

Woodfield Wire

AN E-NEWSLETTER FOR HEDGE FUND MANAGERS
AND OTHER INDUSTRY PROFESSIONALS

Woodfield's monthly e-newsletter publishes articles about hedge fund-related topics and best practices. To subscribe, please send an email to newsletter@woodfieldllc.com. We welcome your comments and ideas.

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Is that shot in or out?

I've been playing a lot of tennis lately at our local club. And I can't tell you the number of times a ball is hit and one player sees it as a good shot and the other sees it as out of bounds. It all has to do with the line: In tennis, if any part of the ball touches any part of the line, it's considered "in."

One day last week I was standing off to the side and saw a ball I would have bet my life missed the line . . . but my friend Kurt, who was standing right in front of it, saw the ball from a completely different angle, and, yes, it touched the line. Line calls are so tricky that professional tennis tournaments routinely employ video equipment to make the call.

It strikes me that the due diligence process - that is, the process an investor goes through prior to investing in your fund to learn about its investment strategy, management team, performance and more - has more than its share of line calls.

You may answer an investor's question with what you think is a clear and rational response, but from the perspective of the questioner, it may not exactly hit inside the line. **Something about it sets off warning bells in your questioner's mind.**

Result? They may not yell, "That shot's out," but they won't be placing any assets with your fund, either.

In the interest of better due diligence, we asked a couple of friends, both of them long-time asset allocators: **What kinds of mistakes do fund managers make as investors are conducting their due diligence? And what can fund managers do to smooth the process?**

Due Diligence Don'ts

Our experts shared with us some examples of due diligence shots that were definitely outside the line.

Like the time one of them went to talk with the COO of a very large fund who decided he **"didn't have time for due diligence and would leave it for his investor relations people."** Our friend is still scratching his head. How can that COO not realize that his statement spoiled his chance with that asset allocator?

Or the CEO who **had to keep running out of the room** to get the information after each question.

Or - when it comes to investment strategy - managers who are trying to operate a fund but **have no experience with the specific strategy.** For example, a fund manager who has plenty of long-only

experience but only minor experience in shorting, who is trying to run a long-short fund. Or a manager who is **trying to mix strategies** by adding a global macro element, for example, even though he's never traded currencies before - and can't provide any evidence that he will succeed.

Due Diligence Dos

So how *should* a fund manager handle the due diligence process? Here are some tips from our asset allocator experts:

- **Prepare for the questions.** Be ready and willing to discuss in detail the questions that are likely to come up. This means **thinking through in advance and being able to articulate** your answers to questions about the fund's investment strategy, structure, conflicts of interest, management personnel, operations and more. Some typical questions appear later in this article.
- **Run well-organized meetings.** Investors can learn a lot more from a site visit than from the offering memorandum. One of our experts talked about the "**smell factor**" he sometimes perceives during a meeting when fund managers are defensive, disorganized, don't understand the questions or don't "get" what the point of the due diligence visit is. Make sure everyone from your staff who will be in attendance is **prepared and primed to be cooperative**. And be prepared for multiple meetings, if that's what it takes.
- **Don't rely on a canned presentation.** It's fine if you have a pitch book that contains basic information about your fund and organization, but don't start there. Just sit down and try and get to know the asset allocator and find out what THEY want to know. Some people are focused on strategy, others on background or operational issues. Once you know what they want, talk about that, including the information on that specific topic in your prepared presentation, but **be prepared to branch off from your pitch book** and answer their actual questions as sincerely as possible.
- **Be open, not defensive.** You may be reluctant to talk about, say, your relationship with your business partners, your background or specifics about the fund. It's tempting to avoid a question you don't feel you have a good answer to. Let's say the asset allocator asks if there is a written agreement between you and your partner, and you have not actually worked that out. If that's the case, **rather than avoiding the question or getting ruffled, just explain the situation honestly as well as you can**. Recognize that an open, willing attitude goes a long way toward earning their respect.
- **Be willing to talk about yourself, including your mistakes.** For example, how much money are you putting into the fund as a percentage of your net worth? One of our experts said he likes to review the fund manager's background in great detail, from investment career beginnings through apprentices, jobs held, and preparation to run a business and manage the portfolio. Don't be afraid to talk about errors you've made and lessons learned. "**I can't stand these guys who never admit to a mistake**," our expert says. "I like to see people make a mistake, recover from it and learn from it."
- **Understand your investment strategy inside and out.** In general, the person interviewing the fund manager is **trying to determine the source of Alpha for that manager** - that is, the component of the return that is based on the manager's skill. He or she may not actually be knowledgeable about the type of investment structure your fund represents - so be prepared to explain it in depth.

Kinds of Questions You Can Expect

An asset allocator's questions will be in three main areas: **Management team, investment strategy and operational issues**. The following questions are not in any particular order and certainly not comprehensive but will give you a good idea of the kinds of questions you can expect.

Management Team

What are the relationships among the partners? How do you know each other? What are your backgrounds? How will you split profits? What will happen when you disagree? Will one person be the decision maker? What potential conflicts of interests are there and how do they affect corporate governance? Who in your organization is responsible for what processes?

If you or your partner's previous experience is as a proprietary trader at an investment bank, be prepared for questions about the client flow that was part of your trading. Be able to explain why that client flow was not an important source of your alpha. In your previous position, how many people were there on the trading desk? What was the risk point limit when you started? What was it when you left? How much were you paid? Why did you leave? How do we know you're ready to run this money for us?

Investment Strategy

What is your fund's investment strategy? What are your risk management parameters? What's the range of the net exposures - gross longs minus gross shorts? What are the sector exposures? What are individual position limits (for longs and shorts)? How liquid is the portfolio? If you have ABL (asset-based lending) investments, do you have a quarterly review by an independent third party on those investments? May we see those reports?

How do you expect to handle crowded trades, especially on the short side? If you know the borrow is tough, will you size it differently?

If shorting is part of your strategy, how much shorting experience do you have? (This can even be personal experience in individual stock if you don't have much professional experience with shorting.) How much do you rely on the indices (S&P 500, Russell 2000, or some other index) to hedge the long side of your portfolio?

Operational Issues

What is your corporate governance structure? Are you registered with the SEC? If so, can we see your ADV form? Do you have independent calculation of NAVs? What service providers do you work with? Has the Offering Memorandum been updated to reflect any new pricing policies? How do you compensate your staff? For example, if you have senior analysts who are not partners, what percentage of their compensation comes from what they do? May we see copies of your 13F filings?

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If you take the time to prepare for a due diligence interview - **not only having your facts and data well organized but also making sure you're ready to receive the interviewer's questions with a positive and open attitude** - chances are better that your return shots will be well within bounds and your "match" a successful one.

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