THE LONG VIEW

WESTLEY CHAPMAN
on capturing the full benefits of operational due diligence

"WHILE OPERATIONAL DUE DILIGENCE IS INFORMATION-INTENSIVE, LET'S NOT FORGET THAT IT IS FUNDAMENTALLY A PEOPLE BUSINESS"

Many investors are not realising the full potential of their operational due diligence (ODD) teams or consultants, in part because too much ODD time is spent on ascertaining basic facts.

Yet, ODD has become as important to the manager selections of high-quality investment committees as investment research and quantitative analysis. After frauds such as Bayou and Madoff, counterparty calamities including Refco and Lehman, zombie funds spawned in the 2008 liquidity crisis, and a governance failure or two, the basic value of ODD is beyond question.

A fully realised ODD process offers much more than review of a fund's control environment. Yet, it is true that the primary purpose of ODD is serving as a 'minesweeper' that helps lower non-investment risks by spotting operational or structural weaknesses, including those that leave the door open to fraud (while not all control weaknesses lead to fraud, the fact remains that nearly every fraud is enabled by poor controls).

Operational due diligence professionals can add as much or more value by providing a unique perspective on managers and portfolios gained through bottom-up scrutiny of key processes including trading and settlement, counterparty management, valuation, and compliance monitoring – all with a focus on financial instruments and daily documentation.

These ODD professionals offer technical expertise which complements that of many investment research teams – particularly those lacking broad capital markets expertise. This added value can only be realised when internal teams are integrated appropriately or when external consultants provide more than basic control reviews.

Most insights grow from unscripted answers and probing follow-up questions. Yet far too much time is spent compiling and verifying such basic housekeeping facts as service providers, dates, and terms.

While operational due diligence is information-intensive, let's not forget that it is fundamentally a people business.

Effective ODD requires forming independent judgments about key control personnel based on in-depth, face-to-face interviews and dialogue on industry issues. It is estimated that document review and basic fact checking consume more than 50% of the 80-100 hours invested per initial ODD review. At the same time, managers now must spend more time supporting demands for heightened transparency, not to mention added regulation.

Although we frequently deploy technology to help meet regulatory demands, the information exchange that ODD requires remains largely unchanged since we moved from hard copy documents to digital PDFs over a decade ago. As a result, we often find ourselves focusing so much effort on data-gathering that we give the value-added elements of the process less energy than they deserve – a lose/lose situation that increases both ODD costs and the risks of failure to capture its full benefits.

In our industry, tough lessons – like the dangers of inappropriate leverage – must often be relearned. As memories of recent operational failures fade, we should resist the temptation to relax ODD demands. Rather than settling into a more mechanical, box-checking mode, investors should seek to optimise ODD and benefit from the full range of insights it can provide.

Meanwhile, our industry should actively pursue ways we can streamline and improve ODD – perhaps starting with greater standardisation in the definition and formatting of basic fund information.

The lessons reflected in fully developed and truly effective ODD practices are ones we can't afford to relearn. ■

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