Due Diligence Deal Breakers for CTAs

By Kate Dressel and Karan Sampson

It is no surprise that institutional investors are ramping up their due diligence procedures in light of recent events. They are asking more questions and are unforgiving of less than ideal responses. The following due diligence “deal breakers” commonly encountered by institutional due diligence teams should be taken into consideration by introducing brokers when preparing for meetings. They are basic, common sense issues that every commodity trading advisor should be able to address in a concise and compelling fashion. Failure to adequately respond will, at best, limit interest in the CTA, and at worst, remove the CTA from consideration completely.

What is the CTAs “edge”? Why should this CTA’s program be chosen over similar programs of CTAs with longer track records and proven business capabilities? This edge, along with the key points of the trading program, forms the foundation of the CTAs presentation. Allocators may look at hundreds of similar programs, so the CTA must clearly articulate these points and explain how their unique strategy will fit into the investment portfolio of the IB’s client. An inability to do so should reduce the CTAs chance of making it to the short list for consideration.

Is the CTAs track record adequate? Institutional investors generally require a three-year track record prior to considering a CTA allocation. Their concern is that statistically, the highest number of CTA failures occur within the first three years of active management. Surviving this critical phase increases confidence in the CTA’s trading program and business judgment. Additionally, the accumulated trading performance data will allow verification of, among other things, any claims of robustness, volatility and attractive risk/reward ratios. The track record provided should be representative of the trading program being considered, and whenever possible, be calculated according to AIMR-PPS standards in order to make independent verification easier. If performance data is found to be materially inaccurate or worse yet, misleading, the CTA should be removed from consideration.

Are key personnel qualified? IBs have a responsibility to their investing clients. If a CTA’s key personnel do not possess appropriate skills and experience pertinent to the trading methodology, they should not be considered for allocation. Education, professional experience and related skills are always important, but they are absolutely critical for firms that lack a significant track record. Without actual trading results to confirm competence, any decision to invest will be based heavily upon the level of confidence the CTA inspires. All CTAs should submit to comprehensive background checks, and if any pertinent material issues are found, the CTA should be removed from consideration.

Is business management a primary focus? Too often, young CTAs focus completely on trading and are unable to manage the administrative burden encountered with asset growth. A clearly defined business plan along with experienced key personnel will solidify the image of the CTA as a viable, long-term business as opposed to a “hobby shop”. Utilizing respected auditors, counsel, FCMs and consultants will not only help the CTA to achieve their organizational goals, but will increase client confidence.

Demonstrating attention to necessary business factors beyond trading will confidence in the CTAs professionalism and business acumen.

Is the CTA adequately staffed? CTAs are often inadequately staffed to handle various workloads associated with a growing business. To avoid this concern, there should be qualified personnel to manage, in addition to trading functions, business and operations functions including back office, accounting, client services, marketing and basic administrative duties. Many of these roles can be processed effectively by reputable third parties. Whether a CTA chooses to employ staff directly, outsource, or a combination of the two, it is important to demonstrate that all necessary operations are administered competently and in a timely fashion. Although outsourcing certain functions is widely accepted, it is best to have CTA staff centrally located as opposed to geographically dispersed.

Is there a culture of compliance? Given the current regulatory environment, coupled with the recent media frenzy over fraud within the alternative investment community, IBs should avoid CTAs that do not demonstrate best practices on the compliance front. It is imperative that appropriate registrations be in place and that all requirements there under are met. Be prepared to obtain a copy of the CTAs compliance manual as well as supporting documentation proving that procedures are being followed. The CTA may demonstrate ongoing involvement by counsel or a qualified compliance consultant as an alternative to having a knowledgeable compliance person in-house.

Is there adequate supervision and risk control? The CTA should proactively identify and address the myriad risks associated with conducting their business prior to allocation discussions. Establishing clear guidelines and processes, as well as forethought for potential obstacles, will increase confidence in the CTA's ability to protect investor interests. Do not limit the scope of your risk management review to only trading-related topics such as investment supervision, style drift, position limits, and managing margin, etc. Include coverage on general business risks such as counterparty failure, death or incapacitation of key personnel, valuation and computer system failure, etc. The list of risks, both trading and non-trading related, is extensive, and full transparency will improve the IBs ability to monitor CTA performance. Enlist the thoughts of colleagues and outside entities such as counsel and auditors in order to address unusual material risk factors.

Do the owners/principals have significant assets invested in the trading program? IBs should expect owners/principals of CTAs to have significant personal assets in any trading program considered seriously. The resulting alignment of interests will increase the likelihood of the CTA reacting in the best interest of their clients.

Although the topics discussed here may seem self-evident, they remain among the biggest deal breakers for investors doing due diligence on CTAs. Don't waste your time, or that of your clients, by fumbling the ball in any of these areas. Making sure these issues are adequately addressed will help assure your clients that the CTA is a "real business" and deserving of their consideration.

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