HEDGE FUNDS REVIEW

Valuation issues stress relationship between hedge fund managers and investors

The valuation of hedge fund assets has become an issue fraught with tension. Fund administrators say they are up to the task. Fund managers believe they alone have the knowledge needed.

The financial crisis revealed the extent to which reliable valuation underpins the investment world. As a result valuation of hedge fund assets has become a key focus area and the use of independent verification continues to increase.

With this greater focus on independent views, different concerns have been raised. The main worry is how investors can ensure they are getting fair value even when a third-party valuer is involved, particularly on esoteric assets, without undermining the reasons for investing in hedge funds. Another concern is the price tag on such independent valuations.

“The hedge fund sphere has always involved valuations that were quite complex and required precise expertise,” explains Jon Anderson, global head of valuations and OTC derivatives at hedge fund administrator GlobeOp.

“Prior to the crisis often the only people who could [value esoteric securities] were the hedge fund managers and the investment banks that sold those products. Marking to market relied on brokers and dealers,” he explains.

“Fund investors often didn’t focus on valuations during their due diligence. In 2008 prices disappeared, which brought to the fore the need for independent, defensible valuations and a transparent and controlled process that stakeholders could understand. These days you won’t find a due diligence process without a huge focus on valuation,” he states.

The importance of valuation has been driven by greater scrutiny by regulators and investors. The changing client base in hedge funds has also had an impact as institutions account for an increasing percentage of hedge fund assets, with some sources suggesting it is as high as 61%.

Institutional investors have brought greater scrutiny and understanding of the valuation process with them, forcing the industry to improve standards and transparency.

“We have seen a major evolution in terms of valuation,” says Phil Niles, director of product development at Butterfield Fulcrum. “Careful attention is being paid to how funds value assets and the role of independent administrators within that process.”

Niles continues: “It has become standard to have a formalised, documented valuation policy in place, which was previously not the case. Some fund managers, especially those investing in more esoteric assets, are also introducing valuation committees.”

One of the most notable trends since the crisis is the increased use of independent third parties to value assets. Research by Ernst & Young shows the majority of hedge funds, in response to investor desire, now outsource to administrators in some capacity. Almost three-quarters (74%) of investors and almost half (47%) of hedge funds polled cited the ability to provide independent valuation as one of the top benefits of doing so. Seventy-four per cent of investors also believed it was important that a hedge fund completely outsource valuation to an administrator.

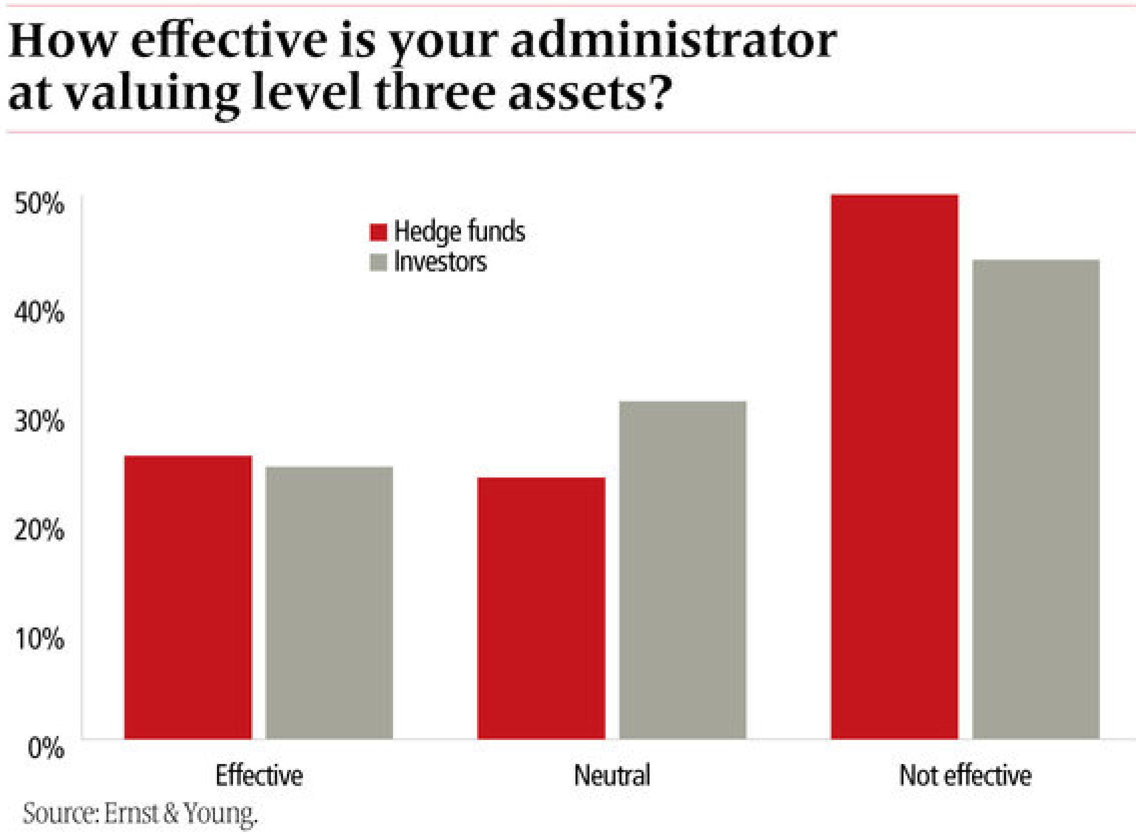
The arguments for doing so are manifold but have been reinforced markedly since the Madoff scandal. “The need for greater protection post-Madoff has driven a greater use of independent valuers,” says Lars Lindqvist of London-based brokerage Cattegatt Capital. “Hedge funds want to provide transparency to avoid future allegations they had the wrong method in place. The way to do that is to have a third-party valuer.”

Increased paperwork

The level of documentation demanded by all stakeholders including investors, auditors and now regulators, has also increased significantly. “The breakdown is now very detailed and includes whether assets have been independently verified as well as the level of independence of the verifier,” GlobeOp’s Anderson says.

Ultimately, it comes down to an ideological issue. Managers have an inbuilt incentive to value assets favourably as that drives net asset value (NAV), which drives assets under management (AUM), which drives managers’ compensation. “Third-party assessment is critical in ensuring managers are not valuing assets for their own gain,” according to Sara Malak, chief compliance officer at the Alpha Cooperative.

Some experts argue that because fund managers select administrators, the conflict is not completely overcome by outsourcing. However, Niles at Butterfield Fulcrum says administrators’ fees are generally covered by the fund’s fees and it is therefore investors who ultimately



pay.

“If the administrator cannot stand behind the NAV it is striking, it is opening itself up to significant risk,” he states.

John Czapla, managing director at independent valuers Valuation Research Corporation (VRC), elucidates this point. “Reputation is everything for us and the crux of the valuation industry is independence. Our businesses, reputations and credentials are at stake,” he says.

The difficulty for independent valuers, however, is that a skill gap is inherent in the model. Their knowledge and expertise will arguably never be as in-depth as the hedge fund manager. A hedge fund’s existence ultimately hinges on its ability to identify and take advantage of areas where markets are not valuing assets correctly.

“If an administrator was as good at it, they would be doing it themselves,” according to one industry source. “The reason hedge funds are in business is they have figured out a better way to value assets."

Because of this and the relative immaturity of independent valuation, many hedge funds and their investors still question the effectiveness of administrators in adequately valuing assets.

Low confidence

Ernst & Young found only one in four hedge funds or investors is confident administrators can effectively and accurately value level three assets.

The Ernst & Young report also points to the questionable feasibility of conducting independent valuation on anything but the most transparent and liquid assets as well as the clear mismatch between what investors are demanding and what administrators are providing in terms of valuation. In many cases administrators do not have the resources to value complex securities independently and particularly level three assets where valuation can be more subjective with no consensus view available.

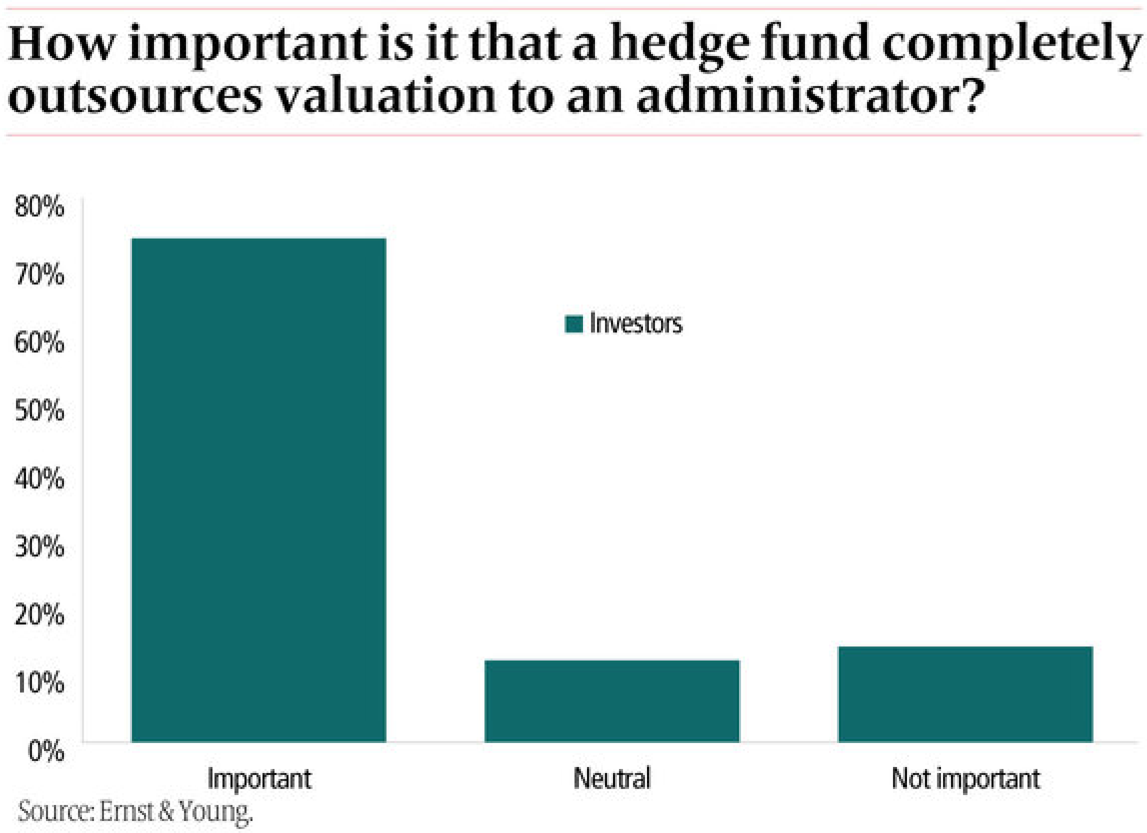
"Having valuers who know and understand the process and underlying asset class is really important," Alpha Cooperative's Malak says. "The quality of the administrator affects the value and performance of a portfolio."

She continues: "Inaccurate valuation can mean investors lose money if, for example, an administrator uses a run-of-the-mill valuation technique, but the manager, who has a better understanding of the assets in question, is using a different technique that points to a higher valuation."

This raises the issue of the risk independent valuations pose to fund managers. According to Ernst & Young's findings, 71% of hedge funds believe there is risk in fully outsourcing valuation.

The potentially lower valuations that using a third party could imply have a direct impact on the manager's ability to generate alpha but also potentially exposes them to risks relating to reputation and proprietary information.

Lack of accuracy, or the perception a manager is not valuing assets accordingly, is a threat to a portfolio manager who would, therefore, be keen to avoid disagreements on valuation with their administrator.



Sharing those valuations and the data on which they are based in a transparent way also means hedge funds have to expose their secret recipe to a greater degree, potentially reducing the scale of arbitrage opportunity available between the market value and where the manager thinks an asset's value should be.

"Hedge funds' businesses depend on proprietary information," Niles at Butterfield Fulcrum says.

"We are willing to work within that, but the role of the administrator is to cut a fair, accurate and independent NAV and to be a rational, independent third party to check if there is a valuation process and policy in place, whether a manager's valuations are in line with that policy and if that policy is in line with the underlying assets," he adds.

In most cases, the fund manager is ultimately responsible for reviewing and approving NAV and resolving disputes over valuation, and therefore carries the bulk of risk associated with this issue, but a balance needs to be struck between the fund managers' interests and those of the fund investors. This is where fund boards come into play.

"The quality of governance is critical. There is a strong desire among investors, particularly in Europe, for boards to have the information and resources to provide good governance in areas such as approving the NAV and fund expenses," according to Julian Young, Europe, Middle East, India and Africa (EMEIA) hedge fund leader at Ernst & Young.

Around a third (29%) of investors believe the board should be ultimately responsible and accountable for reviewing and approving NAV. In reality that responsibility still sits with the fund manager in 65% of cases. Almost half (48%) of investors also believe the board should be responsible for resolving valuation disputes but in 50% of cases it is the fund manager who is currently responsible.

"For the board to be able to do this job, it needs to have the right skills and experience, and fund managers need to communicate and give transparency," Young says. Twenty-six per cent of investors considered boards were not effective at carrying out their duties versus 45% who thought they were.

Just as using less knowledgeable administrators can affect valuations, relying on boards is only effective if its members have an in-depth knowledge of both the manager's and the administrator's valuation methodology, something many hedge fund managers dispute.

In response to the considerable growth potential in the valuation business, administrators have invested heavily in recent years, improving both the technology and personnel available to dedicate to accurate valuation of hedge funds.

"Many administrators have made considerable investments in order to speed up their processes and make them more efficient and accurate," Butterfield Fulcrum's Niles says.

"Also on the people side, we have been making investments in capable, quality people with -specific expertise in these products. Having dedicated personnel is extremely important," he states.

Such a high-cost system clearly favours the bigger administrators who have the capital and backing to pay the higher costs of employing people with the required level of knowledge, such as former traders. "It is difficult for administrators who don't have the right capital to get the job done," Alpha Cooperative's Malak says.

Specialist services

The result has been the emergence of more specialist companies offering valuation services to hedge funds as well as the rise of a model where a central valuation specialist recruits best of breed valuation for the different assets in a manager's portfolio from across the industry.

GlobeOp uses this model, which Anderson describes as 'hub and spoke'. "We are a vetter and aggregator of the different valuation services, which gives managers access to best practice valuation across the range of their assets," he says.

The investment in improving the resources dedicated to making better third-party valuations should have a positive impact on the sector. However, it comes at considerable extra cost, driving up the pressure on management fees. In general investors appear happy to bear that extra cost.

"Little was being done in terms of independent valuation before but now there is a greater need for oversight and independence, which is clearly coming out of the management fee. The costs of maintaining a fund are higher but clients are happy to pay that higher cost, given the increased comfort it gives them," VRC's Czapla says.

The irony for hedge funds is that the costs of independent valuation, coupled with the lower valuations an external party might apply, could undermine the premise for their existence. Hedge funds derive their alpha from spotting where markets are under or over-valuing assets precisely because they believe they have a better understanding of that asset's value. The alpha those insights generate are then eroded by the independent valuation process demanded by the clients who benefit most from that alpha.

GlobeOp's Anderson acknowledges there are assets that are hard to price. In the worst-case scenario there is no market price available, so pricing needs to rely on expert opinion.

"In such cases the role of the independent valuation provider is to evaluate the manager's policy against best practice, including how it is applied. A process that is transparent, controlled and consistent gives investors a fairer understanding of the risks they are taking," Anderson adds.

The problem of offsetting higher costs of valuation versus alpha is particularly acute for smaller funds. These tend to be more focused on niche areas, investing in relatively esoteric asset classes that are harder to value and require a more specialist knowledge on the part of the valuer. This usually means a relatively higher cost for providing those valuations as a percentage of alpha.

"For smaller funds, paying the higher costs of valuation is much harder. It is a delicate balance that depends on how much of the manager's alpha is being eaten into and how it affects end performance," according to Alpha Cooperative's Malak.

One area where valuation remains particularly challenging and, so far, few independent valuers have made real inroads, is that of hedge fund secondaries, an asset class Cattegatt Capital's Lindqvist estimates is worth roughly $50 billion.

In the past many of these assets related to closed but healthy funds still calculating NAVs and trading transparent assets that could be valued using relatively conventional methods. Because those assets were not distressed, buyers would pay a modest discount or in some cases a modest premium to buy the shares on the secondary market.

Since the crisis secondaries tend to be hedge funds that have become very illiquid or are in liquidation and so are considerably harder to value. The underlying assets are often of esoteric vehicles for which prices disappeared in 2008 and where demand still suffers from a significant dose of scepticism about valuation and fear of the risks involved in getting the pricing wrong.

“Hedge fund secondaries require a different type of valuation,” Lindqvist says. “It is more about distressed financing. It has to take into account what information is available and how reliable it is, which is often unclear. The time to exit those assets can also be unclear.”

He adds: “All of that translates to uncertainty, which equals risk, which equals discounts. The main question is what discount to apply. That tends to be arbitrary and requires a high level of due diligence on the part of the buyer.”

Most investors tend to adopt a very general approach using general information about the assets, but for those that are able to dig a little deeper, the benefits can be rewarding.

“Those that do heavy due diligence tend to come up with a better price,” Lindqvist says. “These assets can trade at anything from a 5% to a 90% discount.”

Furthermore, hedge fund secondaries often end up in the hands of traditional auditors who may not have the specialist skills to value, market and sell those assets, applying conventional techniques to unconventional instruments. This often leads to higher discounts. That should prove attractive to potential buyers who can take advantage of their better understanding to buy cheap.

However, these assets exist because a hedge fund manager has been unsuccessful, making the risks associated with valuing those assets for potential buyers even greater. Valuation is made more difficult by the reputation risk the original manager is exposed to, which tends to make them very reluctant to share information on the assets’ value. This is an area where independent valuers have been less able to make a meaningful penetration into the market.

“End valuations can be very different,” Lindqvist explains, “which is a high risk for a fund manager if he has to explain himself when there is a lot of noise around valuations. Managers also don’t want too much transparency on their proprietary valuation process. Because these are often private and highly specialised instruments where an in-depth understanding of those assets is required, how many third-party valuers have that understanding?”

The considerable investment being made and the emergence of more specialists in the face of increasing demand for independent valuation and sound oversight should help resolve the quality shortcomings among today’s valuers by creating a self-perpetuating virtuous cycle. Investors will have to accept some decrease in alpha because of the greater comfort it affords them.

“As a consequence of the regulators and investors desire for there to be third-party valuations, the quality of boards and third-party valuers will have to improve as the industry matures and more institutions invest in hedge funds,” concludes Young at Ernst & Young.