The New Essentials of Investment Due Diligence

Matching Strategy with Product

By Kelly Westfall, CPA, CFA

The Ever-Evolving Essentials of **Investment Due Diligence**

In the wake of the 2008 financial crises, the world has moved towards a more sophisticated approach to investing. Most investors now have at least a fundamental understanding of the need for a due diligence program. At the same time, the universe of investment products has become infinitely more complex. In addition to the monumental increase in the sheer number of products coming to market and closing in recent years, regulatory changes and innovative product development have created an atmosphere wherein even public funds – mutual funds and exchange traded funds (ETFs) – are no longer immune to the need for in depth due diligence analysis. Additionally, private funds are describing and benchmarking themselves more and more creatively in an effort to accumulate assets under management (AUM).

After fund performance and stated strategy, what else is there?

Increasingly complex qualitative attributes of public and private funds alike greatly affect risk profiles and require in depth analysis; expanding the scope of required due diligence beyond the basic descriptive attributes of size, age, performance history and stated liquidity terms. These factors are often the most overlooked by investors. Investors, in good faith, must understand the appropriateness and risks of the actual product (fund or account) as a vessel for its strategy and liquidity terms; additionally, operational risks and investor rights matter now more than ever before.

The Strategy, Holdings, Liquidity Mismatch

Liquidity and Fund Stress -- It is no secret that in an effort to compete with low fee index funds, issuers have, for the past several years, been launching a blitz of products including “alternative” mutual funds and ETFs which seek to mimic hedge fund strategies. Contemporaneously, issuers have pressured regulators to allow more esoteric strategies to come to market as registered funds. These funds have regulatory mandated liquidity terms which may be far too short for the underlying assets. The liquidity of an ETF, for example, is determined by the liquidity of the underlying securities. Not the fact that the fund offers “daily liquidity”. If the underlying securities are illiquid, it is to be expected that the ETF will be illiquid. This mismatch increases the risk of fund failure materially. The failure and abrupt closing of the Third Avenue Focused Credit Fund in December of 2015 is an example of this very problem. The event sent credit markets into a downslide and regulators reeling.

Despite the proliferation of alternative public funds, the flows to these assets, particularly ETFs has been volatile. In fact, the volatility of flows to “alternative” funds when combined with the illiquid nature of the portfolio, exasperates the ability to maintain a fund’s asset base — a primary determinant of fund success or failure.

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Liquidity Gates — Regardless of a funds stated liquidity terms, almost all hedge funds have at least one contractual "discretionary" gate; meaning that the Fund Manager can trigger the gate at his/her discretion. In fact, many funds have multiple contractual gates which may be triggered for a number of reasons. Registered funds do not have contractual liquidity gates. However, this cannot ensure that a Fund will not put one up. When a fund "melts down", the only thing that can happen is for the Fund to freeze investor redemptions. Furthermore, it is likely that regulators will step in and make the decision for them. The bottom line is that stated liquidity terms mean very little in times of extreme market stress or when the Fund Manager decides to trigger a gate.

Investors Pay for More Favorable Redemption Terms – Mismatches between investment products and their underlying assets are not optimal regardless of the state of capital markets or the Fund complex or the Fund. When Funds hold illiquid securities, but offer more liquid redemption terms, they transact redemptions at the price on a stated redemption date. However, the asset sales to meet these redemptions are generally made in the days to follow. The liquidity mismatch often creates a situation wherein the sold assets will be those which can most easily be liquidated; leaving the remaining investors with less liquid and potentially less attractive assets.

Cash Balances – To the extent possible, Investment Managers should manage cash based upon a combination of investment strategy, the state of capital markets and risk management. Clearly, Managers of funds which offer more liquid redemption terms than the liquidity profile of the underlying assets must hold additional cash. In turn, Investors in these funds must recognize that the Manager is now making allocation decisions based on the stated liquidity terms of the fund rather than investment goals. In other words, Investors are paying in terms of opportunity cost for funds to raise assets by offering more attractive liquidity terms or by wrapping the investment in a more attractive product or vehicle. Meanwhile, management fee increases as result of increased assets in the fund accrue to the Management Company, not the fund or fund investors.

Illiquid Asset Classes — Investors should accept that certain assets may not be appropriate for every investment vehicle. Additionally, each investment vehicle has its own, separate risk profile. Calculated required and risk adjusted returns are simply not accurate if these risks are overlooked. Venture Capital and Private Equity, Distressed Opportunities and even Event Driven strategies generally do not have daily liquidity – even if the assets have greatly appreciated in value. Wrapping these assets in a vehicle with daily liquidity both reduces returns when assets prices rise and greatly increases the risk. This typically is an optimal investment strategy pursued by investors.

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Kelly Westfall has extensive experience in the United States and Europe conducting due diligence and consulting on portfolio allocations to investment managers, alternative investments, public funds and other complex investment products and advises on their use in the design and implementation of investment strategies.

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