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Value Matters™

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VALUATION BEST PRACTICES

Hedge Fund Investment Portfolios

Two private-sector committees established by the President's Working Group on Financial Markets ("PWG") released best-practices guidance for the hedge fund industry on April 15, 2008.[1] The Report of the Asset Managers' Committee (the "AMC report") is targeted at hedge fund managers, while the Report of the Investors' Committee (the "IC report") offers recommendations to hedge fund investors.[2] The AMC and IC reports establish a set of key frameworks that aim to reduce systemic risk and promote transparency and protection for investors. This article will briefly discuss the motivation for a robust valuation framework as it applies to hedge funds before delving into the implementation of the valuation framework prescribed by the AMC and IC reports.

MOTIVATION

The global hedge fund industry has exhibited impressive growth in the last two decades. Assets under management have grown from $39 billion in 1990 to around $2 trillion by mid-2008.[3] Unlike other investment vehicles, there is a substantial diversity in investment strategies adopted by individual firms within the hedge fund industry. Common hedge fund strategies may be classified as directional (e.g., equity long/short, managed futures, global macro, etc.), event driven (e.g., merger arbitrage, distressed security, etc.) or arbitrage (e.g., convertible arbitrage, fixed-income arbitrage, etc.). Regardless of the specific strategy employed, many hedge funds invest in securities and instruments that are difficult to value, either because they do not have an easily-identifiable market prices, or they are (temporarily) illiquid, or both.

Typically, a significant share of hedge fund manager compensation is tied to fund performance based on the ultimately realized value of the investment positions held by the fund. These compensation (incentive fee) arrangements align investor and manager interests and provide the requisite motivation for superlative manager performance. However, incentive fees can create conflicts of interest between managers and funds in the valuation of fund investments and presentation of fund performance. The conflicts are especially apparent for classes of investments that do not have easily-identifiable market prices. Further, liquidity of most classes of investments may be (temporarily) impaired by inclement market developments, which adds to the difficulty in valuing these investments.

Hedge fund managers need to dispel (the appearance of) conflicts of interest in the valuation of fund investments to gain investor confidence. Appropriate separation between fund management and investment valuation responsibilities, oversight of the entire valuation process, and a special focus on difficult-to-value investments are critical elements of a well-formulated valuation framework. In addition, a robust valuation framework is best complemented by adequate disclosures that discuss the critical elements of the valuation framework.

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IMPLEMENTATION OF THE VALUATION FRAMEWORK

The Asset Managers' Committee report calls for an integrated valuation framework providing for clear and consistent valuations of fund investments while minimizing potential conflicts that may arise in the valuation process. The recommended framework includes three specific components: 1) Valuation Policies and Procedures; 2) Governance Mechanism (Valuation Committee); and 3) Valuation Personnel.

1. **Valuation Policies and Procedures**

   A set of written policies and procedures addressing each class of investment held by a fund is fundamental to a functional valuation framework. An effective valuation framework should require consistent application of the policies and procedures adopted by a hedge fund. In addition, valuation frameworks should include appropriate disclosures about the limitations of these policies and procedures.

   The AMC report recommends the adoption of valuation policies that, at a minimum, identify the personnel or group(s) involved in the valuation processes, establish valuation methodologies relevant to each class of investment, and provide procedures to effectively alleviate potential conflicts. The valuation policies should adequately define the roles and responsibilities of internal and/or external parties engaged in the valuation processes. A discussion of the valuation methodologies should include potential pricing and informational sources for the various classes of investments. The valuation policies should also address internal documentation procedures and mechanisms for recording material deviations from the adopted valuation procedures.

   The best valuation policies include further guidance for the treatment of investments that do not have easily-identifiable market value and "side pocket" investments. In particular, formulating valuation policies that govern difficult-to-value investment positions can be tricky because of the inherently greater potential for conflicts of interest. The AMC report suggests that, in the absence of satisfactory external (third-party) valuations, the valuation policies should adequately identify the circumstances under which use of internal valuation models is acceptable. A valuation committee should review any material deviation from the application of internal valuation models as prescribed by the valuation policies.

   Likewise, valuation of side pocket investments requires extra care. Side pockets consist of fund investments deemed to be (temporarily) illiquid, thus having no easily-identifiable market value. Many funds elect not to transact side pocket investments until their liquidity is restored. Usually, funds do not assess incentive fees on side pocket investments and prohibit new investors from acquiring stakes in these investments. While the absence of incentive fees substantially removes valuation conflicts associated with side pocket investments, the AMC report emphasizes the need for detailed valuation policies that oversee the use of side pockets. Funds should pay close attention to the specification of the criteria for moving investments into and out of side pockets, and to the valuation of investments held in side pockets.

   In general, valuation conflicts can be mitigated by the use of qualified and independent third parties to either review or generate valuations of fund investments. This is especially true for difficult-to-value investments, particularly if reasonable external valuations of such investments are available.

2. **Governance Mechanism (Valuation Committee)**

   A suitable governance mechanism, usually a valuation committee that oversees the entire valuation process is the second component of the valuation framework recommended by the AMC report. While it is desirable for valuation committees to include key management individuals, a significant degree of independence from portfolio managers and trading personnel is necessary to ensure the valuation committee is reasonably free from potential conflicts of interest.

COMPLIMENTARY WEBINAR

Getting Ready for SFAS 141R, *Business Combinations*

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SFAS 141R, Business Combinations becomes effective in 2009, bringing significant changes to the fair value accounting procedures for mergers and acquisitions. Financial executives need to understand how the new standard will potentially affect deal structures and reported earnings. Consistent with the FASB's broader push toward fair value, SFAS 141R replaces the purchase method framework with the acquisition method.

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The responsibilities of valuation committees include:

- Developing valuation policies and procedures;
- Periodically reviewing and amending valuation policies, as necessary;
- Establishing mechanisms to assess the fairness of the valuation policies and their consistent application; and,
- Conducting regular consultations with independent auditors, third-party administrators, third-party valuation firms, and legal advisors to examine the ramifications of fair value accounting requirements on fund valuation policies and investments.

The AMC report establishes SFAS 157 as a benchmark for disclosures related to fund investments.[4] SFAS 157 institutes a fair value hierarchy based on the quality of inputs used in the valuation of specific investments. Levels 1 and 2 include investments that are valued using observable inputs (of differing quality), while valuations of Level 3 investments require the use of unobservable inputs. Side pocket investments, for example, would virtually always be Level 3 assets.

SFAS 157 requires companies to disclose the amount of investments held at each Level, and imposes supplemental disclosure requirements on Level 3 investments including information on realized and unrealized gains and losses, transfers of investments in and out of Level 3, and a description of inputs used in the valuation processes.

In addition to the responsibilities enumerated earlier, the AMC report recommends valuation committees monitor fund disclosures, which (at a minimum) should be compliant with disclosure requirements set forth in SFAS 157. The AMC report suggests funds make supplemental disclosures for Level 2 investments in addition to Level 3 investments. Valuation committees should periodically review the guidelines and policies for classification of fund assets within the fair value hierarchy prescribed by SFAS 157. In addition, the AMC report also calls for valuation committees to undertake periodic back-testing of sample valuations with a particular focus on Level 2 and Level 3 investments.

3. **Valuation Personnel**

The third component of the valuation framework prescribed by the AMC report provides for personnel who oversee the implementation of valuation policies. In general, qualified individuals from within a fund or a qualified external party (or a combination of the two) could execute the valuation function of the fund. Two considerations are paramount with respect to the valuation personnel. First, they must conduct valuations based on procedures and information sources detailed in the valuation policies adopted by the fund. Second, the valuation function should be reasonably separated from the portfolio management and trading functions of the fund to avoid potential conflicts of interest.

VALUATION BEST PRACTICES: THE HEDGE FUND INVESTOR PERSPECTIVE

Reliable valuations of hedge fund investments are crucial to the entire investment process, from inception (choosing to invest in a/any hedge fund) to end (exiting investment through either redemption or liquidation). The Investors' Committee report recommends that investors (and/or fiduciaries representing investors) in hedge funds exercise special care in studying the documentation and disclosures provided by funds prior to, and for the duration of, investments in hedge funds. In particular, the IC report emphasizes the variety and dynamic nature of portfolio strategies and associated risks, which require continual monitoring of not only the fund investments, but also valuation policies and procedures, and any deviation from such policies.

Like the Asset Managers' Committee report, the Investors' Committee report states that funds should maintain written valuation policies that, at a minimum, identify the classes of investments expected to be held as well as the valuation methodologies and sources for each class. The IC report recommends that investors verify the existence and consistent application of the valuation policies and procedures governing fund investments, as

well as an appropriate governance mechanism that oversees the valuation processes. In particular, investors should examine whether valuations of the investments in the fund portfolio are consistent with GAAP fair value standards, including SFAS 157.

Investors need to be more vigilant in monitoring funds whose holdings include difficult-to-value investments, whether or not they are deemed side pocket investments. The IC report suggests that investors seek independent valuations of funds with significant holdings of difficult-to-value investments on a semi-annual basis. The report also recommends investors confirm appropriate separation between the portfolio management and valuation functions of the fund, and reasonable valuation treatment of illiquid and side pocket investments.

CONCLUSION

This discussion has focused on developing and implementing valuation best practices to foster productive relationships between fund managers and investors.

In summary, the valuation of hedge fund investment portfolios can be fraught with potential conflicts of interests because of incentive fees. These fees, designed to provide adequate motivation to the fund managers, can create perceived or real conflicts, in the context of investments that are difficult to value. This is true whether the difficulties arise due to a dearth of market (pricing) information for similar investments, or due to (temporary) illiquidity, or both. However, a well-executed valuation framework that includes appropriate valuation policies and procedures, an adequate governance mechanism, and an able team of valuation personnel (internal and external) can successfully minimize investors', and indeed, systemic, risk. While external valuation expertise is not a substitute for a sound valuation framework, incorporating such expertise can considerably improve the efficacy of the valuation framework in assuaging investor concerns related to the valuation of fund investments.

Mercer Capital provides independent valuation services to individuals and corporations of all sizes for portfolio valuation, financial reporting, corporate planning and tax compliance purposes. Our professionals are well-versed with the increasingly complex fair value reporting standards. Mercer Capital has valued many liquid and illiquid securities and instruments to auditor, regulatory, and client satisfaction for more than 25 years. Contact us to explore how we can assist you in formulating and implementing your hedge fund valuation framework.

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Endnotes

1 President's Working Group on Financial Markets Best Practices Guidance, released April 15, 2008

From page x of the Report of the Asset Managers' Committee:

> The PWG was established by Executive Order in 1988. The PWG was given the mandate to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets and to maintain investor confidence. The PWG includes the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission, or their designees.

2 President's Working Group on Financial Markets Best Practices Guidance, released April 15, 2008

From page i of the Report of the Asset Managers' Committee:

> The [Asset Managers' Committee], which comprises institutional alternative asset managers representing diverse strategies and perspectives, was formed as a private sector committee by the PWG in September 2007.

From page 4 of the Report of the Investors' Committee:

> The Investors' Committee comprises senior representatives from major classes of institutional investors including public and private pension funds, foundations, endowments, organized labor, non-Us institutions, funds of hedge funds, and the consulting community. Each of the members has reached out broadly to other institutional investors as well as to professional associations and financial services professionals to gain an informed perspective on the best practices for hedge fund investments.

3 "The Lo Down." *The Economist*, June 14th – 20th, 2008, pg.102.

4 For more on SFAS 157, see "A Primer to SFAS No. 157 Fair Value Measurements" in the Article Library at www.mercercapital.com.

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