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## SPECIAL REPORT

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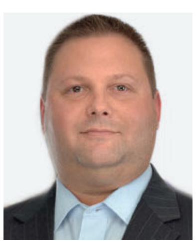
# DUE DILIGENCE AND MANAGER SELECTION

FRANK NAPOLITANI, OF EISNERAMPER, DISCUSSES OPERATIONAL DUE DILIGENCE AND THE OUT-PERFORMANCE OF SMALLER MANAGERS



**Frank Napolitani** is a director and national head of business development of the financial services practice at EisnerAmper LLP in New York. Napolitani has enjoyed a successful 19-year career with a diverse background, having worked at a fund of funds, family office and prime broker covering hedge funds.

Running a successful investment management business in today's environment has proven to be more expensive than ever before. Regulatory requirements have required fund managers to improve upon their existing legal and compliance infrastructure and because of regulatory risk reporting (the likes of SEC Form PF, AIFMD and Annex IV) fund managers need to have robust data captures and reporting platforms, either internally or in conjunction with third-party vendors. As a result of investors' knowing that fund managers have these capabilities, they have increased their demands for greater transparency and frequent reporting, in turn requiring additional resources in investor relations departments.

The continual focus on operational due diligence (ODD) by investors is to further ensure that a manager's middle/back office, legal/compliance, and overall infrastructure are on par with their investment process. In this article we outline some of the key areas which are routinely discussed during the ODD process. Additionally, we touch upon the out-performance of smaller managers in comparison to their larger brethren, and finally discuss some of the key traits that investors look for in successful hedge fund managers.

## OPERATIONAL DUE DILIGENCE

**Investor transparency:** As outlined above, in addition to or because of increased regulatory requirements, investors have become accustomed to certain levels of transparency, and continue to increase their demands for more transparency and reporting, forcing fund managers to invest in their middle office and investor relations departments. However, greater transparency has helped alternative investment products become more accepted by institutional investors.

**Lockup/redemption terms:** The focus on lockup/redemption terms is targeted towards the less liquid or harder-to-value strategies, which may "trade by appointment" and may be held for longer periods of time (potentially two-three years). Investors want to ensure that the fund terms are aligned with the liquidity profile of the underlying securities. As we saw in 2008, particularly with funds of funds, the asset/liability mismatch of offering greater liquidity to investors than is available through the underlying securities caused fund managers to put up gates and/or suspend redemptions. These gates and suspensions forced investors to redeem from more liquid equity fund managers (who may have been performing well).

**Valuation of harder-to-value securities:** The valuation of less liquid and harder-to-value securities can come into question and fund managers should not rely solely on their fund administrator for valuation. The administrator plays a key role in accurately providing a net asset value to investors, but their inputs on securities are only as good as the data provided. That said, having either an internal process or one conducted via an independent firm, being able to provide shadow accounting and books and records provides a three-way reconciliation to the administrator, adds another layer of comfort for the investor and is viewed as a best practice.

## SMALLER MANAGERS OUTPERFORM

According to Preqin, first time funds with less than $300m AuM and less than a three year track record have out-performed the wider hedge fund industry over twelve-month, three-year, and five-year periods. We believe the smaller size allows the managers to be more nimble by trading around 'large footprints' left by larger funds, and invest in less efficient areas including small/micro-cap equities and lower market cap bond offerings where larger funds, due to their size, are often prohibitive, and can do so without moving the market and in an efficient manner. If the performance continues, this will bode well for the start-up and emerging manager segment of the hedge fund market.

In the last two and a half years, we have seen over 350 investment professionals approach EisnerAmper about launching a hedge fund and we anticipate the year-over-year activity to remain fairly steady due to a continued bull run in the equity markets.

> "WE BELIEVE THE SMALLER SIZE ALLOWS THE MANAGERS TO BE MORE NIMBLE BY TRADING AROUND 'LARGE FOOTPRINTS' LEFT BY LARGER FUNDS"

## MANAGER SELECTION

Some of the keys traits that investors look for in successful hedge fund managers include:

**Pedigree**

What is the fund manager's 'upbringing' within the hedge fund industry? Where did they receive their undergraduate and master's degrees? What fund(s) were they employed by? Were they a top performer at their prior firm? What roles did they hold and how long was their tenure? Will former employers be a good reference for them and have they invested in their funds?

**Investment process**

Managers should be able to demonstrate a clear, definable and repeatable investment process that they use to identify investment opportunities. Investors will focus on both the long and short positions, risk management, and volatility. Investors will expect that this process is not only known by the portfolio manager, but has been passed along to the analysts on the team for continuity of process. Additionally, investors will not only ask about your investment process during a period of time where you were making money, but will enquire about your behaviour and approach during a drawdown period.

**Risk management**

Risk management is made up of a number of components which include, but are not limited to: gross and net market exposures (leverage), liquidity and portfolio concentration through individual positions and/or by sector/industry. Risk is dynamic and is often viewed very differently among market participants. Investors have increasingly demanded greater transparency into a fund manager's holdings to determine risk levels of underlying investments to ensure adherence to the manager's stated strategy.

**Performance**

Pedigree, process and risk management do not matter without performance. Has the fund manager been able to demonstrate a track record of success versus their stated benchmark and peer group? If not, the fund manager will find it difficult to raise capital from institutional investors.

## FUND TERMS

The trend over the past three years for start-up and emerging managers has been to offer fund terms that have increased alignment with investors. The '2x20' model is all but dead, especially for equity-oriented strategies; this can be attributed to the recent sub-par performance of hedge funds in general. The following fund terms have become more prevalent:

**Management fee:** For equity funds, not including founder's share class, we are generally seeing 1.25% - 1.5% management fees. We have also seen scaled management fees contingent upon the fund's AuM (1.5% up to $200m, thereafter 1%).

**Incentive fee:** For equity funds, not including founder's share class, we continue to see 20%.

**Multiple share classes:** Over 80% of new launches that EisnerAmper has spoken to in the past three years are offering multiple share classes. Predominately, a 'founder's class' with a discounted fee structure and an extended hard lockup of one-two years, often based on the liquidity of the underlying portfolio of securities. The class is closed when a certain AuM threshold is reached; any new investors thereafter would default to the regular class.

**Hurdle rates:** Hurdle rates are gaining increasing popularity given the under-performance in the hedge fund industry. We have seen hurdle rates range from the ten-year US Treasury yield to that of a peer group benchmark published by one of the hedge fund manager database providers. The concept being, if the manager cannot outperform a risk free rate and/or their peer group, they would not earn the incentive fee.

**Liquidity:** For equity funds, we generally see a soft lockup of twelve months, with a 2-3% penalty for early withdrawal, along with quarterly liquidity (or less) with a 30-45 day notice period. For funds investing in Level II securities, we're seeing a one-two year hard lockup, quarterly liquidity with 90-day notice, and in some cases a 25% investor level gate, to match up the liquidity of their underlying securities.

**Fund structures:** Most of the new managers (approximately 60% in our experience) are launching with domestic-only structures. We have also seen an uptick in the mini-master structure in comparison to the traditional master-feeder structure. Cayman continues to be the offshore domicile of choice for those launching with an offshore vehicle. ■