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## THE KEY TO INDEPENDENT FUND-OF-FUNDS VALUATION

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The recent AIMA Study '*Asset pricing and fund valuation practices in the hedge fund industry*' thoroughly addresses critical aspects of the practice of independent pricing of hedge fund portfolios and the diverse challenges it presents.

Although different issues are associated with independent portfolio valuation for funds of funds, the same fundamental practice applies. The administrator needs to collect the underlying hedge fund price information independently from the FoF investment manager to mitigate the risk of any price adjustment in favour of the latter, who usually earns a performance fee.

In this article, we aim to provide some insights into issues related to independent pricing of FoFs, and share the lessons learned from the process implemented by our firms over the last five years.

### Why independent valuation of a FoF portfolio is challenging

FoFs invest in a variety of underlying hedge funds. As the manager and administrator of these hedge funds regularly update investors on their performance, one would think that portfolio valuation for a FoF would simply require the shareholder statements of the underlying funds. The reality is somewhat different. The absence of public price sources, such as a stock market or a data provider, for the net asset value (NAV) of these underlying funds creates a high dependency on the related parties of the fund investment.

The challenge in independent portfolio valuation is not about the application of sophisticated financial models. To ensure timely and proper valuation, strict processes, persistence, accurate record-keeping and active reviews of the price quality received from the various sources are critical and very time consuming. The issues described below illustrate the difficulties associated with the independent FoF valuation process.

### Waiting for the slowest

One of the challenges of independently valuing the FoF portfolio on an agreed-upon date early in the month lies in obtaining reliable price information on all the fund investments on time. This can raise two issues.

Firstly, many hedge funds launch a new series or share class every month to track the performance fee and the individual high water mark. Investors know for certain whether their subscription has been accepted and in which series they are invested only after they receive final confirmation from the underlying administrator, which can take more than a month. These typical features of hedge funds make the pricing process far more difficult as information about a specific investment may not be confirmed until after the next valuation day of the FoF.

Secondly, most hedge fund managers can provide only *estimated* rates of returns (ROR) early in the month. The required, finalised investor statements with the critical price information are often distributed weeks – or in some cases, months – after the end of the month. Waiting to receive all final statements from all the investments makes the FoF valuation process highly dependent on the responsiveness of the slowest underlying fund.

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### **Lack of access to price information**

The FoF investment manager and/or investment advisor usually have the best access to the hedge fund managers and their NAVs as they perform due diligence visits and establish a professional relationship where strategies are discussed and reviewed on a regular basis. The FoF manager may be tempted, therefore, to perform its own valuations as it receives estimated NAVs from the managers and final NAVs from the hedge funds' administrator. When implementing independent valuations, the FoF investment manager is often required to spend a considerable amount of time getting its administrator onto the distribution list of price information sent out by the underlying hedge fund manager and administrator.

### **Triangular relationship**

When a custodian is involved at the FoF level, the triangular relationship between the FOF manager, custodian, and fund administrator often makes gaining access to accurate prices even more difficult. In those cases, the investor of record at the underlying fund is the custodian, not the FoF. It is easy to understand how the approval process for obtaining the statements just became more complicated.

### **Straight-through processing is in its Infancy**

The NAV reporting is distributed through a variety of different channels, such as e-mail, fax and websites, in as many different formats. Furthermore, there are no unique identifiers for hedge funds to facilitate automated reconciliation between prices and ensure that the involved parties are talking about the same investment. The lack of reporting standards makes it challenging to automate the process to make it more secure and faster. However, certain price distribution channels, such as e-mail and websites, can and have been automated.

### **The quest for independent pricing services for FoF portfolios**

Traditionally, the value of a FoF portfolio is determined only on the basis of the *final* shareholder statement provided by administrators of the fund investments. This practice often results in lengthy delays in the reporting process for the FoF as described above. These kinds of delays are now unacceptable to FoF investors.

Faced with this challenge, we launched an initiative five years ago with the objective of closing the books and distributing the NAVs of our FoF mandates according to a predefined, reliable schedule based on an independently priced portfolio. Early in the project we defined four critical requirements for efficient independent price collection:

- A dedicated, specialised independent price collection team
- A unique approach to elicit the best available prices for the FoF portfolio valuation in compliance with the pricing policies of the FoF as well as sound accounting principles
- A system specifically designed and developed in-house to support the price collection process
- Fully automated checks and balances for quality assurance

This approach now enables us to close the books of our FoF mandates in a shorter period of time *and* to a dependable schedule based on the best available prices at the pre-defined, cut-off date in conjunction with tight quality reviews. The more accurate price data translates into several advantages for the investors. The rebalancing process of the asset allocation is more

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precise and timely, the performance decomposition is more accurate, the volatility of underlying hedge fund prices decreases, and the covenant monitoring activities of the FoF FX hedge or leverage providers produces less opportunity cost.

### **Specialising in core task**

The quality of service to the FoF investors depends in large measure on access to the most up-to-date price information. We have found that collecting independent prices is a daunting task, tying up the fund accountants with non-accounting related tasks. Therefore, one of the main objectives is to establish a single source for price information related to fund investments, providing fund accountants with the best available prices at any given point of time.

This requires gathering the required price information from the underlying fund managers and administrators and managing them in a central database, so providing a single source for independent fund investment prices, including all historic prices with the corresponding proofs, which can be accessed 24 hours a day.

### **A unique approach to elicit best available prices**

The aggressive schedules favoured by some FoFs mean that many fund investments are valued using estimated prices. For this reason, strict reviews of the quality of received prices and the financial impact on the portfolio valuation are essential. More than 3,800 prices may need to be gathered per month and, as a result, the process of checks and balances must be fully automated. These policies and reviews include:

- Continuous and centralised price collection for underlying fund investments to receive final price information from independent sources. Our solution provides real-time reports of missing final prices and allows for easy follow-up with the appropriate contacts. It is an objective of our team to constantly and persistently work on obtaining a final price from the underlying fund administrators, even two or three months after the books of the FoF have been closed.
- This solution provides the team with information on the quality of the estimates reported by the underlying fund manager versus the actual final NAV. This historical review allows us to decide if the provided estimates are reliable for the valuation process. At the same time, this report is shared with the FoF managers as input for their own due diligence process comparing the manager's estimated NAV with the administrator's final NAV. This can be one of several early warning signals in a due diligence process.
- Prior to conducting the portfolio valuation of the current month, the fund accountant reviews the financial impact on the FoF portfolio of the utilisation of estimated prices in previous months. These system-supported reviews quantify the difference between the price used for book-keeping one month as well as two months ago, compared with the final prices received at a later date. If the impact on the overall portfolio is greater than a pre-defined tolerance level, a revision of the prior months' NAV needs to be considered following further analysis. This policy also helps determine whether a particular manager's estimates are sufficiently accurate to be relied upon in the future.

This focused approach on independent price collection enables us to efficiently prepare the FoF net asset value based on the best available prices within days of the month's end. The FoF investors profit directly from a reliable accounting schedule, the best prices available at that point in time and a secure valuation process.

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### **A proposed central pricing instrument for FoF valuation**

All of the work just described would be dramatically simplified if a central database similar to that available to the securities industry was established for the hedge fund industry, giving fund managers and administrators a neutral place where they could report their fund prices (including Classes and Series). Unfortunately, such a database does not yet exist in our industry, and thus every FoF investment manager and administrator spends a considerable amount of time handling price requests on one side and gathering the prices they need for their FoF mandates on the other hand.

We understand that AIMA will shortly be commencing Phase 2 of its work on Asset Pricing and Fund Valuation in the Hedge Fund Industry. We plan to share what we have learned over the years from this initiative as we are convinced that further collaboration will increase the level of credibility, efficiency and transparency in the industry in a way that would benefit all investors, FoF managers and related services providers.