Securities Industry News
www.securitiesindustry.com
JUNE 4, 2007

Critical Issues for Hedge Funds

SPECIAL REPORT

The State of Valuation

Risk management expert Mangiero stresses the importance of process

As institutional investors move into hedge funds in ever-greater numbers, fund managers are under growing pressure to attain the market-beating returns that the investors expect in return for hefty fees. In this high-stakes environment, the accurate valuation of hedge fund investments is a critical challenge.

John Calabrese

Susan Mangiero, president and CEO of Trumbull, Conn.-based research and consulting firm Pension Governance, is a valuations and financial risk expert with over two decades of experience in capital markets. A frequent speaker on hedge fund and risk matters, and an accredited appraiser, Mangiero is the author of "Risk Management for Pensions, Endowments and Foundations" (John Wiley & Sons, 2005).

Before founding Pension Governance in 2005, she worked on trading desks at Bank of America, Bankers Trust and First National Bank of Chicago. Mangiero, who holds a PhD in finance from the University of Connecticut and an MBA from New York University, recently spoke with *Securities Industry News* compliance editor Carol E. Curtis about why valuation has become so important for hedge funds, and how the industry can satisfy investors and regulators that it is handling valuation properly.

How is "valuation" defined as it applies to hedge funds? Generally speaking, the term refers to the price at which informed, willing third-party financial buyers and sellers would transact. That said, there are different standards of value, so valuation must be clearly defined at the outset.

Why is valuation so important in this industry? Valuation numbers drive nearly every financial decision. Hedge fund managers need to know how to rebalance their portfolios, adjust risk management positions and report numbers to investors upon which they earn their fees. Valuation becomes especially important in the case of illiquid investments like private equity, distressed securities, emerging-market securities and complex derivatives. It is also an issue as more hedge funds go public. How else will you come up with a net asset value for the initial public offering, without a formal assessment?

Additionally, institutional investors are on the hook to understand how hedge funds value their holdings. The last thing pension fund, foundation or endowment fiduciaries want is a blowup that could have been prevented with a thorough vetting of the managers' valuation process. That includes assurance from the hedge fund managers that numbers are being provided by an independent third party.

What does that process entail? Selection of a proper valuation model is critical. Moreover, the value of an individual holding or portfolio of securities can, and often does, change over time. That's why it is so important to think of valuation as an ongoing process. This includes ongoing validation of valuation models, a review of source data and a check that valuation standards and practices are in use that are accepted by the industry.

What should institutional investors be asking about hedge fund valuations? In the aftermath of new regulations such as the Pension Protection Act of 2006, endowments, foundations and pension plans can ill afford to put money in alternative investments without asking tough questions. At a minimum, fiduciaries should ask for a copy of the hedge fund's valuation policy and procedures. If told that this information is proprietary, then an institutional investor should ask to meet with the person or persons responsible for establishing, implementing and adjusting valuation policies and procedures. General statements in the private placement memorandum that give full discretion to the hedge fund managers to value positions as they see fit are likely to be cold comfort for an institutional investor. Even if a hedge fund manager chooses not to have positions valued on an ongoing basis (and there could be legitimate reasons for that decision), an institutional investor needs to inquire about risk drivers. Has the hedge fund manager conducted any type of sensitivity

analysis on identified qualitative and quantitative factors to identify likely impact (direction and magnitude) on portfolio value as one or more of the factors changes? Has the portfolio been stress-tested?

Who is responsible for the valuation process? Right now, the issue of who has the most to lose is up for grabs. I've worked with some hedge fund managers who are at the top of their game with respect to risk management and valuation. On the other hand, there are those who choose not to do more in the area of valuation, unless and until their institutional investors require them to formalize a process. Related to that is the issue that not everyone feels comfortable with assessing a hedge fund's valuation policy, if one exists at all. I think that's a recipe for disaster. If a hedge fund invests in hard-to-value instruments, ignoring that reality does not get institutional investors off the hook. They need to check with counsel but will likely be reminded that they are ultimately responsible for making informed decisions, even when using a consultant or investing via a fund of funds.

Some of the pressure for more formal valuation analysis is also coming from the institutional investors' auditors. Recognizing that it's not enough to get to the point of purchase, they need to figure out how they are going to show the investment on their books. Should a position be reflected at cost or adjusted later on to reflect a change in economic value? What is the role of side pockets [which are portions of a hedge fund with their own liquidity provisions]? How are the fees paid to hedge fund managers impacted by their use? What is the relationship between leverage and portfolio value? How is redemption or subscription activity impacted by valuation analysis?

What do regulators have to say about valuation? State, federal and international regulators encourage investors to do their homework, including but not limited to a verification that traders are not posting their own marks, that independent parties are used to regularly verify model results and prices, and that a demarcation between responsible parties is documented and implemented.

What are some of the difficulties of valuing illiquid holdings such as private equity investments and complex derivatives? One of the most difficult areas concerns terminology and standards. In appraisal-land, the term fair value is often a standard defined by state law. In contrast, fair value in public accounting-land is what appraisers would usually refer to as fair market value. Interested persons can check the International Glossary of Business Valuation Terms for formal guidance. Another often-used standard in appraisal-land is USPAP, the uniform standards of professional appraisal practice. Elsewhere, there are a plethora of standards such as those put forth by the Private Equity Industry Guidelines Group or the International Organization of Securities Commissions. There are overlaps but they are not necessarily identical. In the event that a valuation case goes to court, a judge may reject an expert's report if based on valuation standards that are not considered mainstream. Then there is the issue of relying on a simplistic formula to adjust for something such as the lack of marketability. An appraiser must be able to justify the basis of the discount, or any type of adjustment for that matter, and document it accordingly.

What is the biggest issue for valuation? A pension fund executive recently asked me if it was all right to get a valuation from a prime broker or securities custodian. This is a huge issue but ultimately rests on the ability of the service provider to substantiate their numbers in the case of hard-to-value positions. Is there independence, or is the prime broker reporting the valuations it gets from the traders? Assuming the numbers are independent, the next issue is, how are they getting the numbers? Do they employ trained experts who can render justifiable numbers? More and more judges are throwing out opinions of value unless they come from a qualified valuation professional. Additionally, valuation literature is replete with examples of mistakes, many of which arise from taking shortcuts or not employing proper methodology.

Has the pressure on hedge funds to do proper valuation had an impact on the valuation industry? The awareness of the need for a good valuation process is rising exponentially around the world. However, it's almost as if there are two separate communities—the professional appraisal industry and everyone else. I've worked on three trading desks and done a lot of work with financial institutions and funds. I feel comfortable in that world. However, some appraisers may choose not to work with hedge funds and instead specialize in areas such as manufacturing or biotech. On the other hand, some in the hedge fund industry may be rendering valuations without specialized training or credentials. I think there is room for improvement. Our company is creating a course about hedge fund valuation in partnership with the National Association of Certified Valuation Analysts. It will be offered in a few months to appraisers, hedge fund chief compliance officers, institutional investors and regulators.

What is the biggest risk for hedge funds in valuation? I see valuation as a subset of risk management. I don't see how you can have good risk management without having a good valuation process in place. Besides the obvious problems that felled hedge fund giant Amaranth [Advisors in Sept. 2006] and others, poor or no valuations can lead to undue leverage or flawed decisionmaking with respect to setting stop-loss points. So ultimately, a huge risk for hedge funds (and their investors) is not connecting the risk management valuation dots.

What advice do you have for hedge fund managers looking to improve their valuation process? If you don't have a valuation process and related procedures, put one in place post haste. If you have a valuation process, make sure it reflects reasonable standards such as independence, oversight and regular review. Talk to your institutional investors. Ask them what they need to know in order to discharge their fiduciary duties and yours. (Depending on how much Erisa [Employee Retirement Income Security Act] money is in your portfolio, you may be a fiduciary yourself.) Make sure that your risk management policy clearly lays out requisite activities related to valuation. Don't rely on a formulaic approach. If you use an independent appraiser, be clear on what has to be valued and how often and on what basis. Hedge fund partners may want to get a valuation of the business itself for a variety of reasons such as succession planning, key-person insurance or bringing a new investor on board.

Hedge funds who [promote] their process as good business practice or to differentiate themselves from competitors may be wasting their time if gatekeepers can't appreciate their discipline. Spend time with the auditors. Explain the valuation models and the process by which models are verified. Get good analytic systems in place. Make sure that staff, including back-office personnel, are properly trained and understand what's at stake. Finally, avoid perverse incentives that encourage flawed valuations. Recognize that traders have a built-in motivation to inflate values after purchase if they are being rewarded accordingly.

Is there any silver lining here? Yes. The increased attention being paid to valuation numbers and process can only be a good thing for the hedge fund industry and its investors. ■

©2007 SourceMedia, Inc. and Securities Industry News. All rights reserved. SourceMedia, One State Street Plaza, New York, N.Y. 10004 (800) 367-3989