Integrating Artificial Intelligence into Operational Due Diligence:
A Comprehensive Guide

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Introduction

The rapid advancement of artificial intelligence (AI) technologies, exemplified by the launch of OpenAI's ChatGPT in 2022, has sparked widespread interest in how AI can be harnessed to streamline business processes and drive efficiency gains. In the asset management industry, operational due diligence ("ODD") teams are increasingly exploring the potential for AI to enhance the depth and breadth of their diligence efforts while enabling them to "do more with less" in an increasingly resource-constrained environment.

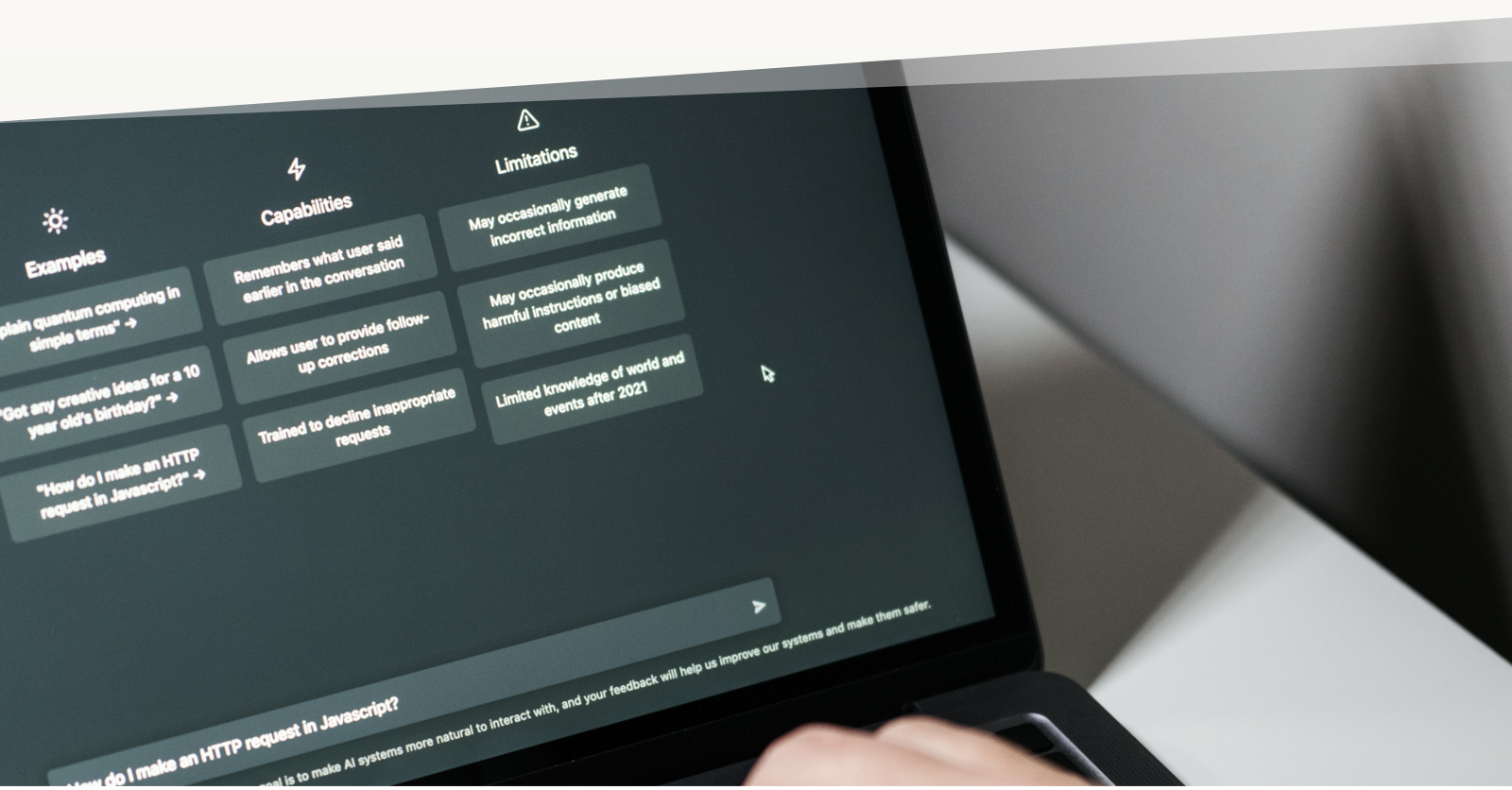
This white paper, drawing on our experience at Castle Hall Diligence, provides a comprehensive guide for investors seeking to effectively integrate AI into their ODD processes. We will examine the current capabilities and limitations of AI for ODD use cases, outline best practices for deploying AI solutions, and provide a framework for incorporating AI into the overall ODD workflow.

Understanding the Capabilities and Limitations of AI for ODD

Today's AI technologies, particularly generative models like ChatGPT, have demonstrated remarkable abilities to process and synthesize information, generating outputs that can mimic human-level knowledge and reasoning. When applied to ODD, AI has the potential to consistently screen large volumes of manager and fund data against predefined risk frameworks, flagging potential issues for further review by human analysts.

However, it is critical to understand that AI is not a panacea, and current models have significant limitations. AI cannot autonomously uncover new information or interpret data with the nuance and contextual understanding of an experienced ODD professional. Instead, AI should be viewed as an exceptionally intelligent but naïve assistant that requires detailed guidance and oversight from subject matter experts.

> i When deployed appropriately, AI solutions for ODD can deliver significant value, but they are not infallible and should always be subject to expert human review and validation.



Keys to Successfully Deploying AI in ODD

Effectively deploying AI for operational due diligence requires a thoughtful approach that prioritizes data quality, subject matter expertise, and human-machine collaboration. Castle Hall has found the following factors to be critical for success:

DETAILED AND INCREMENTALLY REFINED PROMPTS

AI models require highly specific instructions on the desired scope, format, and tone of their outputs. Experienced ODD professionals must invest significant time upfront to develop and refine prompts that elicit relevant, consistent, and well-structured results. This is an iterative process that requires multiple rounds of testing and feedback to optimize prompts for specific use cases.

There is, quite simply, no quick shortcut to successful and value add AI deployment.

HIGH-QUALITY, STRUCTURED DATA INPUTS

The performance of AI models is heavily dependent on the quality and structure of the data they are trained on and applied to. Unstructured, inconsistent data sets tend to produce scattered, unreliable outputs that offer limited value for ODD purposes. In contrast, carefully curated, standardized data sets enable AI to generate much more targeted and actionable insights.Investors should prioritize collecting and organizing high-quality data across key dimensions like manager and fund characteristics, service provider relationships, and regulatory filings.

In practice, Castle Hall has found that AI models for ODD are most effective when focused on specific, well-defined tasks and provided with structured, high-quality data inputs. For example, we have found that extracting key data fields from Form ADV filings produces more relevant and consistent AI outputs than simply uploading the entire form. Indeed, our testing showed that uploading the full text of the Form ADV Part II into the AI actually increased randomness and dispersion of results. While on occasion the AI materially enriched its findings with information from the Part II document, on other occasions the AI could miss major points or become inconsistent and confused when overwhelmed with detail. Similarly, AI reviews of legal documents works better when the AI considers each document individually. A detailed prompt guiding the AI in its review of an individual Limited Partnership Agreement is more successful than a process which asks the AI to simultaneously review all the legal docs at one time.

CLOSE COLLABORATION BETWEEN ODD EXPERTS AND TECHNOLOGISTS

Successfully deploying AI in ODD requires deep cooperation between experienced due diligence professionals who can define business requirements, interpret results, and provide feedback to improve model performance. Firms should foster cross-functional collaboration and ensure that ODD and technology teams are closely aligned on objectives and workflows.

While AI-generated outputs can often appear highly coherent and authoritative, they can also be inaccurate or misleading, particularly when dealing with edge cases or nuanced issues. As such, it is essential that knowledgeable ODD analysts carefully review and validate all AI outputs, providing feedback to refine prompts and retrain models as needed. Human expertise remains critical for interpreting and contextualizing AI results and should not be bypassed in the due diligence process.

RIGOROUS EXPERT REVIEW AND OVERSIGHT

Integrating AI into the ODD Workflow

To maximize the value of AI investments, ODD teams should take a structured approach to integration that focuses on delivering incremental gains at each stage of the diligence process. AI will not autonomously (miraculously!) generate comprehensive ODD reports from raw document uploads.

One effective framework is to break down the ODD workflow into its constituent steps - such as collecting and analyzing manager and fund documents (e.g. Form ADVs, financial statements, PPMs/LPAs), conducting background checks on key personnel, assessing service provider relationships, and reviewing compliance or valuation policies - and identify specific opportunities to deploy AI within each step to streamline data collection, flag potential risks, and surface relevant insights for further review.

For example, Castle Hall has developed AI-powered tools to extract and structure key data from reviews of audited financial statements, enabling more efficient and comprehensive analysis of financial reporting risk areas. By deploying AI in a targeted manner at each stage of the process, ODD teams can realize compounding efficiency and quality gains that enhance the overall depth and breadth of their diligence efforts.

To support effective AI integration, ODD teams should invest in developing detailed process documentation and training materials that codify best practices for prompt development, data management, and result interpretation. Clear guidelines and standardized workflows are essential for ensuring consistency and reliability of AI outputs across the organization.

Driving Continuous Improvement with Human-Machine Collaboration

As AI technologies continue to advance, ODD teams have an opportunity to create a powerful positive feedback loop by leveraging human-machine collaboration to drive continuous process improvement.

By actively soliciting feedback from ODD analysts on the quality and utility of AI outputs, and using that feedback to refine prompts, retrain models, and optimize data inputs, firms can create a virtuous cycle of learning and improvement that enhances the effectiveness of both human and machine intelligence over time.

ODD leaders should prioritize fostering a culture of experimentation and iterative refinement, encouraging team members to test new use cases, share learnings, and propose ideas for further optimization. By embracing a mindset of continuous improvement, firms can position themselves to fully harness the power of AI to enhance the efficiency, depth, and scalability of their ODD efforts.

i The Japanese word «Kaizen», used in production optimisation, means «continuous improvement». A Kaizen process looks for small, incremental gains, compounding over time. Kaizen is also a great way to think about how to best use AI.

Conclusion

The rapid evolution of artificial intelligence presents significant opportunities for asset management firms to streamline and enhance their operational due diligence processes. By understanding the capabilities and limitations of current AI technologies, following best practices for prompt development and data management, and ensuring close collaboration between experienced ODD professionals and skilled technologists, investors can effectively harness AI to screen more managers and funds, identify potential risks, and surface key insights to support informed decision-making.

While AI is not a silver bullet, and human expertise remains critical for interpreting and contextualizing machine-generated outputs, the judicious application of AI across the ODD workflow can deliver meaningful efficiency gains and enhance the overall depth and breadth of diligence efforts. As AI technologies continue to mature, firms that embrace a culture of experimentation, iterative refinement, and continuous process improvement will be best positioned to realize the full potential of human-machine collaboration in operational due diligence.

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