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The Importance of Highlighting Manager Strengths During Operational Due Diligence

When investors think of the concept of operational due diligence being performed on fund managers, it is easy to focus on the negatives. Often times, some of these negatives can include, what practices a fund manager is employing that deviate from best practice that may present unnecessary risks to both the fund and investors. These operational risks can run the gamut from traditional back office operations to other areas such as valuation, service providers and information technology.

Many investors view the goal of operational due diligence as only to detect and analyze operational risk in hedge funds. While, these are certainly key goals of the process, an operational due diligence review of a fund manager can also add value in other ways. One often useful output of the operational due diligence process, which is too often overlooked, is not what a fund manager is doing wrong, but what they are doing correctly. Operational due diligence is, in part, a learning exercise for investors. During the operational due diligence process investors will often learn details about:

- How a fund manager performs certain operational tasks
- Who at the fund performs such tasks
- What systems or service providers are utilized to assist with such tasks

In reviewing the answers to these questions, investors may find that a fund manager has solid, well thought out systems in place in certain areas and weaker systems in others. Investors should not simply cast aside the manager strengths that were learned during an operational assessment. Instead, an investor can paint a more complete picture of a fund manager's operational risk landscape by evaluating both the operational strengths and weaknesses of a fund manager. Depending on the importance an investor assigns to certain areas operational strong points may somewhat mitigate certain operational weaknesses. Other factors which can also assist in evaluating the balance between fund operational strengths and weaknesses can include firm assets under management and fund strategy. Additionally, if a fund has a very strong operational infrastructure (i.e.- low operational risk) then investors may consider these strengths in determining how much capital to allocate to a manager.

Outlining a fund manager's strengths during the beginning of an operational due diligence process can also yield benefits with regards to on-going monitoring of a fund after an initial investment has been made. For example, through ongoing monitoring an investor can determine if a manager continues to focus on their strengths or perhaps declines in certain areas over time. Motivations for the development of operational weaknesses could include a rise in assets that highlights cracks in processes which are not scalable. Alternatively, a funds operational priorities may shift to other areas and expose weaknesses. By focusing on both fund manager strengths and weaknesses investors can conduct more complete operational reviews, and get the most out of their operational due diligence processes.

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