In Brief

Q&A: Operational Due Diligence

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Past performance is not necessarily indicative of future results. No assurance can be given that any investment will achieve its objectives or avoid losses. **Risk management and due diligence processes seek to mitigate, but cannot eliminate risk, nor do they imply low risk.** **Unless apparent from context, all statements herein represent GCM Grosvenor's opinion.**

Ivaldo Basso
Chief Financial Officer

Christopher Sandberg
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IN THIS EDITION OF *IN BRIEF*

Ivaldo Basso and Chris Sandberg discuss the importance of performing operational due diligence ("ODD") in seeking to mitigate uncompensated risks. They highlight the key elements of an effective ODD program, citing relevant examples from GCM Grosvenor's approach.

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Mitigating "Risk without Reward": The Role of Operational Due Diligence

Given the widespread adoption of alternative investments and increasing complexity of financial instruments, institutional investors are devoting significant resources to investment due diligence. While investors focus on the market risks associated with these investments, the myriad of potential operational risks are frequently overlooked. We believe evaluating operational risk is equally important in order to avoid taking on uncompensated risk, or "risk without reward."

Q WHY SHOULD INVESTORS CONDUCT OPERATIONAL DUE DILIGENCE?

IB: While investors should expect to be compensated for assuming market risk, the same cannot be said for operational risk. In fact, the potential monetary and reputational losses stemming from operational errors or fraud can exceed those resulting from market losses.

People often associate operational due diligence ("ODD") with trying to detect and avoid blowups or fraud. We believe an effective ODD program is much broader in scope and, when given the authority and resources to be done correctly, serves to lower the risk profile of an investment. For example, when conducting ODD, we frequently influence managers to strengthen their internal control environments in order to better manage conflicts that may enrich managers at a cost to investors. In addition, through rigorous review and negotiation of terms, we seek to optimize the structure and attractiveness of the deal.

CS: While ODD is often most closely associated with hedge funds, we believe it should be applied across all asset classes, including private equity, infrastructure and real estate. While the nature and scope of the diligence may vary, similar risks and issues exist. We've been performing ODD for private markets investments — including co-investments — for several years and routinely identify operational and legal risks that require mitigation.

Q WHAT DO YOU VIEW AS THE MOST CRITICAL ELEMENT IN DESIGNING AN EFFECTIVE PROGRAM?

IB: The governance structure. An effective ODD program needs to have teeth in order to make a meaningful impact. We believe it is critical for an ODD team to have a seat at the decision-making table. With that in mind, we have instituted a dual-track approval process by which investments must be approved by both the relevant Investment Committee and our independent Operations Committee. Our Operations Committee is comprised of senior non-investment professionals: our Vice Chairman, General Counsel, Chief Operating Officer and Chief Financial Officer. If our Operations Committee does not approve an investment, we will not invest.

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CS: Equally critical is a "deal team approach" to due diligence. Our investment and operational due diligence teams collaborate and share information and views on a regular basis. When our ODD team discovers an issue with a manager, the first call we make is to the investment team working on the deal in order to inform them and get their views.

Q HOW MANY INVESTMENTS HAVE BEEN VETOED DUE TO OPERATIONAL DUE DILIGENCE CONCERNS?

CS: Since establishing our ODD program approximately two decades ago, there have been more than two dozen instances in which the Investment Committee approved an investment and the Operations Committee did not approve, thus preventing an investment from being made.

In the majority of our ODD evaluations, we are recommending — and many times requiring — changes that either lower the risk profile of an investment or improve the terms of the deal.

IB: I think the more relevant question is how often ODD influences an investment. In the majority of our ODD evaluations, we are recommending — and many times requiring — changes that either lower the risk profile of an investment or improve the terms of the deal. It is not uncommon for us to require changes to a manager's personnel, service providers, policies and procedures or governing document terms as a condition of our investment.

Q HOW SHOULD ONE THINK ABOUT STAFFING AN ODD TEAM? WHAT ACTIVITIES, IF ANY, ARE YOU ABLE TO OUTSOURCE?

ODD requires seasoned judgment; it is not a check-the-box exercise.

IB: ODD evaluation requires seasoned judgment of complex risks. It's more art than science and not conducive to a "check-the-box" exercise that can be performed by inexperienced staff. A well-structured ODD team requires a multi-disciplined group of professionals with experience in accounting, audit, tax, trading, information technology, internal controls, regulatory compliance and securities law. For example, when hiring for our ODD team, we typically consider seasoned professionals who are attorneys, CPAs or CFAs.

CS: While we have chosen to develop the expertise and perform ODD in-house, we do outsource certain activities. For example, we utilize third-party private investigative firms to perform background investigations on senior investment and operations personnel at managers. In some cases, we may also supplement our internal resources by engaging external counsel or tax advisors. For example, when performing due diligence in jurisdictions that are new to us, we'll engage outside advisors in order to better understand the legal and tax issues in those jurisdictions.

Q HOW LONG DOES THE ODD PROCESS TYPICALLY TAKE?

CS: There is no "one size fits all" when performing operational due diligence. The nature and scope of our evaluations can vary widely based upon the profile of the underlying investment or the size and complexity of the manager's business.

Operational due diligence of a hedge fund takes approximately 200-250 hours, while private markets investments take approximately 50-75 hours. The difference is primarily due to the increased operational complexities of hedge fund managers. For example, the evaluation of a hedge fund firm's people, policies and procedures — as well as the technology platform required to support potentially thousands of trades per day — far exceeds the amount of time required to diligence a private equity firm with a considerably lower volume of investments.

IB: While ODD is labor intensive in terms of "production hours," it is often critical to complete this work in a short amount of time. For example, co-investments can have "single-digit day" timelines. Thus, ODD professionals need to be nimble, able to travel on short notice, and work long hours to complete their work. At GCM Grosvenor, we've never passed on a deal due to lack of time to complete our due diligence, but for many organizations, this represents a significant challenge and prevents them from being able to participate in co-investments.

Q WHAT ROLE CAN OPERATIONAL DUE DILIGENCE PLAY ONCE A COMMITMENT HAS BEEN MADE?

IB: Monitoring investments is a core component of a good ODD program. Hedge fund investors are generally able to “vote with their feet” by redeeming capital if changes in the business cause an unforeseen risk. However, it’s far more difficult and costly to exit private equity, infrastructure or real estate investments mid-stream. I think many industry participants may have used this lack of liquidity as an excuse for failing to vigorously monitor investments from an operational perspective.

Similar to hedge funds, private market funds can undergo changes during their lifecycle that require an ODD team to engage. We expect our ODD team to be aware of, and evaluate, changes in practices, regulatory inquiries and examinations, threatened or pending litigation and turnover of key operations personnel, among other things, across all managers with whom we invest.

CS: While private market investment structures do not permit redemptions, there are a number of levers that may be used to respond to changes in the risk profile of an investment.

One approach may be to persuade a manager towards a different path or outcome. Or, one may elect to work through the Limited Partner Advisory Committee to pursue change. In the rare instances where those techniques don’t work, there are more severe measures, such as the removal of the General Partner or a third party sale of assets.

Q HOW HAS YOUR DUE DILIGENCE EVOLVED IN THE DYNAMIC MARKET AND REGULATORY ENVIRONMENT OF ALTERNATIVE INVESTING?

CS: An effective ODD program must stay on top — even ahead — of the evolution of the industry and work with managers to implement enhancements to their organizations, as needed.

While not an exhaustive list, areas in which we have heightened our scrutiny include: (i) conflicts of interest, (ii) risks related to data security, (iii) regulatory compliance, including issues related to the handling of material non-public information, (iv) legal and operational considerations with respect to artificial intelligence or big data, and (v) off-market fund expenses.

While we believe our ODD program is robust and industry-leading, we are always looking for ways to enhance our process in response to a dynamic and evolving industry.

Chris, Ivaldo and other GCM Grosvenor colleagues discuss this topic in more detail in the Webinar titled “Mitigating Fund Managers’ Operational Risk.”

Click to view the webinar.

ABOUT GCM GROSVENOR

GCM Grosvenor is a global alternative asset management firm with approximately $50 billion in assets under management in hedge fund strategies, private equity, infrastructure, real estate and multi-asset class solutions. It is one of the largest, most diversified independent alternative asset management firms worldwide.

GCM Grosvenor has offered alternative investment solutions since 1971. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong and Seoul, serving a global client base of institutional and high net worth investors.

BIOGRAPHIES

Ivaldo M. Basso, CPA, Managing Director, Chief Financial Officer, Operations Committee Member
Mr. Basso is the firm's Chief Financial Officer and a member of the Operations Committee. Prior to becoming Chief Financial Officer, he was Head of Investment Operations. Previously, from 2002 to 2004, Mr. Basso worked in the Financial Services Industry Practice for Ernst & Young, L.L.P. From 1994 to 2002, he worked in the same capacity for Arthur Andersen, L.L.P. He received a Bachelor of Science in Accounting from Northern Illinois University in 1994. He is a Certified Public Accountant and a member of the American Institute of Certified Public Accountants and the Illinois CPA Society.

Christopher Sandberg, CPA, Vice President, Finance
Mr. Sandberg heads the Operational Due Diligence Team. Mr. Sandberg is primarily responsible for operational due diligence matters, including the operational and internal controls review and ongoing operational monitoring of investment managers. Prior to joining GCM Grosvenor in 2012, Mr. Sandberg spent eleven years in public accounting with a focus on auditing public and private companies in the financial services industry. From 2002 to 2012, he worked at Ernst & Young, L.L.P., with extensive experience in the asset management industry and two years' experience in the hedge fund practice of the Cayman Islands office. He graduated from Trinity International University in 2001 with a Bachelor of Arts in Business and Accounting. He is a Certified Public Accountant and a member of the American Institute of Certified Public Accountants.

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