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Why Familiar Names Do Not Automatically Produce Low Risk Environments

During the operational due diligence process, many investors, hedge fund and private equity fund managers may be tempted to equate familiarity with lower degrees of operational risk. Perhaps this is because familiar items seemingly represent known entities, with which investors themselves may have direct experience or they have heard positive things about them from others. This phenomenon may be prevalent across multiple areas of a multi-faceted operational due diligence process, ranging from fund personnel and valuation sources to software and service providers.

So for example, during the operational due diligence process, an investor may learn that a fund utilizes one of the larger more common fund accounting platforms. Because of its prevalence, many investors may be inclined to mentally check the box and assume that any fund that uses a particularly well known or popular fund accounting system does not really have any material degree of operational risk to note of in the area of fund accounting systems. Indeed, many fund managers, consciously or otherwise, perhaps are willing to make the additional capital expenditure to utilize such a well known system, as compared to perhaps cheaper systems. This may be because of this often implicit Pavlovian check boxing response to hearing the name of certain systems. This would be a mistake. Such an approach leads investors down a dangerous path of turning operational due diligence into solely an exception reporting exercise where they evaluate, not the operational infrastructure of a fund in its entirety, but rather what is different about the fund from all other similar funds.

While many big name systems are certainly high quality and operationally a good fit for a fund manager, they are only so in capable hands. The same misguided optimism seems to be unfortunately placed with fund service providers as well. As an example, at a recent conference, Corgentum personnel overheard a fund manager make comments to the following effect, "my fund doesn't have any operational risk issues, we use a big name administrator."

While a big name administrator may have many capabilities and resources which far exceed a smaller administrator, this does not automatically mean that the larger (and often more expensive administrator) is a lower risk one. For example, a mid to large size fund manager, which works with a smaller administrator, may receive much more attention than at a larger administrator. This may be the case because the fund will be a bigger fish in a smaller pond. This is not to suggest that a smaller administrator necessarily has advantages over larger ones. On the contrary, a larger administrator may be able to afford to better cross train employees or have more overall staff in general to prevent turnover among individuals such as fund accountants which may be critical to the fund administration relationship.

Investors should not automatically assume that there is little to no risk when they come across a familiar name during operational due diligence. Only through appropriate due diligence can investors evaluate whether or not a particular risk factor, including service providers, are appropriate.

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