MEKETA
INVESTMENT GROUP

Operational Due Diligence

WHITEPAPER
OCTOBER 2019

CONTRIBUTORS
Emily Agnew, CFA

As the alternative investment industry continues to grow and mature, so too does the prominence of operational due diligence ("ODD") as part of investors' overall due diligence efforts. ODD has become a mandatory component of the overall due diligence process for many investors, including for those investors who customarily allocated to more traditional long only strategies via separately management accounts ("SMAs"). ODD is especially important for those investors that operate within stringent fiduciary standards. The reputational impact of investing in a fund that suffers losses due to operational failures may exceed the impact of losses due to underperformance. Weak internal controls and infrastructure can lead to operational inefficiencies that in turn could negatively affect an advisor's investment strategy.

Many investors are now very familiar that the fraud perpetrated by Bernie Madoff and the failure of both Lehman Brothers and MF Global prompted an increased focus on ODD. In addition to outright fraud and counterparty failure, a number of other concerns including cybersecurity and data breaches at major institutions, changes within the regulatory landscape both in the US and abroad, and operational risk lapses at some of the largest global banking institutions have contributed to the importance of ongoing operational due diligence.

Definition of operational risk

Broadly, operational risk can be defined as all non-investment related risks affecting an investment advisor and the investment vehicles (e.g., hedge funds, private equity, long only, etc.) that the advisor manages. Specifically, operational risk is defined as the "risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events."[1]

[1] Source: Base II Committee.

Operational risks fall across a broad spectrum of categories including, but not limited to the following: accounting and trade operations; business and organization; cash and treasury management; compliance and legal; information technology; service provider and counterparty risk management; valuation.

Role of operational due diligence

The role of operational due diligence (ODD) is to discern potential business and operational deficiencies in an organization, understand the controls that the organization has implemented to mitigate the potential risk associated with a deficiency, and opine on the severity of those risks. Not all deficiencies carry the same level of risk. Certain strategies may inherently have more pronounced levels of operational risk. For example, distressed credit has higher valuation risk than a long/short equity strategy that holds 100% exchange traded securities. A thorough understanding of an investment advisor's strategy plays a key role in ODD.

Beyond uncovering and understanding the potential operational risk areas, the role of ODD is also to highlight where an organization has implemented best practices and share those best practices with industry participants.

Approach to operational due diligence

As the investment industry evolves, so too does the operational due diligence process. A cookie cutter approach to operational due diligence is imprudent. A risk-based approach is more efficient and can be more impactful. Operational due diligence should begin with a review of the firm's and the fund's constituent documents. This review helps form the basis for the onsite meeting with the firm's senior back office professionals as it helps to assess the culture of the firm, the effectiveness of the firm's policies, procedures, and controls, as well as the level of transparency that the firm provides. From this review, ODD professionals can begin to evaluate where operational deficiencies may lie, or conversely where the firm has implemented best practices.

> Operational due diligence can unmask potential fraud and questionable business practices, such as manual trade processing, lack of compliance support, and inferior cash controls.

The onsite meeting is used to assess whether or not each individual is qualified to serve in his or her respective role, identify inconsistencies between written documentation and in the firm's practices, and obtain further detail into the firm's controls or lack thereof. An assessment of the firm's culture, while qualitative in nature, can be quite telling. Operational due diligence can unmask potential fraud and questionable business practices, such as manual trade processing, lack of compliance support, and inferior cash controls, and can also help to determine whether a firm operates with a deep culture of compliance and high ethical standards.

The operational risk profile for advisors to different investment types (i.e., managed accounts, private funds, real estate investments, funds of hedge funds, and hedge funds) are each different. Understanding the type of advisor and their strategy is a critical component to formulating an appropriate ODD review. Based on the investment strategy, specific risks can be identified and reviewed, including but not limited to: (1) custodial risk, typically found in hedge fund investments, (2) liquidity risk, for advisors to hedge funds and separately managed accounts, and (3) valuation risk, for investments made in private equity fund or within vehicles not typically traded on national exchanges.

Preventing operational errors

Adequate policies, procedures, and controls, commensurate with the size and complexity of the advisor's firm and investment strategy, can reduce the risk of errors such as fat finger trading, reconciliation errors, or trade misallocations between funds (if an advisor manages more than one investment vehicle). The investment advisor should document operational errors and mistakes and amend its policies and procedures as necessary to try to prevent future errors. Mistakes do happen. Understanding why and how the mistake occurred in the first place and implementing appropriate controls can prevent future mistakes of the same nature from occurring. Having experienced, competent individuals in key operational and compliance roles, who are empowered to develop and implement an effective operational infrastructure is key to preventing operational errors.

Conclusion

Given the ongoing changes within the investment industry, regulatory landscape and best practice standards, ODD is, and will continue to be, subject to continuous evolution. While accepted operating standards certainly exist for mitigating specific operational risk areas such as cash movement, valuation, and financial stability, defining standard or best operating practices within other risk areas such as data privacy, cybersecurity, and ESG issues continue to evolve. Operational risks can undermine investment returns, yet not all operational risk areas carry the same level of risk, and not all investors have the same risk appetite. Therefore, developing a thorough understanding of the nature, cause, and severity of unmitigated operational risks is key to implementing a successful investment program.

Disclaimers

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided "as is," without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special or consequential, which arise out of the use of this presentation.

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results.