

# F&L

## SEARCH



Perspectives from a  
Head of ODD

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# Perspectives from a Head of ODD

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*I've had the pleasure of getting to know an experienced Head of ODD with over twenty years of experience with a very large multi-manager outfit, where he's specialised in manager due diligence on hedge funds. In that time, he's done front to back ODD on over 600 managers across institutions that have run large to small FoHF portfolios, always with veto power which has been exercised a few dozen times. Here are some of his thoughts on the industry and his time thus far.*

## *"What has stood out to you in your career thus far?"*

The world of hedge funds is a bit like the world of people. 99.5% of their DNA is exactly the same, but it's the .5% that, like people, makes all the difference. Even when two funds have the same Man Co they can be completely different, where one fund might hit the standard and the other might not. It's also sad but very interesting that often when hedge fund managers first set up, they may be poorly advised; they've typically been spoiled by previous shops where they've had all the best systems and support and took a lot for granted and are often in a hurry to get things up and running, and might receive the wrong advice from lawyers or other parties can be detrimental in the beginning. It's a catch-22 that you need to be very sharp when you're a new manager, but you might not be able to pay for the best. That's why sensible decisions have to be made and invest in the right aspects if an institutional quality shop is aimed.

## *"Can you tell me about the times you've employed your veto right?"*

It's been a number of things over the years; from the administrator not willing to confirm fund AUM or extreme style drift, through to managers outright lying, holding their own books and records with the administrator doing shadow accounting instead of the other way around and managers using clients' money for personal purposes. There are always ways of checking that the information received from the manager is accurate, simple things like verifying the existence of relationships with the counterparties, the work that the administrator performs, etc.. In all those instances described I was very happy to apply my veto and I'm confident we safeguarded those portfolios and our investors' money. Trust but verify is paramount in the ODD world.

## *"What are the big trends in ODD?"*

In truth? I think things are slipping, a lot of people aren't focusing on the smaller details, and more and more ODD is being conducted as a "tick the box" exercise. For instance, there is a greater emphasis on things like ESG – people are paying a lot of attention to that and penalising small managers for not having reams of internal policy on things like diversity and sexual harassment. While that's important, we shouldn't let the moral high ground become the focus of ODD, because at the end of the day we are looking for proper risk-adjusted returns for our clients' money. Also, the analysis of the culture of the manager has always been considered in the ODD – aspects like turnover, staff compensation, personal trading, insider trading policies, etc, have been an important part of the work. The juniorisation of ODD is also playing a part in this loss of depth. It takes time to learn all the angles and the things to look out for on the operational side, which has so many more facets than investment due diligence.

*“Do you think that’s because we’ve not had a spectacular blow up since Madoff?”*

Absolutely. Just because the perceived risk of absolute failure seems to have gone down doesn’t mean you shouldn’t check. There is a trend where investors think bigger is always better and that’s exactly what happened with Madoff. You also need to make sure that you’re getting the right product from a manager, and that the fees you’re paying are being spent in the right way to manage money properly.

*“There is a lot of talk about the pressure on fees, particularly in the hedge fund space. What are your thoughts on this?”*

Expenses and fees, in my opinion, have been criticised in the wrong way. Most of the hedge funds I see are still 2/20 or 1.75/17.5, but they spend the money properly in State-of-the-art technology with incredibly bright people. If I can see that managers are spending their fees in the right way to better manage my clients’ money, then I’m happy. When I see large managers, who are effectively collecting fees but still running on old systems and not employing or remunerating their staff in the right way, then I question their fees and other practices. You have to remember that ODD isn’t a one-off project; it’s vital to be continuously monitoring managers to spot any shifts in direction as it gives you a good indication of where they’re going.

In my opinion just focusing on fees is the wrong approach. I’m happy if a manager is spending the fees on the right things and investing wisely in their business and processes.

*“Do managers struggle with how they justify their fees?”*

Yes, otherwise we wouldn’t see this much pressure on them! Managers need to be more open with investors in terms of describing upcoming projects and how they plan on budgeting. Managers should do a better marketing exercise in terms of telling investors what they’re spending money on and what they plan on spending it on in the future. Running a manager is expensive, and so is upgrading hardware, software, personnel, administration, compliance, operations, etc. Investors need to be made aware of these costs. I understand it can be difficult; investors can be arrogant and misunderstand, and managers are sometimes scared of miscommunication, but they should make an effort to educate potential investors. I remember in 2010 when a manager told me they were migrating all their CPUs to the cloud. I was very sceptical but did consult with my CTO on his view and got comfortable with the idea; now it’s standard practice!

*“What skills does someone need to be good at ODD?”*

Intellectual curiosity and the awareness to be trusting but always verifying. Once you have that, the rest can be learned over time. I’m not a lawyer, but I can check and understand some pretty complex legal documents. Due diligence is a fine mix between analysis and asking good questions; the only stupid question is the one you don’t ask!

### *“How has your role changed over the last 15 years?”*

Initially ODD was much less complex from a compliance, corporate governance, and systems side. Back in '05/'06, hedge funds were private vehicles. There was no compliance guy, it really was the wild west, and everyone used just Bloomberg and Excel. When they had external directors, they were usually just friends and family. After '08, the crisis, Lehman and Madoff – the industry evolved significantly towards institutionalization. Especially compliance, driven by regulation, has led to investors asking for a proper compliance culture in hedge funds. Nobody wants to be caught in a similar situation to Galleon for instance.

Systems are another area that have completely changed. There is now so much technology involved in the running of hedge funds that it's mind boggling. Specifically, the number of solutions available to smaller managers, the likes of Infusion and Orchestra in particular, that can help to provide a proper initial set up.

### *“What is your favourite question for a manager?”*

“What keeps you up at night?” It's important to understand what risks the business faces and to see how far into the future a manager is looking. It also helps highlight special projects that might be under way.

### *“What makes a manager stand out to you?”*

The quality of the individuals working there is very important: a good COO, a good CCO, Head of Operations, Head of Investor Relations – good people in those positions are a killer. Especially because they allow the CIO/PMs to concentrate on just trading. They can help the firm ride out tough times and usually end up contributing to a great company culture. With a strong team and a strong set up, everything else should all fall into place. Tech helps, but we shouldn't just make decisions based on analytics. You need that gut feeling.

### *“What advice would you have for someone looking to specialise in ODD?”*

The beauty in ODD is there is always something to learn, improve on, find out, or develop. A natural intellectual curiosity and fantastic attention to detail are vital. It can be a very interesting role, where you're constantly trying to help build a picture of how individual managers run and what new trends are impacting them. Also, get yourself on an interesting project: a strong proposition and lots of change can be very rewarding, particularly if a firm is looking to move in a different direction.

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*This interview is part of an ongoing series I will be conducting with individuals in the industry. If you have any questions, comments or critique, or would like to speak about a particular topic, please feel free to let me know.*

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