

‘Blink’ : The Intangible Art of Operational Due Diligence

“Just as global economies and markets are dynamic...so too are hedge funds...That is to say, no due diligence questionnaire or architecture can cover all such risks, much less produce a definitive yes-or-no answer to investment opportunities. This is where the value of an experienced ODD team is demonstrated.”

, CPA, Senior Managing Director, Head of Operational Due Diligence

The following story is recounted by journalist Malcolm Gladwell in his wonderful book *Blink: the power of thinking without thinking* (Little, Brown and Co., 2005).

The Statue that Wasn't Right

In September of 1983 an art dealer approached the J Paul Getty Museum in California with a marble statue he claimed dated from the sixth century BC. The statue was what is known as a kouros, a free-standing ancient Greek sculpture representing a nude male figure. At that time there were only several hundred known kouros in existence, and most of those were only broken fragments or partial busts. This one was unique however, in that it was in near perfect condition. It stood nearly seven feet tall and was almost uniformly preserved. It was, if indeed a true kouros, an extraordinary treasure. The art dealer was asking the museum for \$10 million.

Naturally the Getty sought to be thorough in its due diligence before committing to purchasing the statue. Was the sculpture consistent in look and design with other known authentic kouros? Yes. Where was it found? The art dealer provided reams of documentation tracing its roots to a Greek archaeologist from the 1930s. Did the material it was made from appear authentic? Again, yes. A geologist from the University of California spent two days examining the surface of the statue with a high-resolution stereomicroscope.

He also removed a core sample and analyzed it using an electron microscope. It all checked out. The statue appeared to be made from dolomite marble from the ancient Cape Vathy quarry on the island of Thasos, the geologist determined, and its surface was covered in a thin layer of calcite. The calcite was significant because the assumption was that dolomite could only turn to calcite over the course of hundreds, if not thousands, of years.

The Getty was satisfied with their investigation, and in their minds the kouros was indeed real. After a 14 month examination the museum agreed to buy the statue, and in the fall of 1986 it went on display as a special and rare antiquity. But was it?

Once available to the public many expert art historians and aficionados excitedly went to view the kouros — and this is where the story gets interesting. Despite the Getty's seemingly thorough investigation to establish authenticity, to the experts something about the kouros just did not *feel right*. Without any real tangible evidence to support their assessment, most just sensed the sculpture was somehow...off. The first to point this out was an Italian curator, who found himself staring at the sculpture's fingernails. In a way he could not immediately articulate... they just appeared wrong. Then a Greek expert expressed reservations, and then the director of the Metropolitan Museum of Art in New York described the kouros as 'fresh looking', not quite the adjective you would expect for a two-thousand year old object. Months followed, more experienced and veteran art historians visited the museum to see the statue, and the chorus of skeptics grew louder. The Getty — with its army of geologists and lawyers and scientists, and having engaged in months and months of scrutiny — had come to the conclusion that the statue was real. Sculpture experts and art historians, however, after having only viewed the statue momentarily and from a distance, disagreed. Within the first few seconds of gazing upon it, Angelos Delivorrias, director of the Benaki Museum in Athens, described an 'intuitive repulsion', an innate sense that it was a fake.

Long story short, today the statue is widely considered by most to be bogus. As it turned out, a lot of the documents used to support its authenticity were forged. Also, as experts began to examine the statue in great detail, they realized that a hodgepodge of styles from many distinct time periods were reflected in it. Lastly, artificial means of creating the dolomitization observed on the statue's surface have been demonstrated, thereby discounting the notion that the marble was centuries old. Of note, the Getty has never said definitively whether it believes the kouros is real or fake (certainly not after having paid \$10 million!). Today the statue's label reads "Greek, about 530 B.C., or modern forgery".

The Intangible Art of Operational Due Diligence

When discussing alternative investments, or more specifically hedge funds, the importance of a quality operational due diligence program cannot be overstated. In the view of most investment professionals, myself included, operational due diligence ('ODD') is critical to any holistic alternative investment process. While, according to modern portfolio theory, investors should be compensated for taking on investment risk, they are not paid for incurring operational risk, and so it is imperative that any and all efforts be made to identify and avoid managers that may introduce meaningful operational risk to a portfolio. A 2007 paper from the NYU Stern School of Business suggested that operational due diligence is 'an important source of alpha in a hedge fund portfolio strategy' (Brown, Stephen J., Fraser, Thomas L. *Hedge Fund Due Diligence: A Source of Alpha in a Hedge Fund Portfolio Strategy*. July 18, 2007. <http://ssrn.com/abstract=1016904>). While I disagree with this assertion in terms of my preference for measuring alpha in the quantitative sense, and not as an abstract qualitative value, I do strongly agree that – quite intuitively – robust operational due diligence could add tremendous value to an investment program. The question then remains, how does one define 'robust'?

Naturally there are industry standard practices and protocols associated with any quality ODD system. Significant amounts of time, energy and resources are also required (more later). But perhaps the most important aspect of any successful ODD framework, a trait that cannot be easily measured or quantified, and one that is subjective and learned from years of experience and wisdom, is intuition — or rapid-cognition. This is the 'intangible art' of due diligence, the part that is about those 'thin-slicing' seconds when sub-conscious decisions are sometimes made. While intuition may be an abstract component of successful ODD, we believe it is no less critical...just ask the Getty museum.

Rapid Cognition

Gladwell explores this concept of intuitive decision making in his aforementioned book (which if you have not read I highly recommend). His supposition is that past experiences often allow people to make informed decisions very rapidly (in the 'blink' of an eye), based upon subconscious interpretations of previous cues and events, which he describes as rapid cognition.

When you meet someone for the first time, for example, or walk into a house you are thinking of buying, or enter a new restaurant, or read the first few sentences of a resume, your mind — unbeknownst to your conscious self and in a matter of seconds — has already jumped to a series of conclusions. Gladwell believes those instant decisions are really powerful, important and, often really good. Of note, Gladwell avoids the word intuition in his book, suggesting it describes emotional reactions, gut feelings -- thoughts and impressions that don't seem entirely rational. He believes what goes on in those first moments is perfectly rational. It is thinking he says — just the kind that moves a little faster and operates a little more mysteriously than the kind of deliberate, conscious decision-making that we usually associate with 'thinking'.

From my view the theories Gladwell puts forth do seem to have merit...at least at first glance (wink wink). At a minimum, it seems reasonable to suggest that the more experience and practical application one has in a particular field, whether it be ODD or shipbuilding, the better he/she will be at their job, and in applying so called rapid-cognition. Naturally this would be of great value in assessing the less black/white questions associated with ODD. How does one weigh facts against gut instincts? What is the appropriate balance between the desire to do a deal and negative information? Is there pressure to make an investment? Has the manager been given a suitable amount of time to respond effectively? Is the manager patient and candid in their responses? Can the manager be trusted? Are there hints of concern about ego, arrogance, pride, complacency, carelessness, excessive optimism, or personal difficulties? Etc.

The point is it is not only about hours put in (though a great many are required at great expense), nor is it about the depth or rigor of the DDQ or other checklist documents applied to the exercise. Often the true test of an effective due diligence program is in the art, or the experience, of the investigators doing the work.

ODD: Avoiding Myopia

For my money there is little question that a robust ODD practice begins and ultimately ends with the quality and depth of professional experience of the staff executing the process. It is also a fluid exercise, and one that requires 'outside-the-box' thinking in many instances. Senior Managing Director XXXXXXXX, who has more than 30 years of accounting and fund operational experience and heads XX's Operational Due Diligence team, talks about the need to avoid myopic thinking when conducting fund reviews.

"Just as global economies and markets are dynamic and perpetually in flux, so too are hedge funds. Individuals change over time, responding differently to evolving situations and incentives. Strategies change over time. Every organization and process has its own series of investment and operational risks. That is to say, no due diligence questionnaire or architecture can cover all such risks, much less produce a definitive yes-or-no answer to investment opportunities. This is where the value of an experienced ODD team can be demonstrated."

In other words, establishing a checklist or road map for an effective operational due diligence program can only be expected to serve as a starting point, or rough framework, for effective ODD. As the nature of the hedge fund business is fluid, organic, and sufficiently complex, any suitable ODD process needs to be in a similar state of evolution, such that new circumstances are recognized and demands are met. A static guidebook cannot suffice.

ODD: Some Guideposts

There are, however, some philosophical tenets that XXXX applies consistently as a foundation to support the framework upon which he manages XX's ODD process. They are as follows:

- Hedge funds should not get frustrated when there is a tendency to ask the same questions during on-site visits that are already addressed in a firm's DDQ. Consistently hearing the same things from multiple people in meetings reinforces the institutionalization of principles – something we find reassuring.
- Overreliance on DDQ's and other materials is not good. We focus on conversations – understanding the culture at a hedge fund allows us to hopefully predict how it will act under stress.
- Many hedge funds have the right infrastructure; however, often it is not being utilized properly. For example, relying on Excel spreadsheets for certain exercises when more appropriate and effective tools are available and being used by other departments at the same firm.
- Outsourcing of certain functions is inevitable and not a bad thing for investors. What we look for in these cases is the level of control the fund maintains over whatever it is that is outsourced.
- Valuation is a significant aspect to operational risk that can have a meaningful impact on manager performance and integrity. Asset valuation is inherently a function of quality of data inputs. In terms of pricing and valuation, we will always seek to fully understand the investment strategy of any manager; what they are trading and the instruments they hold in their portfolio. We will look at whether a manager has written valuation procedures that are germane to the strategy, as well as a governance structure around the valuation process i.e. does the manager have a valuation committee? What is its composition? How are issues escalated? Who are the people and infrastructure used to support pricing and valuation? Are there clear segregation of duties within the firm?

- Lastly, it is critically important that the ODD role can act independently from the research and portfolio management teams. The due diligence staff should have an independent veto they may exercise when reviewing research recommended managers.

An Expensive, Specialized and Time Consuming Craft

An article published in *InvestHedge* magazine in 2011 suggested that the resource costs associated with effective hedge fund due diligence programs, particularly in terms of what is required as part of an operational review - are often underestimated by market participants. The story went on to say that institutional investors were likely not fully accounting for the significant amounts of time and energy a quality ODD program requires.

The Alternative Investment Management Association estimates that best-practice for a thorough initial operational due diligence review of a hedge fund manager would likely require roughly 100 to 150 hours. Of course the actual time spent depends on the contextual circumstances, the size and complexity of the organization, the depth and rigor of the review, and the skill and expertise of the team conducting the exercise. Broadly speaking, however, the time necessary to conduct thorough and meaningful ODD can be substantial, and demand significant resources. A study from 2006 (Anson, Mark J.P. *Handbook of Alternative Investments*. John Wiley & Sons, Inc. 2006) suggested a minimum of 75 to 100 hours are required (reflecting only the initial investment, and not include the time needed for ongoing monitoring). And a later report from Princeton University in 2007 called for upwards of 400 hours on initial due diligence, and then approximately 70 hours per year in ongoing reviews after the investment (See "Testimony of Andrew K. Golden, President of the Princeton University Investment Company, presented to the Financial Services Committee, United States House of Representatives" (March 13, 2007) (in this instance the estimates were intended to reflect both operational and investment management DD).

From our perspective, in terms of operational due diligence only, we would suggest the average time required would fall somewhere between the two estimates – generally. While 75 hours would likely be on the low end of the spectrum, 400 hours, at least in terms of ODD only, would more often than not be the exception (for initial review only, assuming no ongoing coverage). Broadly speaking, however, the time necessary can be substantial, and demand significant resources.

In terms of monetary cost estimates for ODD, a white paper published by the NYU Stern School of Business in 2008 suggests a conservative range of \$50,000 to \$100,000 per hedge fund. Again, in practice the cost of due diligence may vary widely and is contingent upon circumstances, but in our view we consider the NYU assessment reasonable if not skewed to the lower end of the scale.

Of note, an important aspect of the cost structure of ODD relates to the pedigree and experience of the staff on hand. For many organizations less seasoned and more junior staff may be responsible for aspects of a fund's analysis, if not for the entire process. Clearly, this would lend itself to a lower overhead cost in terms of human resources, although the quality of the analysis could very well suffer. As the adage says, you get what you pay for. This speaks directly to the notion of the intangible value of ODD when conducted by a sufficiently seasoned and experienced team.

It's the People

In summary, the 'artistic' nature of operational due diligence is a human exercise, and one that cannot be readily quantified and cataloged. One often needs to judge individuals and organizations based on limited exposures, and must discipline themselves to examine and reexamine assumptions and conclusions. The importance and value of the abstract or intangible qualities of a solid ODD program – wisdom, experience, and judgment – cannot be overstated. This is the 'art' of due diligence, the part that is about those 'intuitive' seconds. The blink of an eye.

Thanks for reading.

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The firm’s investment philosophy is centered on a steadfast commitment to the prudent allocation of client capital—with an emphasis on rigorous and sophisticated risk management programs—while seeking to generate steady asymmetric returns in various economic environments. K2 uses a wide range of hedge fund strategies that exhibit lower volatility and correlation to the broad capital markets to achieve investment objectives. Products offered include discretionary and nondiscretionary custom-tailored investment programs, commingled funds of hedge funds, and hedge fund investment advisory services. K2 is registered as an investment adviser with the United States Securities and Exchange Commission and is registered as a Commodity Trading Advisor and Commodity Pool Operator with the Commodity Futures Trading Commission and is a member of National Futures Association. K2 Advisors Japan Ltd, a Japanese subsidiary of K2/D&S Management Co., L.L.C., is registered with the Kanto Local Finance Bureau as a financial instruments firm engaging in investment advisory and investment management business.

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