Fund Administrators and Valuation

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For alternative investment managers and funds, the January audit season is generally their busiest and riskiest period as they value their portfolio holdings for year-end reporting. After such a turbulent and dramatic year in the financial markets, this task may seem more difficult and complex than ever. The 2011 year-end features a heightened focus on the process of valuation, as investors—further spurred by a series of fraud scandals in recent months—demand far greater transparency and accountability from their managers. Moreover, as they seek assurances of independent and unbiased fund valuation, investors have extended their scrutiny to service providers as well, most notably fund administrators.

However, as a recent Ernst & Young (E&Y) report shows, there remains a significant opinion gap between investment managers and investors when it comes to valuation. While more than half the investors Ernst &Young surveyed believe that funds should outsource valuation to a third-party administrator, conversely, 71% of investment managers surveyed feel that outsourcing valuation actually increases risk. Only one in four of these investment managers believe that fund administrators can conduct valuations effectively.

Clearly, the industry must remedy this divide. As the breadth of asset classes traded in alternative investment funds continues to expand, it is imperative that investors have confidence in the independence and accuracy of their net asset value calculations. This focus on valuation is certainly not a passing fad—it requires resolute attention from the fund industry, whose credibility could hang in the balance.

Unfortunately, to some extent, both sides are right, since the valuation expertise of fund administrators is by no means standard across the industry; in fact, it is often alarmingly diverse. Many established fund administration firms, while quite reputable, are known as “plain vanilla” shops, focusing on a client base chiefly trading highly liquid, listed investments such as stocks, bonds and futures. Should a client stray outside of these relatively safe, easy-to-understand assets, these firms may struggle with valuation.

A few fund administrators, however, are able to handle even the most esoteric and hard-to-value assets. They offer internal teams devoted exclusively to valuation and staffed with capable, experienced professionals. They have also built the infrastructure their personnel need to excel in valuation, combining great technology with robust processes.

These administrators stand out from the rest by delivering not only independent valuation, but also true added value to their alternative investment clients and the investors they serve.

These administrators generally focus on clients trading over-the-counter (OTC) instruments requiring more in-depth and specialised knowledge. Some of their clients follow particularly complex strategies or hold unique assets—which might include anything from music catalogues, litigation claims, trademarks and patents to sports teams, wine collections, power plants and toll bridges.

Fund administration firms serving these types of clients can only maintain their businesses by hiring outstanding personnel with experience in valuing these unusual assets. Indeed, some forward-thinking fund administrators actually staff their teams to service individual clients and engagements. Typically, in a situation like this, the client needs extremely specific capabilities to satisfy both their own portfolio valuation requirements and the demands of their investors. Such resolute commitment to accurate, reliable valuation allows some fund administrators to differentiate themselves.

Nonetheless, even the most committed fund administrator will find it difficult to supply valuation expertise for absolutely everything. Therefore, to ensure accurate pricing, some fund administrators will employ their own external service providers for valuation. In fact, bringing in third-party assistance might be an instant solution for fund administrators lacking valuation expertise—or could prove an industry-wide solution to the complaints cited in the Ernst & Young report.

Even if they themselves do not have in-house experience in valuing esoteric strategies and instruments, fund administrators can use their scale to benefit all market participants. While a small fund could find it far too expensive to obtain an independent valuation directly, if a fund administrator purchases and manages third-party valuations, it could spread the costs across its entire client base (subject, of course, to the terms of their particular agreements regarding data). This process can drastically reduce the cost for everyone involved, yet still yield an independent and reliable valuation.

If the industry as a whole adopted such a solution, it might go some way toward closing the opinion gap between fund managers and their clients that the Ernst & Young report highlights. While investment managers may be justified in their belief that many fund administrators have significant deficiencies in their valuation capabilities, they are wrong in thinking that this issue plagues all fund administrators. Organisations that have made significant internal investments in people and processes—and that continue to gain expertise through servicing a diverse client base—are well equipped to handle the nuances of complex valuations.

While there may be no substitute for the hands-on experience and in-depth understanding of the investment manager, the right fund administrator can offer what investors increasingly want: a truly independent third party to ensure an accurate portfolio valuation.