long way in terms of transparency and performance reporting since the bad old days leading into 2008, the result of a more stringent regulatory environment and investor insistence. But differences remain between performing due diligence on LPs and more traditional—and much more liquid—investments such as exchange-traded funds (ETFs), mutual funds, or separately managed accounts. Those differences in what is required come primarily from a qualitative due diligence perspective.

One approach is to follow what might be called a SMART², i.e., SMART-squared, approach[1]—a simple and useful acronym for 10 separate issues that good qualitative due diligence should cover. This approach is equally useful for hedge funds and other LP investment due diligence.

THE SMART² APPROACH

The SMART² ranking system gives a numerical value from 1 (poor) to 4 (excellent) to each of 10 factors influencing the viability and performance of a fund. Each factor is assigned a weighting such that the sum of the weightings equals 100 percent, with the weightings based on the perceived importance of each category. The total SMART² value is a weighted average score. Both the combined total score and the individual score on each attribute are considered, and minimum acceptable scores are established for each attribute (see example shown in table 1).

This ranking approach, of course, does not provide proof positive that any particular hedge fund or alternative investment is good or bad, and it certainly does not constitute everything that is involved in due diligence.

But its disciplined application does have three positive results: (1) it allows for an apples-to-apples comparison among multiple funds (because all funds are subjected to the same ranking system); (2) it provides a useful checklist that helps ensure the analyst is not overlooking anything or overly influenced by the new fund's sales pitch; and (3) it helps to create an evergreen institutional process that endures past any given analyst's tenure.

STRATEGY AND STRUCTURE

Strategy. What are the fund's philosophy, objectives, and strategy strength relative to peers, i.e., peer ranking, as well as the analyst's thoughts about the relevance and viability of the strategy given existing market opportunities and conditions? Does the fund's investment thesis make sense? Is it implementable and repeatable? Is it easy to understand and explain to potential investors?

Structure. What is the fund's organizational structure—its simplicity or complexity—and is it appropriate for potential clients? What are the fund's investment terms, liquidity, and transparency characteristics? Do the fund's third-party accounting, legal, administration, and prime brokerage relationships check out? How quickly does the fund deliver estimated and actual return numbers? What is the investor service model?

MANAGEMENT AND METHODOLOGY

Management. What is the extent of the management's experience and the depth of the infrastructure? How long has the management team been together? What is the team's prior experience? Do the personal and professional references and background checks show anything of concern?

Methodology. What is the investment decision-making process, including idea generation, hypothesis testing, modeling, execution, and risk monitoring? How does the fund implement its investment thesis? Of the ideas generated, how many are rejected, and why?

ASSET ALLOCATION AND AUM

Asset allocation. How robust is the asset allocation process and is there true added value? Is there a meaningful quantitative aspect to it? Is it purely subjective? Is it tactical or strategic? Is the manager trying to build a diversified portfolio or simply gather a portfolio of best ideas? There is no right or wrong answer to that question, by the way, and both approaches can be effective. But it is important to know what to expect in terms of the allocations within the portfolio.

Assets under management (AUM). Does the fund have sufficient AUM to successfully execute its strategy? Has it reached critical mass to secure business viability? Have assets grown too much or too quickly? Has the manager grown so big that it can't successfully execute on its best ideas? Conversely, has there been a redemption trend that might threaten the viability of the investment approach?

RISK MANAGEMENT AND RESEARCH

Risk management. What is the fund's risk management protocol? Who is responsible for managing this protocol? What analytics, procedures, and tools are used? If analyzing a fund of funds, is the manager conducting meaningful risk management on each underlying manager and on an aggregate portfolio basis? Is the fund delivering adequate levels of transparency? Conversely, is the manager providing adequate levels of transparency to end investors and advisors?

LPS, FUNDS OF FUNDS, FEEDER FUNDS, AND REGISTERED PRODUCTS

The SMART[2] approach is applicable to any alternative investment vehicle. This article focuses on limited partnerships (LPs), where the advisor or end client is making a direct investment into the strategy. But there are some subtle differences for other commonly used access vehicles.

Funds of funds (FoFs). With FoFs, the advisor or end client is essentially outsourcing the strategy search and selection process to the FoF manager, and there may be 10 or more underlying strategies in the fund. For most investors, it is infeasible to perform deep due diligence on every underlying fund. So, the due diligence as described in this article needs to be done at the FoF level, but otherwise all the same protocols apply.

Feeder funds. With feeder funds, a third party creates an access path into the underlying fund, typically at a lower minimum, e.g., there may be a $1-million minimum at the fund level, but the feeder may provide access at $100,000. The feeder then aggregates those smaller investments into one appropriately sized "investor" for the underlying fund. It is the feeder fund's responsibility to perform all required due diligence and performance reporting on the underlying strategy, and for this plus the access itself the feeder charges a third-party fee of perhaps 50 basis points. All the same due diligence rules apply, but the analysis is done on the third-party firm that is providing the feeder fund.

Registered investment companies (RICs) and interval funds. Registered products are a rapidly growing segment of the alternative investment industry as managers seek to democratize access to their underlying strategies. These funds are registered under the Investment Company Act of 1940 (the '40 Act), like mutual funds and ETFs, though they typically do not offer daily liquidity. Managers make their strategies available to accredited investors,* which is a lower level of required individual wealth and income than the usual qualified purchaser"** requirement for LPs, FoFs, and feeder funds. Because RICs and interval funds are regulated more heavily than LPs, most investors can take some comfort that many due diligence items have been thoroughly and publicly addressed. Investors still must do their own due diligence, but accessing alternatives through registered products may allow an investor to focus more on quantitative aspects, including liquidity.

** Accredited investors (AIs) need an annual income of at least $200,000 (or $300,000 in combination with their spouse) in each of the last two years, with a reasonable expectation of reaching the same income level in the current year. Alternatively, this status can be achieved with a household net worth of $1 million or more, excluding the value of their primary residence.*

*** Qualified purchasers (QPs) must have $5 million or more in investable assets not including their primary residence.*

Research. Is the fund's research sufficiently robust and adding value? Critically, is there an information or analysis edge, i.e., does its research and analytical approach provide a competitive advantage? Is the depth of the research team adequate? Is there meaningful use of qualitative and quantitative analysis?

TRACK RECORD AND TAX EFFICIENCY

Track record. What are the length of the track record, risk-adjusted returns, alpha generation, volatility of returns, drawdown analysis, skew and kurtosis analysis, correlations, and peer group performance comparisons? Has the fund

Table 1

SMART^2 MANAGER RANKING

	Weight	15%	5%	15%	10%	10%	5%	10%	15%	10%	5%	100%
Strategy	Managers	Strategy	Structure	Management	Methodology	Asset Allocation	AUM	Risk Management	Research	Track Record	Tax Efficiency	Total
Absolute Return	Absolute Manager A	4.0	3.0	4.5	4.0	3.5	3.5	4.0	4.0	4.0	3.0	3.9
	Absolute Manager B	4.0	3.5	3.5	3.5	4.0	3.5	4.0	3.5	3.0	3.5	3.6
	Absolute Manager C	4.0	3.0	4.0	3.5	4.0	3.5	4.0	4.0	4.0	3.5	3.9
Equity: Alternatives	Long-Short Manager A	4.0	3.0	4.5	3.5	3.5	3.0	4.0	4.0	4.0	4.5	3.9
	Long-Short Manager B	4.0	3.5	3.5	4.0	3.0	5.0	3.0	3.0	3.0	3.5	3.5
	Long-Short Manager C	3.5	4.0	4.0	3.0	3.0	4.0	3.0	4.0	5.0	3.0	3.7
Futures	CTA Manager A	3.0	4.0	4.0	4.0	4.0	3.5	3.5	3.0	3.5	3.0	3.5
Private Equity/ Real Estate	Private Real Estate Manager A	4.0	4.0	4.0	4.0	3.5	3.5	3.5	4.0	4.0	3.5	3.9
	Private Equity Manager A	4.0	4.0	4.0	3.5	3.5	4.0	4.0	4.0	4.0	3.5	3.9

performed as expected through different market regimes?

Tax efficiency. Is the fund's strategy tax efficient? Are the fund's historical after-tax returns compelling? How efficiently, timely, and accurately does the fund generate its K-1s?

HYPOTHETICAL EXAMPLE

Assume you are analyzing a variety of funds across a variety of strategies, and each fund has provided a stellar and compelling sales pitch. Now comes the hard part: How do you differentiate among them and pick the one you are most comfortable with, from both a quantitative and qualitative perspective?

Note: There rarely is a best fund because this analysis by definition is qualitative. There may be a clearly best-performing fund, but that is only half the battle with alternative investments.

So, you create your SMART^2 ranking matrix, and perhaps it looks like table 1.

You now have a way of force ranking these different managers across the various metrics you analyzed. May you have missed or mis-evaluated something? Yes—this is an approach, not a solution. And, of course, each analyst or firm may ascribe different weightings to each of the metrics, and so may come to different conclusions about the same group of managers.

But the primary benefit is that you have developed a consistent, disciplined, and repeatable approach to evaluating alternative managers based on what matters most to your firm and your clients, and it may help to improve the consistency of the investment experience across your client base.

One final comment: This is not a one-and-done methodology. It needs to be reviewed and updated on a regular basis, at least annually, and more often if conditions change rapidly.

CURRENT MARKET ENVIRONMENT

After more than a decade of lying dormant, alternative investments are enjoying a comeback. Since the Great Financial Crisis of 2008–2009, when central banks around the world dropped interest rates to essentially zero and kept them there, strategies that typically thrive on rising rates and rising volatility simply have not delivered. All you needed was to be invested in equity beta and down-the-fairway bonds and you did just fine. Anything else added to the portfolio was labeled as "deworsification"—the phrase coined to suggest that the more diversified the portfolio was the worse it did from a performance perspective. Why add volatility-damping strategies to your portfolio when there was no market volatility? Why add strategies where the interest earned on the collateral for futures contracts was an important part of the total return profile when interest rates were zero?

Well, we may be entering a new market regime. Inflation is up, interest rates are up and rising, and market volatility is volatile. This is the market regime where alternative investments historically have thrived, and without question the interest level in adding these kinds of strategies to client portfolios has increased dramatically. Clients are saying to their advisors, "Market valuations are high and rates are rising, what can I do to improve the risk-return profile of my portfolio?"

So, there is a definite increase in interest in incorporating alternative investments, hence the need for thorough due diligence. Furthermore, one question that almost always comes up is, "How do I incorporate them, and how do I fund them?'

There is no exact right answer to that question, and many smart people disagree on the correct approach. One way might be to simply fund the allocations pro rata out of existing allocations—directional equity strategies, e.g., long-short, private equity, etc., get funded out of the existing equity allocation and directional rate- and credit-sensitive strategies, e.g., private credit, alternative credit, etc., get funded out of the existing fixed income allocations.

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Another approach is simply to carve out a specific allocation for alternatives and label them as such. We would argue against that approach, because we believe most of these strategies are not different from traditional strategies, they just have fewer constraints with respect to leverage and liquidity.

Still another approach is to use capital-efficient core portfolios that employ futures contracts, i.e., implied leverage, to provide the traditional core portfolio, i.e., the 60/40 portfolio, and then use the remaining capital to allocate to alternative or private investments. In other words, if you have $100 to invest, allocate $66 to a leveraged core portfolio that gives you the traditional 60/40 portfolio and then use the remaining $34 to invest as you please, including allocations to diversified alternatives.

CONCLUSION

The current market regime suggests that more advisors will be paying more attention to alternative investments.

Even with more-liquid and more-regulated liquid and traditional investments, e.g., '40 Act funds, bad things can sometimes happen. Fraud and illegal activities can and have occurred. But the primary risk with regulated traditional investments is quantitative—a manager's performance simply falls apart.

However, the due diligence requirements for less regulated, less liquid, and less transparent hedge funds and other LPs are significantly higher.[2] You can potentially improve the outcomes of your decision-making, however, by taking a disciplined and consistent approach to your due diligence.

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ENDNOTES

1. I'll give credit where it is due: I learned the SMART² approach from Steve Togher, a long-time colleague who was head of alternative investments at a firm where we both used to work.
2. This has resulted in a blossoming "outsourced" industry, where third-party specialists can be hired to perform the demanding levels of required due diligence.

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