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The Limitations of Operational Due Diligence

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As operational due diligence efforts become increasingly more expansive, it might seem that the process can safeguard against every significant issue that may arise with making an investment. Unfortunately, another high-profile fund will eventually fail due to operational problems and may lead many in the industry to express surprise at some of the fund's investors. Operational due diligence, or "ODD", seeks to prevent problematic investments, but also has certain inherent limitations. ODD may not necessarily uncover or predict every problem that managers might encounter – or that investors might experience. In other words, operational risk can never be completely eliminated regardless of the level of ODD performed. This article reviews some of ODD's inherent limitations.

Purpose for Operational Due Diligence

ODD refers generally to the review process undertaken by allocators seeking to evaluate operational risk at an investment manager's firm and in the manager's investment funds. ODD may be performed by the investor or by a third-party consultant hired by the investor. Detailed and thorough ODD will help the investor understand the level of operational risk and identify ways to decrease it. In addition, the ODD process and resulting review materials can serve to demonstrate that an investor conducted an adequate review prior to making or continuing with an investment. This documentation may be necessary if a significant operational issue arises in the future.

ODD can be characterized as an examination of two areas. First, the process seeks to assess objective, measurable, and quantitative operational issues. For instance, the ODD process will generally look to determine that a manager has acceptable internal systems and controls, reasonable policies and procedures, a sound fund and firm structure, and reputable outside service providers. The ODD process is typically well suited to make these determinations. Second, the process seeks to assess less measurable qualitative issues. For example, the ODD process will attempt to evaluate the skills and abilities of employees, firm culture, moral character and ethics. This part of the process necessarily involves a certain degree of subjectivity and experience in spotting potential issues.

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Limitations of the Operational Due Diligence Process

While the ODD process seeks to minimize the operational risk of investing in a private fund, the ODD process cannot be expected to identify and prevent every potential problem that might arise. Some of these inherent limitations are described below.

Limited Scope and Resources. While the ODD process can be very thorough and intensive, itis still limited by time and resources. As a result, and notwithstanding the best efforts of the ODD team, some issues or potential issues can go undetected. In addition, the depth of the ODD process can vary across the industry. Some investors maintain designated teams of experts who spend vast amounts of time on the project or engage an outsourced consultant, while others may conduct very limited amounts of ODD as part of a broader investment due diligence process.

It's About Investing. Ultimately, ODD is about the larger undertaking of making investments, and is therefore only one component of the process. As a result, the ODD portion could be impacted by the other components, such as a potential manager's likelihood of success, unique investment strategy, assets under management or general reputation.

The Immeasurables. Not every potential issue is fully measurable, particularly those relating to character and ethics. The ODD process attempts to glean information about these immeasurable qualities and to limit the potential for problems, but it is unfortunately impossible to entirely eliminate the risk relating to a manager's character and ethics.

Expertise and Quality of the ODD Team. A typical ODD team will consist of members each with various backgrounds and areas of expertise. Perhaps unsurprisingly, the focus of the ODD process will be on those areas the team members know best, while other areas may not receive the same degree of attention. Similarly, some ODD teams vary in the quality and consistency of their composition. The best ODD teams are experienced and well compensated, and stay together over the course of several years. In some circumstances, however, ODD members are tempted to leave for positions that, for a variety of reasons, may be considered more appealing. Turnover among ODD team members can impact the quality of ODD reviews.

More than Documents. An ODD team typically will request and review a voluminous amount of documents from the manager and the fund. While documents can help paint a better picture of the firm and the fund, these materials are typically highly polished, making them somewhat limited in value. It's also possible for an ODD team to spend a disproportionate amount of time reviewing documents. The best ODD teams should be able to key in on the most significant and unique information contained in documents and also look beyond them to spot potentially significant issues.

One Size Doesn't Fit All. Management firms, including their middle and back offices, tend to be leanly staffed, particularly in the startup phase. Firms also employ various investment strategies that impact the complexity of their operations. So systems and structures that might work well for one firm may not work as well for another, and may also depend on the skill sets of the manager's personnel. Consider, for example, a manager who hires a CFO or COO and also designates that person as the firm's Chief Compliance Officer. In some cases, the CFO/COO might be very knowledgeable about compliance requirements and have prior experience in the CCO role. In other cases, the individual could be wholly lacking in CCO experience. The ODD team will then need to make a qualitative assessment about the risks this arrangement presents, and whether those risks are acceptable. Other areas are also likely to surface, making comparisons from one manager to another very challenging and requiring a great deal of experienced judgment.

Industry Group Think. The intensity of the ODD may vary depending on whether other well-known allocators are already invested in the fund and on whether the firm and fund are large, prominent and well regarded. The presence of other allocators, for example, may suggest that ODD reviews have been completed and that investors have already have a high degree of comfort with the manager in question. Of course, the reverse may be true as well. Nevertheless, the presence of other allocators, the size of the fund and reputation of the manager should not lessen the allocator's duty to perform an adequate level of initial and ongoing ODD.

The Constant State of Flux. The business of running a private fund is in a constant state of flux with new products and technology emerging at a fast pace. What might be considered a best practice today might not be a best practice tomorrow. Likewise, what was considered an absolute necessity yesterday may not be required today. A good ODD process depends in part on the ability of the ODD team to keep pace with ever-changing developments in the private fund industry, including those brought on by advances in products and technology.

Initial Versus Ongoing ODD. Leverage changes once an investment is made, and explicit and implicit costs arise with redeeming and replacing a manager. As a result, ODD can become more challenging when it moves to the monitoring or ongoing phase. With a successful manager, at times the ODD team may face more of a negotiation and may be limited to reviewing what the manager is willing to provide, both in terms of documents and systems, as well as personnel.

Conclusion

The ODD process serves a number of useful purposes, including most prominently the ability to avoid investments that will be subject to operational issues. The limitations described above, however, underscore the fact that even the most thorough and in-depth ODD process cannot ensure that every problem or issue can or will be identified – much less resolved. Awareness of these limitations may help improve the practice. At the same time, investors (and managers) should properly calibrate their expectations of what can be achieved in the ODD process.