



The Depth of the Dive: Gauging the Scope and Scale of Due Diligence

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A depth gauge is a type of pressure gauge used by SCUBA divers to determine their equivalent depth in water. Divers utilise these gauges to, among other things, avoid such things as decompression sickness.

In the same way that the term due diligence does not have a universal meaning, particularly when applied to a hedge fund context, neither does the scope and comprehensiveness – the depth – of operational due diligence reviews.

In the post-Madoff environment it is no longer acceptable for a fund of hedge funds or any institution, which allocates to hedge funds, to simply claim that they have comprehensive investment and operational due diligence practices. These firms must be able to consistently demonstrate the depth and breadth of their due diligence.

Similarly, investors must be equipped to gauge the quality and effectiveness of this work. Below are some guidelines that both individual investors and professional hedge fund allocators can utilise in determining the scope and scale of their due diligence process.

A primary way in which due diligence methodologies vary is in terms of the type of risk factors weights vetted. As an example, within an operational due diligence context certain hedge fund investors will take care to review certain categories such as the insurance coverage of the hedge fund manager. Others will simply ignore these factors all together. Still other due diligence approaches gloss over these items with cursory reviews without understanding appropriate coverage levels for each manager.

On a related note, another consideration is the weight that each allocator puts on the importance of a particular factor, in this case adequacy of insurance coverage, in the overall operational decision and asset allocation process. In a perfect world, a risk-averse investor would likely prefer to understand these risks and weigh them accordingly rather than turning a blind eye and roll the dice.

Another way in which due diligence methodologies differ in scope is in terms of the number of factors covered. Continuing the insurance example, a due diligence process which does an extremely detailed job of vetting a hedge fund manager's insurance coverage and nothing else certainly fails the scope test.

Unfortunately, there is no one universal standard as to how many factors should be covered. In practice, investors should gauge a due diligence process by not only the number of operational risk factors analysed but by the quality, hedge fund strategy relevance and its overall comprehensiveness as a function of the total potential operational risk in place at a hedge fund.

Certain hedge fund allocation organisations will have resources specifically dedicated to different aspects of due diligence (ie operational and investment). Others will dedicate less resources to due diligence and instead blend the roles of investment analysts with operational due diligence. In these cases, investors must ask themselves if the professional hedge fund allocator is dedicating sufficient resources to due diligence and properly vetting the full spectrum of increasingly complex operational risks, which accompany hedge fund investing.

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