Due Diligence Guide to Cash Management

Presented by

HORIZON

Cash Management

Horizon Cash Management

Few aspects of hedge fund due diligence deserve more attention – and receive less – than cash management. Historically, fund managers and investors have focused their evaluations on other, more glamorous parts of a fund's assets and operation. For some funds, cash balances often represent a substantial percentage of the fund's total assets. For others, the cash component may be a less significant percentage of the total. In every case, however, it is imperative that fund managers – and their investors – know at all times where that money is being held, the safeguards in place for those cash balances and the investment returns those balances are generating.

Making certain that a fund's unencumbered cash assets are kept as safe and secure as possible should be among a fund manager's most important responsibilities. This has been underscored by the separate pronouncements in early 2009 by three highly respected and objective third parties, for each of whom alternative investments are a realm of proven expertise.

> In January, the Asset Managers' Committee of The President's Working Group delivered its "Best Practices for the Hedge Fund Industry". Among its many recommendations, this report instructed fund managers to:
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> - be aware of the risks of holding certain short-term cash-like instruments (such as money market investments and short-term securities that depend on a liquidity put) as a substitute for cash, given the potential for illiquidity in these cash-like products
> - consider opening cash and custody accounts at financial institutions other than its prime brokers
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> In March, the Managed Funds Association released its 2009 edition of "Sound Practices for Hedge Fund Managers" which also exhorted fund managers to open cash and custody accounts at financial institutions other than its prime brokers, so as to increase access to liquidity while diversifying counterparty risk.
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> In April, Casey, Quirk & Associates, a consulting firm with 40+ years of experience advising investment management companies, in concert with The Bank of New York Mellon released a whitepaper, "The Hedge Fund of Tomorrow: Building an Enduring Firm" which observes that, if hedge funds are to continue to prosper, they must:
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> - turn to independent, non-conflicted third parties for a host of functions that were previously handled by prime brokers and in-house operations. Among these: reconciliation, portfolio accounting, custody of non-collateral assets and cash management
> - replace passive cash management (often entrusted to prime brokers or handled in-house) with active cash management (performed by an independent third party)

Horizon welcomes each of these recommendations. Coming as they do from knowledgeable and accomplished industry experts, they provide impartial guidance on the right way to manage cash. To assist fund managers in performing thorough and comprehensive due diligence on the cash component of invested monies, Horizon Cash Management has developed this guide. Having served the alternative investment industry since 1991, Horizon understands the importance of cash to fund managers and investors alike. It is the most important and valuable asset of all.

This guide encompasses more than 50 questions about cash management. These questions have been drawn from numerous meetings and conference calls with managers and investors who represent a variety of funds that reflect all strategies and sectors. We trust you'll find it an indispensable tool.

If you have any questions or would like to know more, we invite you to contact us via email info@horizoncash.com or by phone 312.335.8500.

Due Diligence Questions You Should Ask of your Money Manager

Organization and Structure

1 Provide a brief description of the firm.
2 Where is the firm organized?
3 Is the firm registered with any regulatory body?
4 Where is the firm headquartered? Are there other office locations? If yes, where?
5 What is the ownership structure of the firm? Has the ownership changed in the past 2 years? If yes, explain.
6 Is the firm related to any clients or investors for whom it manages assets?
7 Who is responsible for the management of the firm?
8 How many employees does the firm have? What is the breakdown by department?
9 Has there been significant employee turnover in the past 2 years? If yes, explain.
10 How are employees compensated? Is compensation linked to portfolio performance?

Assets and Clients

1 What are the current assets under management?
2 How many clients does that represent? How has this figure changed over the past 2 years?
3 Have any clients terminated their relationship in the past 2 years? If yes, explain.
4 What percentage of total assets does the firm's largest client represent?
5 What types of clients does the firm serve? What is the breakdown in percentage of type and geographically?
6 Are assets managed in separate portfolios or in a pooled investment vehicle?
7 Does the firm manage assets denominated in non-dollar currencies?
8 Where are the securities held? Who appoints the custodian? Can clients use custodians of their own choosing?
9 What is the minimum account size?
10 Is the firm fee based or performance based for compensation? Provide details.

Due Diligence Questions You Should Ask of your Money Manager

Investment Process and Portfolio Management

1 Describe the firm's investment process.
2 What types of securities does the firm invest in?
3 Does the client control the investment parameters? Can the client define what investment securities are and are not permitted in the portfolio? How often can the client revise these investment parameters?
4 Does the firm utilize derivatives such as interest rate swaps, credit default swaps or futures in its investment strategy?
5 Does the firm apply leverage? If so, how much leverage?
6 Does the firm allow client securities to be borrowed as part of a securities lending program?
7 Does the firm have credit quality guidelines? If so, describe in detail. Can guidelines be overridden? If yes, under what circumstance? What is the oversight?
8 Does the firm currently hold debt instruments that have been downgraded in the past 3 months by any of the rating agencies? If yes, explain.
9 What happens if a name on the firm's approved list is downgraded? Describe procedures, notification etc.
10 Is the firm invested in any illiquid securities? If yes, explain.
11 Who prices the securities? If priced internally, is there independent oversight? If priced externally, what processes are in place to review pricing? In both instances, what is the policy regarding any pricing mismatch?
12 What is the weighted average maturity of clients' securities? What is the duration?
13 Does the cash manager use call dates or stated final maturity dates to determine WAM?
14 Does the client have 100% daily liquidity? Explain.
15 If there is not 100% daily liquidity, what happens if daily liquidity amount is exceeded and the firm must liquidate securities to meet liquidity demands? Describe procedures, notification, etc.
16 Does the firm have an approved broker/dealer list? How many broker/dealers are used? How are the broker/dealers selected and monitored? Has any firm been removed from the broker/dealer approved list in the past 2 years? If yes, explain.

Due Diligence Questions You Should Ask of your Money Manager

Risk Management

1 How does the firm evaluate and monitor risk? Is risk evaluation handled internally or outsourced?
- Who is responsible?
- How often are the risk parameters re-examined?
- Explain the process and procedures.
- If outsourced, which provider is used? How is a provider selected? How often reviewed? By whom? Has the risk control provider changed in the past 2 years? If yes, explain.

2 What systems are used for portfolio management? For accounting? How are these systems upgraded? Does the firm have internal or external technology personnel?

3 What internal controls exist in the firm's systems? Can any control be overridden? If yes, describe the circumstances and the authority required.

4 If not already described, explain the controls the firm has in place to prevent trading in a security the client has not authorized.

5 Does the firm have rules in place regarding maximum exposure to a single issue and maturity restrictions? Does the firm have trading limits?

6 How does the firm ensure these rules are followed?

7 Does the firm act as principal or agent?

8 If the firm is registered by a regulatory body, when was the last review or audit? Is a report available for review?

Due Diligence Questions You Should Ask of your Money Manager

Reporting and Reconciliation

1 What reports does the firm provide clients? How often?
2 Does the firm provide 100% transparency on all client investments? Is this transparency provided daily?
3 If a client has a dispute with a statement, what procedures and policies exist for resolution?
4 Are any reports also available directly from the custodian? If yes, describe.
5 How often are cash and security transactions reconciled? By whom? What is oversight of this function?
6 If differences are detected in reconciliation, what policies and procedures are in place to report and reconcile the variance?

General

1 Does the firm publish performance? What benchmark is used?
2 Whom does the firm employ as its accountant? What is the scope of their work?
3 Who serves as legal counsel?
4 Does the firm employ an administrator?
5 Does the firm have errors and omission insurance? Has the firm ever had a claim? If yes, explain.
6 Does the firm have a SAS70 report? Is the report available for review?
7 Does the firm have a disaster recovery plan in place? If yes, please describe. When was the last test of the plan? How and by whom is the plan maintained?

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