

HEDGE FUND VALUATION: WHAT PENSION FIDUCIARIES NEED TO KNOW

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INTRODUCTION

Oscar Wilde once described a cynic as “a man who knows the price of everything and the value of nothing”.¹ In today’s world, that could be a label that some pension fiduciaries end up wearing with regret. As pension decision-makers think about allocating money to “alternative investments” such as hedge funds, private equity funds, commodity pools, managed futures and real estate, they need to be mindful of their fiduciary duties. Understanding the risk and return characteristics of various non-traditional investment choices is paramount. Unlike mutual funds, some alternative fund managers invest in assets for which

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there is no ready market mechanism or a market exists but trading occurs infrequently. Either way, the investor is exposed to higher risk levels because of the potential difficulty (and cost) of unwinding a position. This is a problem for any pension plan in search of liquidity. Even plans with a longer-term view are advised to at least investigate the relationship between valuation and asset fungibility.

This article specifically examines valuation-related issues as applied to hedge funds. Several reasons account for this. First, hedge funds are gaining in popularity with pension plans, both in the U.S. and abroad. Second, some hedge funds invest in arcane and/or relatively illiquid securities as part of their strategy, thereby forcing investors to acknowledge that they will not receive frequent net asset values from the manager(s).² Third, regulators are becoming more vocal about their concerns as relates to the valuation of hedge fund assets.

HEDGE FUND BASICS

With over \$1.0 trillion in assets under management at end of year 2005, the hedge fund industry continues to grow.³ Low or zero correlations that offer diversification potential, a multitude of available strategies and expectations of high returns are oft-cited benefits associated with hedge fund investing.⁴ At a time when more than a few pension funds are under pressure to close their funding gaps, hedge funds understandably have appeal. Similar to any investment choice, hedge funds are neither good nor bad. Their appropriateness depends on a variety of factors, including strategy, fund structure and internal policies and procedures as relates to risk identification, measurement and control. Numerous hedge fund managers are registered with the U.S. Securities and Exchange Commission. Others have opted out by satisfying permitted exemptions relating to size and lock-up provisions.⁵

Contrary to popular belief, not all hedge funds hedge nor are they all uniform with respect to how they invest, what they trade and

Table One: Regulatory Concerns

1. "A key element of monitoring the risk of hedge funds is to understand the valuation used by said funds and counterparties to the funds. The complexity of the strategies employed by hedge funds as they aim for absolute returns adds to the barrier of understanding regarding the specific risk posed by the investments. With each twist, another layer of valuation is added on, obfuscating any clear understanding of the underlying risk. The SEC has stated that it would issue additional valuation guidance, but we have yet to do so." ("Remarks before the SIA Hedge Funds & Alternative Investments Conference by Commissioner Roel C. Campos", U.S. Securities and Exchange Commission, June 14, 2006)

2. "You will not be surprised to learn that the FSA, in pursuing one of its key objectives of promoting efficient, orderly and fair markets is becoming actively involved in the issues of valuation of hedge fund assets. We are currently undertaking a thematic review of the accuracy of valuations sent by hedge fund managers to their administrators, and are examining the systems and controls that managers have in this area. The work is reviewing the frequency and basis of valuations, the separation of duties between the fund managers and those providing and checking the prices and the reliance that can be placed on third party pricing specialists." ("Hedge Funds: Are their returns plausible? Speech by Dan Waters, Sector Leader Asset Management, FSA National Association of Pension Funds Investment Funds Conference", March 16, 2006)

3. "Unlike a mutual fund, hedge fund valuation practices are not overseen by an independent board of directors. A number of the Commission's enforcement cases against hedge fund advisers involve the adviser's valuation of fund assets in order to hide losses or to artificially boost performance. Thus, a review of valuation policies and practices is a key element of hedge fund adviser examinations." ("Testimony Concerning Hedge Funds by Susan Ferris Wyderko, Director, Office of Investor Education and Assistance, U.S. Securities & Exchange Commission Before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs", May 16, 2006)

the extent to which they employ leverage via use of short-selling, margin and/or derivative instruments. Those that follow some type of arbitrage strategy have a markedly different risk-return profile than an equity market neutral or long/short fund for example.⁶ Some funds report a daily net asset value. In other situations, this is simply not possible because marking-to-market a "hard-to-value" asset portfolio everyday would be cost-prohibitive.⁷ This lack of transparency continues to be a

deal-breaker for some retirement plan fiduciaries who do not feel comfortable allocating monies to hedge funds without more and better information than what the hedge fund managers may be willing to provide.⁸

WHAT'S THE BIG DEAL?

Valuation drives nearly every investment activity. It is impossible for hedge fund managers to make meaningful decisions about asset allocation, portfolio re-balancing, risk management, fee assessments

and performance evaluation in the absence of good valuation numbers. It is equally difficult for the pension fund investor to evaluate managers, decide whether to redeem or subscribe, verify calculated incentive fees charged by the typical hedge fund and otherwise carry out their mandated fiduciary duties.

As shown in Table One, regulators worry about the valuation of hedge fund assets.⁹ A sizzling "hot button", enforcement agents and government auditors are putting valuation at the top of their list as they seek evidence of foul play in the form of conflicts of interest, lack of documentation and/or sloppy or ineffective process. While not empirically documented, it would appear that they are likewise asking tough questions of service providers such as outside auditors whose valuation processes should help to identify problems of asset mispricing, missing internal controls and so on.

Their fears are shared by hedge fund liability insurance underwriters as well. Wendy Dowd, global underwriting manager for the investment industry, Chubb Group of Insurance Companies, offers: "The hedge fund valuation issue is significant. We've paid out several claims tied to valuation issues and this is one of the key areas of risk we have identified in our underwriting of hedge funds. The primary concern is lack of process, followed by lack of independence. If hedge funds aren't more pro-active about putting a good valuation process in place, they are exposing themselves to significant liability risk."

BEST PRACTICES

The news is not all gloomy. A recent study documents a rise in the number of hedge funds hiring risk officers.¹⁰ Given the interrelation-

Table Two: Some Suggested Valuation Best Practices

3.1	A Hedge Fund Manager's valuation policies and procedures should incorporate the concept of "fair value".
3.2	A Hedge Fund Manager's valuation policies and procedures should be fair, consistent and verifiable.
3.3	A Hedge Fund Manager should establish pricing policies and procedures that assure that NAV is marked at fair value. ¹⁴
3.4	A Hedge Fund Manager should choose reliable and recognized pricing sources to the extent practicable.
3.5	A Hedge Fund Manager should establish policies for determining valuations associated with instruments that may have multiple "official" settlement prices.

ship between valuation and risk control, these individuals are often tasked with the responsibility of establishing appropriate policies and procedures. Topics such as model selection, risk measurement techniques, frequency of internal and external reviews, reporting and the hiring of experienced appraisers are a few of the items that keep them busy.

Repeated again for emphasis, process is everything. According to Attorney Tim Selby, partner with Alston & Bird LLP, Financial Services and Products Group, "There are various alternatives available to hedge fund managers for determining valuations for difficult-to-value securities such as distressed debt, derivatives and private equity. In some instances, hedge fund managers may choose to develop internal pricing models. In these cases, managers must be able to explain and support the model parameters used in determining the valuation. These internal valuation models should be continuously tested, and where possible, independently reviewed and verified. Alternatively, managers may opt to obtain pricing information from an independent pricing service which provides a market value or assists the fund to establish a fair value. This can help to avoid conflicts of interest such as

when a trader's bonus is tied to inflated assets."

While implementation may vary from fund to fund, most people agree that a good valuation policy ought to embed certain elements such as reliability and verifiability. Excerpts from one industry source, the "MFA's 2005 Sound Practices for Hedge Fund Managers", are shown in Table Two.¹¹ The "Uniform Standards of Professional Appraisal Practice", "Private Equity Industry Group Guidelines" and "Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry" are other standards worth review.¹²

Attorney Aileen Doherty, hedge fund engagement manager with Jefferson Wells International, Inc. warns that having no written valuation policy is a sure red flag. "Senior managers must have a concrete method by which to evaluate hedge fund valuation process effectiveness, something they cannot possibly hope to do without documented guidelines that are reviewed and appropriately adjusted on an ongoing basis."

Other sensible measures necessitate the hiring of independent outsiders who have both experience and specialized training in valuation methodologies. In fact, more than a few judges have expelled so-called experts (and oth-

erwise rejected their opinions of value) if they are unable to demonstrate adequate training and abilities in the valuation area.¹³ (What they are asked to value will necessarily determine whether their particular credentials are appropriate.) Knowing this, and given the frequency of comments from regulators about valuation-related enforcement intent, does a pension fiduciary want to introduce more risk by failing to engage the right people to handle valuation work?

OUTSOURCING THE SELECTION PROCESS

ERISA does not let pension fiduciaries off the hook with respect to delegating duties. Even when a pension adviser is retained to evaluate and recommend hedge fund managers, a plan sponsor must make sure that the consultant is comfortable with asking the right valuation-related questions. In some cases, a pension plan may go directly to a fund of funds manager to assume the role of reviewer and clearinghouse. Regardless, it is important that all relevant decision-makers know enough about valuation issues to justify their decisions to beneficiaries and other interested parties. This is sometimes easier said than done. Model risk, data integrity issues and systems inter-

face may not be everyone's strong suit.¹⁵ However, ignorance is no excuse. Resources such as online courses provided by the Regulatory Compliance Association can help pension fiduciaries better understand the compliance risks associated with hedge fund investing, including those associated with asset valuation.¹⁶

SUMMARY

Hedge fund valuation is a crucially important topic and mandates consideration of a multitude of factors. For a pension fund fiduciary with a lot to do and know, recognizing that valuation and investment risk go hand in hand is a significant step in the right direction towards effective oversight.

Disclaimer: The information provided by this article should not be construed as financial or legal advice. The reader should consult with his or her own advisors.



NOTES

1. <http://literaryquotes.paulpolititis.com/quotes10.html>
2. Critics assert that some economic interests should not be valued and that doing so would jeopardize the asset allocation decision that led to investing in relatively illiquid holdings in the first place.
3. Federal Reserve Board, "Testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics Before the Subcommittee on Securities and Investment, Committee on Banking, Housing, and Urban Affairs, U.S. Senate", May 16, 2006, <http://www.federalreserve.gov/boarddocs/testimony/2006/20060516/default.htm#fn4>
4. Center for International Securities and Derivatives Markets, "The Benefits of Hedge Funds: 2006 Update", May 2006, page 2, <http://cisdm.som.umass.edu/research/pdf-files/benefitsofhedgefunds.pdf>
5. <http://www.sec.gov/rules/final/ia-2333.htm>
6. http://en.wikipedia.org/wiki/Hedge_fund
7. A discussion of price versus value is beyond the scope of this article. Theoretically, if the Efficient Market Hypothesis maintains, traded prices should reflect the value upon which two rational, informed and willing participants transact.
8. There are various gradations of transparency and what that means in terms of quantity and quality of information provided. Some hedge fund managers counter that disseminating too much data puts them at a competitive disadvantage vis-à-vis peers. The result would be lower returns, something an investor could not possibly want.
9. Roundtable participants differentiate between valuation-related fraud and well-intentioned hedge fund managers who err when trying to value assets. Refer to "Hedge Fund Roundtable", May 15, 2003. See <http://www.sec.gov/spotlight/hedgefunds/hedge2trans.txt>.
10. "Hedge funds improve risk management" by Sarah Spikes, *Financial Times*, June 21, 2006.
11. See <http://www.mfainfo.org>.
12. Several industry commentators have observed the similarity between some hedge funds and private equity funds.
13. A business valuation credentials chart can be found by visiting the website for the National Association of Certified Valuation Analysts.
14. "NAV" refers to Net Asset Value.
15. Model risk is a huge topic and is especially relevant for more complex securities where variables are themselves modeled before being used as inputs for a valuation model. Consider the valuation of mortgage-backed securities. Future expected cash flows that depend on interest rate assumptions are simulated after first assessing the likely behavior of interest rates. See "Financial Model Risk Looms Large" by Susan M. Mangiero (http://www.bvalle.com/library/articles/risk/il_gsmassociates.pdf) or "Asset Valuation: Not a Trivial Pursuit" by Susan M. Mangiero. (Send an email to pension@bvalle.com for a copy.)
16. See <http://www.rcaonline.org>.