EATON PARTNERS
A Stifel Company

Shadmoor
operational due diligence • operational risk

The Evolution of Operational Due Diligence in the Time of a Pandemic and Thereafter

Eaton Partners & Shadmoor Advisors White Paper

Thomas S. Kreitler
Partner, Eaton Partners
Email: tsk@eaton-partners.com
Website: eaton-partners.com

Michael V. Merrigan
Founder, Shadmoor Advisors, Inc.
Email: info@shadmoor.com
Website: shadmoor.com

INTRODUCTION

In April 2020, about one month into the pandemic in the U.S., Shadmoor Advisors ("Shadmoor") published a white paper titled, "A Roadmap for Operational Due Diligence in the Time of a Pandemic". Shadmoor's thought process at that time was that operational due diligence ("O.D.D.") practitioners were in unchartered territory in more ways than one due to the inability to conduct on-site investment manager meetings and travel restrictions related to the COVID-19 pandemic.

Given the symbolism of a year passing, a strong progression in vaccinations and a sharp decline in number of COVID-19 cases, Shadmoor thought it timely to revisit our collective assumptions and expectations related to the O.D.D. paradigm, including in the past, today, and going forward. To add an additional perspective to this discussion, Shadmoor invited our friends at Eaton Partners, one of the world's leading placement agent firms, to co-author this updated version of Shadmoor's 2020 whitepaper. Eaton Partners has tremendous insight into alternative investment strategies, and has closely followed how institutional investors have considered allocations and O.D.D. during the pandemic.

Since there was no 'roadmap' for how best to conduct O.D.D. under such circumstances, O.D.D. practitioners were searching for the appropriate balance between maintaining high standards related to process and forced compromises with regard to typical O.D.D. procedures that were no longer an option.

At that time, the beliefs of our peers in the industry tended to fall into three categories:

a) Suspend due diligence on investment managers and funds that were new to an allocator's platform until there was more clarity on the duration of the pandemic.

b) Execute due diligence on investment managers and funds that were new to an allocator's platform, but on the conditions that the investment managers and funds must be qualified as large in AUM and personnel, 'institutional', well-established, and with robust operations.

c) Embrace virtual operational due diligence as an evolving method to evaluate investment managers.

At the time, Shadmoor advocated for c) as a reasonable solution with regard to how best to proceed with O.D.D. in an incredibly uncertain pandemic-driven environment. We chose this path because of its practicality and the belief that good substitutes for the key objectives of onsite O.D.D. meetings were generally available, as further discussed below.

The ability to reach an industry-wide consensus regarding O.D.D.'s go forward plan was further muddied by the fact that most employees of allocators were just beginning to work remotely from home on a consistent basis. Adapting to this new environment in a situation where IT configurations were being refined, family distractions were regular, and employees still had to complete day-to-day work, certainly pushed discussions related to the merits of virtual O.D.D. to a lower magnitude.

EATON PARTNERS' PERSPECTIVE ON THE LAST 12 MONTHS

At Eaton Partners, our core competency is introducing high quality hedge fund and private fund managers to our institutional investor relationships. We review hundreds of managers each year and ultimately work with only a handful. We employ a rigorous selection process and our investment manager criteria includes: a strong team with established pedigree, focus on a robust market opportunity for alpha generation, a differentiated strategy approach, an excellent track record, a clear investment process, a detailed risk management process, a critical mass of "sticky" capital (minimum of $200 - $250 million) and an institutional platform including operational staff and well-known service providers.

Operational due diligence is a critical component of our process and thus we rely on the expertise of groups like Shadmoor Advisors for this work. We initiate a complete O.D.D. review on those managers who we'd like to pursue and we receive a comprehensive report on their operations. Often times there are particular operational practices that need to be improved or enhanced before we will pursue a fund raising assignment with a manager.

Eaton Partners conducts a quarterly survey of our global investor clients to extract relevant information and trends within our industry. Themes for the past year were dominated by the effects of the COVID virus on manager introductions, investor due diligence practices, and potential allocations. With regard to virtual due diligence and allocations, some key highlights from our recent surveys:

Our Spring 2020 survey found:

- 73% of investors expect virtual meetings to play a bigger role in the investment process over the long-term.

Our Fall 2020 survey found:

- 66% of investors said they don't need a physical meeting in order to make investments with a new fund manager.

Our Winter 2021 survey concluded:

- Only 10% of investors said they are not comfortable making new investments without physically meeting a fund manager.

The progression is interesting. Throughout the early stages of the pandemic, new investment manager allocations were frequently put on hold and existing investment manager relationships were largely the beneficiaries of additional capital allocations. Most investors "sized up" on their current investment managers with additional capital and postponed new investment manager introductions.

However, more recently we've observed (and the survey results above bear this out) that investors have become much more comfortable with virtual manager introductions, due diligence and ultimately allocations. Investors have embraced the efficiency of conducting videoconferences with prospective investment managers and screen time face to face has begun to replace the need for in-person meetings. There are clearly challenges to ensuring quality relationship development through these means, such as poor Wi-Fi connections, dogs barking or kids yelling in the background, but ultimately our goal of achieving a positive connection is being achieved.

Additionally, without physical meetings, investment managers are now required to provide extensive transparency to investors including detailed exposure and performance attribution, position level transparency, risk management metrics and detailed case studies. Data rooms with robust, detailed information are particularly helpful in these efforts. Ultimately, we are now seeing investor allocations based upon a completely or mostly virtual due diligence process. We anticipate this trend continuing as the intensity of the pandemic declines with investors increasingly embracing the efficiency of virtual investment manager introductions and due diligence.

SHADMOOR ADVISORS' PERSPECTIVE ON THE LAST 12 MONTHS

Based upon interactions with our clients and colleagues in the industry, Shadmoor's experience included a definite slowdown in O.D.D. activity in the March to May 2020 period. Allocators were effectively regaining their bearings after the seismic energy that the pandemic rippled through markets, lowering overall confidence about the economic outlook going forward. Informal surveys at the time, based upon discussions, etc., absolutely evidenced a hesitation related to making new investments without onsite O.D.D. reviews as an option. Shadmoor estimates it took two to three months for many groups to acquire a sufficient level of comfort with the rotation away from traditional O.D.D. to virtual O.D.D. What was the largest factor in that adjustment successfully being accomplished? Probably the collective realization that the pandemic was not going to end in weeks, but rather if ever, only under a timeline that was more realistically many months or over a year. By the time late Spring / early Summer of 2020 arrived, the lockdown in the U.S. had ended, but the pandemic was nowhere near over. It was at that time that allocators began to recognize that their fiduciary obligation was at a perplexing crossroads. An epiphany of sorts. Either remain in investments that are neutral or underperforming knowing they were 'diligenced' appropriately from their outset having used traditional O.D.D. procedures, or shift investments into higher conviction investment managers and funds, but having to accept the use of virtual O.D.D., a largely unproven and not widely used procedure, as the only option to achieve these new investment exposures.

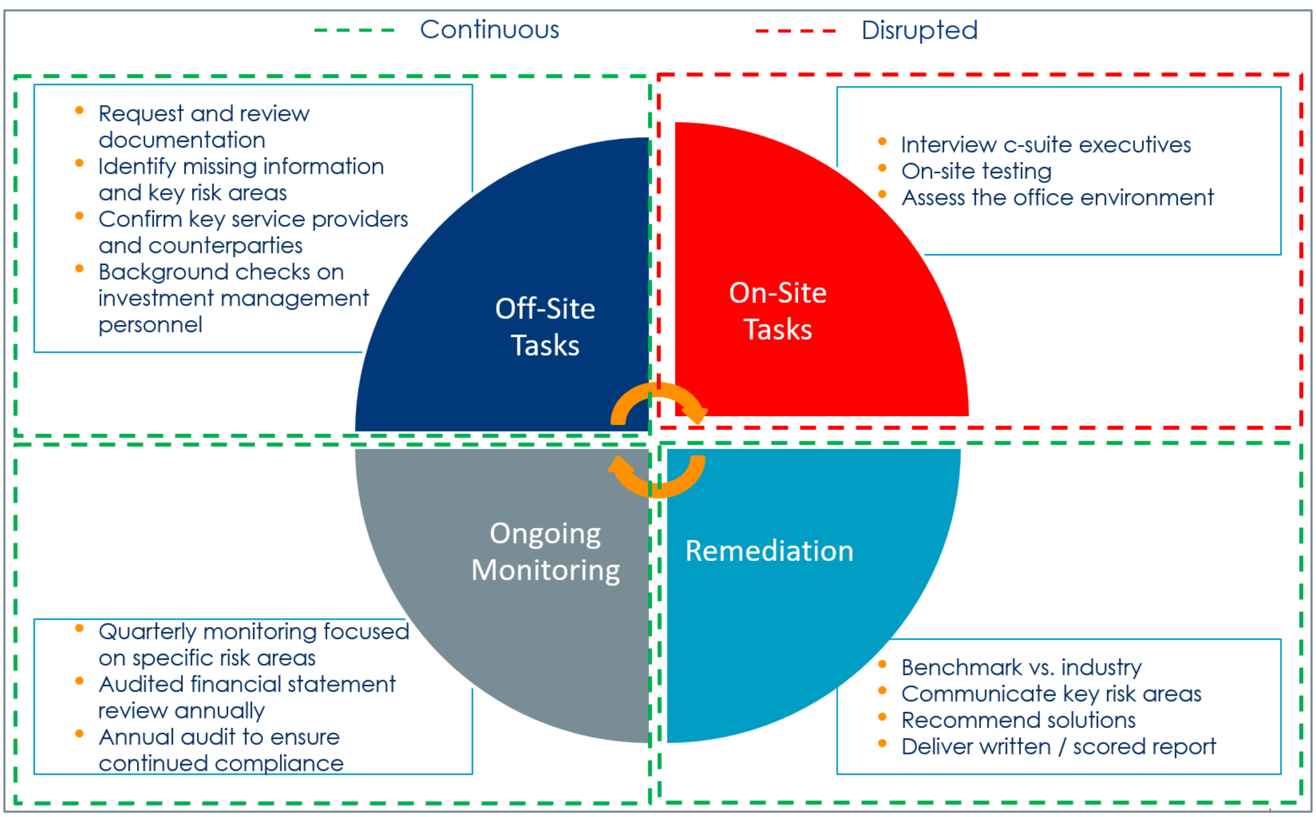
VIRTUAL O.D.D. TODAY

Last year's white paper highlighted the fact that three primary objectives drove the desire for onsite O.D.D meetings:

1. The ability to interview and assess the knowledge, abilities, and qualifications of key business executives that manage the 'business' or 'non-investment' side of the investment manager on a day-to-day basis.

2. The ability to complete 'testing' on-site of materials, procedures, and systems that are not readily available in a distributable electronic format and/or the investment manager considers to be proprietary or confidential. The amount of testing that can be completed during an on-site is dependent on an investment manager's proclivity toward transparency and their levels of concern that such data could be easily distributed outside of the firm as a result of such 'testing'.

3. The ability to assess the physical office environment via an office tour. A tour allows the O.D.D. practitioner to assess a variety of factors, including, but not limited to how physically secure the office is, how various employees are grouped within the office, whether there are there non-related businesses sharing office space with the investment manager, to see if confidential information is conspicuously displayed on employees' workspaces, and to see if the décor of the office is elaborate or frugal.



Could good substitutes be identified to bridge the gap as it relates to the three instances above? The overwhelming answer after one year of exercising virtual O.D.D. is, in most instances, yes.

Due to the fact that high quality videoconferencing was widely available before the pandemic began, the ability to continue to interview investment manager personnel was easily completed during the pandemic. In some instances, it was more efficient to conduct virtual O.D.D. interviews than traditional O.D.D. interviews due to time flexibility (not having to align a group of persons at the same time and at the same location) which often reduced time spent traveling and related expenses.

With regard to on-site testing, Eaton Partners and Shadmoor have experienced a modest up-tick in non-disclosure agreement requests, and an overwhelming willingness on behalf of investment managers to share documents and demonstrate systems virtually, which was never a viable option by-and-large prior to the pandemic.

Assessing the office environment was probably the point that we found the least number of options to serve as a good substitute, but arguably this point is less important than the first two. With the majority of personnel not in the investment manager's office, some investment managers offered virtual tours similar to that which a residential real estate website may offer. But largely, O.D.D. practitioners had to rely upon investor references or other less meaningful tools to gain confidence or an understanding of an investment manager's office environment.

2021 and Beyond

As vaccinations increase and hopefully some level of herd immunity is achieved over the coming months (assuming viral mutations do not upend our long-fought progress), we increasingly ask what will become of O.D.D. procedures going forward? Eaton Partners and Shadmoor's collective sense, grounded in our own opinions and based in part on discussions with peers in the industry, is that there will likely not be a full return to traditional O.D.D. procedures, i.e., on-site visits in all or the majority of O.D.D. reviews. Even if the pandemic completely subsides, investment managers themselves are expressing interest in reducing office space. From a personal perspective, investment management personnel will likely not spend the majority of their work time within their corporate offices as was the case up until March 2020. They have enjoyed the fringe benefits of increased work/life flexibility while demonstrating no measurable decline in the quality or output of their work. Increasingly, investment management personnel may work full-time from far-flung locations, relative to historically, where many lived within daily commuting distances of the investment manager's primary office space. In parallel, allocators, flush with savings related to less travel expenses, are recognizing that by and large, this new virtual O.D.D. paradigm has been effective at mitigating risk.

Going forward, digital, or virtual due diligence, while still requiring the steady hand of seasoned O.D.D. practitioners to analyze data, interview investment managers, confirm service provider engagements, and to draw considerations related to operational risks, will continue to play a larger role going forward. In addition to the importance of operational due diligence in general. In the future, we believe that decisions related to onsite visits will be a) largely driven by physical proximity of the O.D.D. practitioner or allocator relative to the location of the manger – meaning travel to and from is not a significant expense – and b) risk-based.

In terms of a risk-based approach, we mean taking measured actions with regard to O.D.D. that are commensurate with the asset class, the investment manager, the fund, etc. Is the investment manager itself or the strategy a greater operational risk relative to peers in the same categories or relative to the investment manager's universe in general? The key operational risk areas (i.e., liquidity, valuation, segregation of duties, cash controls, quality of service providers, etc.) and the context of the relationship (i.e., new investment or ongoing monitoring of an existing relationship) will weigh heavily into the decision to hold an onsite meeting or not going forward. This would be an evolution from the historical insistence that all O.D.D. meetings must be held onsite.

CONCLUSION

As we turn a year on the pandemic, what strikes us more than any other factor related to O.D.D., is the driving ability of the investment management and due diligence communities to constantly adapt to the pandemic and to address each other's needs. The ability to reconcile such challenging circumstances while simultaneously redefining best practices to fit those circumstances as an industry has been remarkable. We hope that as a consequence of these events, persons working within these industries can continue to have better work/life balances going forward, while continuing to deliver the best solutions possible as it relates to the due diligence process. Never before has there been more tools that can assist in organizing the due diligence process and providing better and more convenient access to people, documentation, the addressing of inquiries, etc. Eaton Partners and Shadmoor are excited about these developments and will continue to evolve our own procedures to continue that adaptation into its next iterations.

On behalf of Eaton Partners and Shadmoor, thank you for your consideration.

DISCLAIMER