



Andrew Kandiew, head of operational due diligence for K2 Advisors, talks to Sasha Jensen, CEO of Context Jensen Partners, about the firm's approach to sourcing managers for its liquid alternatives offering

Q What is K2's approach to doing due diligence on managers for its liquid alts offering?

A K2 utilises a multi-disciplinary process for vetting potential investments with alternative investment managers. This includes quantitative and qualitative research, risk management, legal and operational due diligence teams. This institutional-quality approach we have developed for reviewing commingled investments in hedge funds over the last 20 years is equally applied to our liquid alternative managers.

Q How does doing hedge fund due diligence for liquid alts products differ from evaluating managers for traditional FoHFs?

A Although the framework of our approach to review these investments is similar, there are also some key differences. Our traditional FoHF investments are made through commingled funds, while our liquid alternatives products are made through separately managed accounts.

As a result, certain operating risk elements between these investment mandates will be different,



Sasha Jensen
CEO, Context
Jensen Partners

such as custody. For example, in a commingled fund where the manager has selected and established a prime broker, the operational due diligence process will include confirming the relationship as well as verifying its key terms and conditions. In the case of liquid alternatives, the prime broker or custodian will have been selected by us and as such, does not require an independent confirmation.

The process differs in other ways as well. For example, our liquid alternatives programs are part of a regulated structure such as '40 Act or Ucits funds. As a result, our compliance expectations and requirements of the sub-advisers are more stringent than they would be in our traditional FoHF products. The sub-advisors' policies and procedures are subject to independent review, regular certifications, and are also subject to additional oversight by Franklin Templeton's global compliance team.

Q What are the main considerations / concerns from a strategy and trading perspective that K2 takes into account?

A Key considerations when evaluating a manager's investment strategy from an ODD perspective is whether the staffing, systems and other support is adequate and appropriate. From time to time, we observe managers who, in the interest of conserving resources, do not invest enough in human resources or the systems needed to efficiently support their business. We limit our reliance on headcount metrics, evaluating each manager on a case-by-case basis. We consider the simplicity or complexity of the investment strategy, volume of trading and other factors that determine operational complexity. Because of our experience with many different investment managers and strategies, we are able to compare any





Lifting the lid on liquid alts

K2 Advisors, the \$10.1bn FoHF arm of Franklin Templeton, provides hedge fund and alternative investment products to institutional and high-net-worth investors as well as liquid alternative fund offerings for retail investors.

Liquid alternatives offerings include the multi-strategy Franklin K2 Alternative Strategies Fund, the Franklin K2 Long Short Credit Fund and the Franklin K2 Global Macro Opportunities Fund.

Underlying managers as of 31 March 2017 include: P. Schoenfeld Asset Management, Halcyon Capital Management, Emso Asset Management, Graham Capital Management, P/E Global, Chilton Investment Company, Impala Asset Management, Wellington Management Company, Jennison Associates, Portland Hill Asset Management Limited, Chatham Asset Management, Basso Capital Management, Loomis Sayles & Company and Lazard Asset Management.

individual manager's operation to a broader peer group.

Q When doing ODD on a manager, what are the most common red flags you see these days?

A The most common red flags we have identified have been for insufficient or inadequate staff to support a manager's operations. This has become especially difficult for emerging managers, as they experience higher operating standards by clients and regulators, while simultaneously having to address management fee compression.

Furthermore, during the past year, we have avoided investing in managers who: lacked sufficient valuation support for their hard-to-price securities; had poorly structured funds whose terms were inconsistent with ours; had funds with inadequate administrator arrangements, such as NAV-lite; and managers with unacceptable

conflicts of interest – for example, where the brother of the portfolio manager was serving as the firm's chief compliance officer.

Q How important is the IR/client servicing function to the ODD process? How should IRs prepare for an investor such as K2 coming to do ODD on them?

A IR/client servicing personnel are very important as they help set the tone for the meeting and provide access to appropriate individuals we need to interview. A very good team is able to field general or background-related questions and facilitate our requests before, during and after the onsite process. Our work begins with numerous document requests in order to analyse the firm and fund before arriving for our onsite review. The IR/client service person is most effective when they are able to procure these documents for us in ad-

vance, which will result in a more effective meeting and help limit the amount of follow-up required afterwards.

Q What is K2's approach to providing managers with feedback from the ODD process?

A We are neither obligated to provide feedback to the manager nor do we generally believe it is prudent to do so. A key objective of the due diligence process is to weed out managers from the selection process who exhibit unacceptable levels of operational risk – including the potential for fraud. Providing managers with insights to our approach can compromise the integrity of the process. Accordingly, our feedback is generally limited and entirely at the discretion of the ODD team.

Andrew Kandiew is head of operational due diligence for K2 Advisors.