Ten Reasons Not to "Phone It In" and One to Smile
By Alan Snyder

Whether buying a house or an investment portfolio, on-site inspection is an integral final step before putting up money. Due diligence on any purchase has two overarching criteria: is the purchase what it appears and is it worth the price? In the case of an investment portfolio, visiting the offices of the asset manager is important to verify that the team, systems, and documentation promised in earlier diligence are real and true (see "Ham and Eggs" and "Mirror, Mirror on the Wall" commentaries at http://www.shinnecock.com/#articles).

Unfortunately, breezing into the offices and sitting down for a long talk in a conference room, though useful in answering general questions, is not enough to verify that what has been learned this far, is what will ultimately be gotten. Much like walking through an open house, a casual glance at an asset manager's operations may show only what the sales team highlights. If the prospective buyer, or a trusted advisor, crawls underneath and gets dirty, this is a minor problem compared to overpaying for a house with a poor foundation or worse.

Take, for example, the "smartest guys in the room" – Enron's management. In 1998, Enron set up a fake command center to show off their nascent Enron Energy Services team. While the actual trading center had yet to be finished, this phony command center, complete with employees pretending to make deals, was used to show off Enron's new team to equity analysts. Though Enron was successful in hiding the truth for four years, an analyst forgoing the tour and seeing what was actually taking place may have uncovered the truth earlier.

On-site due diligence can help avoid a similar calamity. Though there is no perfect protection against the proverbial "pig in a poke", we continuously ask ourselves what is missing from our efforts that might create an ugly surprise, leading to buyer's remorse.

Let's use an alternative lender visit as an example.

1. **Spend some time with employees individually**
   Meeting employees without a supervising chaperone can make for a more revealing conversation. When visiting, taking some time to speak with the laboring oars who may not have been on previous calls will give insights into operations, the team's abilities, and the general vibe of the firm.

Thoroughly underwriting a loan and the attendant credit evaluation is critical. Has the team embraced what has been publicly stated? Do analysts work independently or are they simply confirming the partners' ideas? Is there pressure to meet loan funding deadlines or to quickly invest incoming capital from new investors, which may result in a truncated due diligence process?

2. **Documentation of the investment process**
   Randomly select several loans and scrutinize the file documentation. Were the processes followed without shortcuts? Of particular note, review files for loans that are "in-arrears" or defaulted. Does the manager do what they say they do, from idea generation to implementation?

3. **Documents and contracts with service providers**
   If third-party loan servicers are employed to collect principal and interest payments, check them out. This is a critical function. How is the data passed from the servicer to the in-house accounting function and independent administrator? Changes in auditing firms may also mark valuation trouble, an important issue for Level 3 assets.

4. **Regulatory documents**
   The lending business is subject to intense regulation. Bad actors are shut down, potentially imperiling an investment. Review any correspondence in this area, e.g., examinations by regulatory bodies, any regulations mentioned in documents such as the FAQ ("Frequently Asked Questions") or a due diligence questionnaire ("DDQ") and manager adherence thereto.

5. **Litigation files**
   Has the fund, firm, or any key persons employed by either been accused of wrong doing?

   Lending by its nature may engender some controversy. Borrowers, hopefully infrequently, can raise smoke-screen issues to avoid paying. Examine how these borrowers are pursued; were collections against the oft-cited protection of personal guarantees invoked?

6. **Any documents that must be seen "on premises" due to confidentiality**
   Some investment managers are reluctant to allow electronic dissemination of confidential files key to evaluating the business risk of an investment. These include credit committee meeting minutes, investment committee meeting minutes, valuation adjustments, financial statements of the manager, business continuity plans and compliance guidelines.

7. **Employee hiring policy, documents, and procedures**
   Discuss vetting procedures for key employees, e.g., confirm records of drug testing or background checks for key employees, if that has been represented as part of the hiring process. Have all of the employees signed confidentiality agreements and the employee handbook? How tight of a ship does the management company run?

8. **Compliance records**
   Has any investor made a complaint? If so, the site visit is the perfect time to see records refuting the complaint. How well does the firm follow the limited partnership agreement ("LPA"), or operating agreement in the case of a limited liability company ("LLC"), and/or compliance manual?

9. **Records of business continuity plan tests**
   Ask to see records of the most recent test. Was it conducted within a reasonable timeframe? Was it successful? If not, what didn't work and what corrective steps have been taken?

10. **Ask any remaining questions needed in person**
    Calls and emails are a more constricted medium for in-depth conversation, and these inquiries seldom elicit anything more than the requested information. Telephonic distance makes the quality of the conversation one of cold efficiency to start, only to be broken by skillful discussion. Controlling the conversation can be done more naturally in person and allow more difficult questions to be asked and answered without raising barriers (managers are selling and can be like the politician who does not answer the question directly but segues to how an investor can best be sold on them).

We have attached a guide of documents to review, actions to perform, and questions to pose during the on-site visit, a handy checklist to use before and after a visit. To make the best use of time, however, the following advice may be more useful than any checklist. Whether visiting a small boutique or large institution, tone, approach and demeanor will be the determining factors for what can be learned. Being in "attack mode" only shuts people down and raises their guard. Sarcasm and snippy asides to a colleague may kill any desire people may have to be forthcoming. Keep opinions close for later reflection. Be respectful and, if asked, helpful.

Finally, to avoid being glib, we pose to you the same question we put forward to each investment manager at the end of any visit: is there anything we have forgotten to ask?

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Look out, there is much more to come. We started our manager/strategy notes on the due diligence areas of what to ask, information to seek and doing an on-site visit because these are the issues most frequently raised to us. There are other areas just as important to explore: finding managers on which to do due diligence; delineating a quantitative tool kit for pre- and post-investment; exploring alternative ways to make any investment; and, leaving a bad investment behind.

Over the coming months betwixt and between our other duties, we will fill in these nooks and crannies which we hope will be helpful. As usual, comments, suggestions and your input are sought. Let's get better together.

GUIDE TO ON-SITE DUE DILIGENCE

1. MEET AND ASSESS KEY PEOPLE

- ☐ Handoffs between roles
- ☐ Corporate culture

2. INVESTMENT PROCESS

- ☐ Procedures
- ☐ Investment files
- ☐ Signoffs

3. SERVICE PROVIDER AGREEMENTS

- ☐ Contract with the third-party administrator
- ☐ Any prime brokers, futures clearing merchants, etc., particularly in relation to soft dollar agreements or other conflicts
- ☐ Auditor engagement letter and any historical engagements with previous auditors
- ☐ Any management letters from a current or past auditor
- ☐ Any loan servicing agreements including agreements for backup servicers

4. REGULATORY ISSUES

- ☐ Any filings with relevant regulatory bodies
- ☐ Correspondence between regulators and the manager, i.e., SEC or NFA exit letters

5. LITIGATION FILES, IF ANY

- ☐ Non-public records

6. ANY DOCUMENTS THAT MUST BE SEEN "ON PREMISES"

- ☐ Credit committee meeting minutes
- ☐ Investment committee meeting minutes
- ☐ Valuation adjustments
- ☐ Financial statements of the manager

7. HIRING POLICY AND RELATED DOCUMENTS, INCLUDING CONFIDENTIALITY

- ☐ Employee handbooks and signatures
- ☐ Vetting procedures and adherence thereto

8. COMPLIANCE RECORDS

- ☐ Employee agreements
- ☐ Confidentiality files
- ☐ Ethics training
- ☐ Promotional materials
- ☐ Customer complaints

9. EXAMINE PHYSICAL SET-UP, INCLUDING BACKUP PROCESS AND DATA SECURITY

- ☐ Date of last test of backup systems in case of disaster
- ☐ Date of last test of data security systems
- ☐ Leases for equipment and/or office space
- ☐ Investor files