

Valuations

Not all NAVs are created equal

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In today's market, the importance of a strong valuation policy can never be underestimated. It is important to bear in mind the manner in which a fund is valued as it can greatly influence the final return on investment. If the fund is overvalued on entry, or conservatively valued on exit, the impact on returns could be significant. So when talking to the fund manager about how securities are valued and to the administrator about how it will implement the valuation policy, it is important to go beyond asking the industry standard questions. Here are 10 questions to determine the quality of your NAV.

1. Valuation experience

How much experience does the administrator have valuing the securities held in the fund? Ideally, the administrator has an established track record valuing the securities your fund holds and, if necessary, has experience working with complex fund structures across various markets. It should be able to instill confidence that it is unlikely to misprice securities.

2. Documentation

Ask to see a copy of the fund's valuation policy and any other valuation process documents. These documents should be both precise and comprehensive because they form the basis from which NAV is calculated. They should clearly lay out the duties and responsibilities of the administrator with respect to valuation and NAV calculation. If the manager cannot produce these documents or if the documents seem incomplete, inadequate or deficient in any way, it is possible the fund does not have a thorough set of procedures in place to ensure consistency in pricing securities.

From an investor point of view, this should be a concern. Many due diligence experts have suggested as many as 80% of all hedge funds do not have a detailed valuation policy in place beyond the NAV language in their offering memorandum.

3. Valuation policy

How does the administrator value the fund's portfolio? The administrator should always follow the prescribed valuation policy established by the fund as documented in a set of detailed procedures written by the administrator. These documents should cover primary and secondary data sources, valuation methodology, the time at which securities are to be priced, and what to do when valuing securities not covered in the valuation policy. It's also important to confirm that the administrator has verified that the policies and procedures comply with the wording used in the fund's offering memorandum.

4. Valuation process

How is the portfolio priced and where are the key risks? Most securities are priced in one of three ways. Each way has associated risks.

- Exchange traded prices should be pulled by the administrator at the same time every day and directly from reliable price feeds such as Bloomberg or Reuters.
- Solicited quotes should be sent from the price provider directly to the administrator. When market support is provided to the administrator by the manager and not by the price provider, the level of independence involved in calculating the NAV is reduced.
- Industry standard models should be maintained and run by the administrator using market inputs obtained by the administrator. Where industry standard models cannot be run, the fund manager should clearly document the rationale for using such models and the processes involved in running them. Model valuations should be compared on a regular basis to counterparty marks.

5. Policy exceptions

What happens when the manager cannot get a market price or the manager and the administrator disagree on a price? In the event the manager cannot get a market price, the rationale behind the methodology used to determine pricing should be documented and provided to the administrator for review from a 'common sense' perspective. This ensures the methodology used is applied consistently. In some circumstances it may be necessary to change the methodology. A change is easier to support if the original and new methodologies are clearly documented. If a manager regularly changes how a security is priced it could suggest the manager may be under or overvaluing a security depending on the performance of the fund. However, if there are pricing disagreements between the manager and the administrator, it is important that a pre-determined and documented tolerance level between the two exists on a security-by-security basis. Disagreements may arise due to timing differences in marking the portfolio at the end of the day. When the difference is below the prescribed tolerance level, it is preferable to use the price provided by the administrator because it is generally viewed as having a higher level of independence. Where the difference is significant or where no price can be obtained, the manager should look to an independent valuation agent to validate the accuracy of any prices used.

6. Policy enforcement

What happens if the administrator is unable to follow the valuation policy? It is essential that a documented process exists for communicating all policy exceptions to the manager as soon as is practical. Ideally, all exceptions are documented in a policy exception report that is reviewed and approved by senior management and/or a fund valuation committee before the NAV is issued. The approval of these exceptions should be documented and then communicated back to the administrator.

7. Oversight

Who oversees the valuation process and what is their role? The administrator should have its own valuation group and/or manager that oversees the daily and monthly valuation process. In many cases, an administrator may even have its own valuation committee. This provides a higher level of independence and accountability in the valuation process. An administrator's lack of a valuation group, manager or committee suggests that no one individual or group beyond the team directly serving the client is accountable for the client's valuation process.

8. Pricing review

How often do the administrator and manager meet to review prices? Ideally, the manager and administrator should hold regularly scheduled meetings prior to month-end to discuss any valuation issues that emerged intra-month. They also should meet immediately following month-end to discuss any problems that arose during the valuation process. These meetings should include a discussion of the applicable FAS 157 levels for all GAAP-compliant funds.

9. External review

How frequently is the valuation process reviewed by an external party? Most funds undergo an annual external audit. It should include a review of the valuation process and documentation. It also should sample test the prices and positions used to calculate the year-end NAV. The findings can be found in the final audit report produced by the auditors. Additional comfort can be derived if the administrator has an internal audit department, or if the fund has a well-written monthly or quarterly 'agreed-upon procedures' review. This review takes the form of an independent valuation review by a party independent of the manager, administrator and auditor. As year-end audits can typically take two to three months, an agreed upon procedures review can help identify and address problems more quickly than an annual audit would permit.

10. Policy review

How often do the administrator and manager meet to discuss valuation issues? Ideally the administrator and manager should meet every quarter to make sure all valuation processes and procedures are up-to-date and working. This includes the review of any valuation issues that may have been identified through the administrator's monitoring process. Although valuation is ultimately the responsibility of the manager, the importance of the administrator and the role it plays in calculating NAV should never be underestimated. **THFJ**

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