The Essential Guide to Third-Party Valuations for Hedge Fund Investors

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The Importance of Accurate Valuations for Hedge Funds

Investing in less-liquid or illiquid assets within a hedge fund structure is a complex issue. Hedge fund managers' challenges in this space are different from those of private equity managers. While private equity managers may face more complexity in valuing portfolios of truly private assets, they also benefit from closed-end investment structures where there are no Limited Partner (LP) transactions occurring in the interim that impact the portfolio before an asset sale and where fees are crystallized upon the sale of the asset. Hedge funds, on the other hand, must manage less liquid investments keeping in mind redemptions by investors that may occur frequently, often quarterly. Investors transact at net asset values, or NAVs, determined by valuations. LPs are typically permitted to subscribe monthly and redeem at the end of a quarter at the net asset value of the investment vehicle.

In addition, accurate asset valuations are critical for hedge fund managers as their fees—management and incentive payments—are determined monthly or quarterly based on unrealized market values; investor redemptions crystallize these fees regardless of later underlying asset sales.

A Robust Valuation Framework

At NEPC, we have observed a multi-layered approach to valuing illiquid assets held through investment vehicles at hedge funds.

Starting from the top, every fund manager must have a written valuation policy in place that is used to price the portfolio. We have the following recommendations to ensure a robust valuation policy:

(a) Thorough: The policy should be detailed and specific to the assets in which the fund invests.
(b) Compliant: The firm's compliance department and the fund's board of directors should sign off on the valuation policy.
(c) Pricing sources: The policy should specify primary, secondary and tertiary (if necessary) pricing sources for each asset type and outline the process for resolving price discrepancies.
(d) Valuation committee: A formally organized valuation committee should meet to review and approve the completed valuation package monthly before striking the NAV.

Additionally, best industry practices dictate that portfolio managers should not be voting members of the valuation committee, as their compensation is frequently tied to portfolio performance and their ability to vote would create a conflict of interest.

In an emerging trend, managers are actively engaging third-party valuation specialists for guidance on pricing less-liquid or illiquid assets. To the extent third-party service providers are utilized in the valuation process, the valuation policy should indicate the circumstances under which these providers are used, which providers are used (and for which asset types), and the process by which their reports are provided to the manager and recorded in the minutes of the valuation committee meetings.

As the reliance on third-party valuation specialists increases, it is vital for investors to understand the role they play. Presently, convention calls for the use of external service providers for their independent and unbiased fair-value estimate on illiquid or non-trading assets. Where, in the past, managers might price an asset to internal models or solitary broker quotes, investors, regulators and auditors may prefer an objective assessment from a third party.

The increasing clamor for external valuation experts is at least partially due to guidance from the American Institute of Certified Public Accountants (AICPA), which allows limited partners to use the stated NAV as their fair value estimate for private fund holdings, but only after verifying that the fund is providing fair value-based NAVs to the LPs.

Investors may accept private fund NAV as fair value, if the production of that fund's NAV is consistent with ASC 820 fair value guidelines. This creates a burden for LPs to verify valuation methodology and consistency with fair value guidance. To the extent a fund is investing in less liquid or private investments, the call for external valuation providers brings additional assurance to the fair value measurement.

To be sure, the hedge fund manager still has ultimate responsibility for the fair value estimate even if a third party is involved in the valuation process. It is also possible that an investment manager overrides a valuation from an independent provider in favor of pricing derived through internal models. This practice effectively defeats the purpose of hiring a third-party provider and is often not clearly reflected in price-assurance reports to investors. To this end, investors must pay close attention to the valuation procedures and internal controls in place to ensure the process is well-defined and monitored. An exaggerated valuation can inflate performance and fees while an overly cautious estimate can distort redemptions to the disadvantage of investors.

Types of Services from Third-Party Valuation Providers

Third-party valuation providers typically offer these three services to hedge fund managers:

i. Negative assurance: This is the least detailed approach, under which the hedge fund manager provides a self-created valuation report to the third-party valuation provider. The outsourced valuation specialist reviews the manager's pricing methodology to determine the approach used is not unreasonable. This process covers only the pricing model; it does not address the validity of the methodology for the asset in question or the particular inputs used in the valuation model.
ii. Positive assurance: This service takes the negative-assurance process a step further with the independent valuation expert reviewing the inputs and methodology provided by the hedge fund manager to opine that they are reasonable and in line with industry standards.
iii. Full valuation: This is the most detailed service and, as a result, the costliest. Therefore, it is also the least utilized. Here, the third-party valuation provider carries out a detailed analysis on the relevant inputs, discount rates and pricing methodologies. The end result consists of providing the manager with an acceptable valuation range or spot value for the asset.

The Drawbacks to Third-Party Valuations

(i) False sense of security: All third-party valuation providers are not created equal. Investors and hedge fund managers alike should guard against complacency while using the services of an outsourced firm. While many are capable, individual providers typically specialize in particular asset classes and, therefore, it is critical to match the right valuation specialist to the asset type.

(ii) Multiple valuations for same asset: A firm may value the same investment differently for multiple funds. A position could be marked differently in two funds for reasons such as a difference in the size of the position, different model inputs, or different pricing methodology. However, we would expect there to be some reasonable threshold for multiple prices of the same security across a number of funds. For instance, one fund holding a security at 20 cents on the dollar while another valuing it at 90 wouldn't

be explainable by those factors. NEPC's Operational Due Diligence team reached out to a number of valuation specialists to better understand these challenges to their business. For instance, the service providers we spoke to had internal mechanisms to catch different prices ascribed to the same asset across multiple clients, but there was no protocol to ensure consistency. This is largely because the basis for "reasonableness" for assurance providers allows for disparate clients to use different inputs or methodologies for the same asset, leading to different valuations, while still satisfying the "reasonable" clause.

(iii) Lack of communication: While independent valuation providers have fiduciary responsibilities, they have no direct contact with investors. They can be fired at will by the fund management company without notifying investors. They can be terminated over significant disagreements around asset pricing and in cases where the two parties could not resolve a discrepancy in the external and internal valuations. In fact, NEPC has encountered managers touting the use of third-party valuation agents only to override non-assurances or maintain modeled pricing.

(iv) Limited accountability: Independent third-party valuation providers are often indemnified by the funds for their duties. Indemnification protects them from legal action by investors unless investors can prove gross negligence. This increases the moral hazard of the relationship where the third-party provider should be accepting the fiduciary responsibility on behalf of the investors, but is hired and reports to the manager.

A Roadmap for Investors

To navigate the potential pitfalls mentioned above, we encourage investors to take a more active role in seeking greater transparency around how hedge funds value their illiquid holdings. Investors should question their investment manager to gain comfort around valuation methodologies and compliance. To this end, the following check list should be included by clients during their due diligence process:

- We recommend a careful reading of the valuation policy. Is it specific to the types of investments held by the fund? Has it changed in the last year? Valuation policies are not consistent between managers so it is important to read each one individually.
- It is vital to understand the third-party vendors being used and the asset types covered by them. Does the named service provider have expertise in the asset class it is engaged to value?
- What level of service is being provided? What happens if the outsourced provider does not assure the manager's pricing, or provides a value range that does not include the manager's price?
- Has the independent valuation specialist ever been asked to not issue a report on a security it was tasked with pricing?
- How are price exceptions recorded and approved? Does the board receive reports of pricing exceptions?
- Has the third party interacted with regulators regarding its valuation opinions, and did it withstand regulatory scrutiny?
- Are Level 3 securities, that is, highly illiquid assets, priced using the same methodology at each valuation date? Are changes to the process documented, along with the reasons for the changes? Under what circumstances is the methodology or inputs altered?
- In the instance where funds are receiving a range of values from a third-party vendor, what is the process for deciding the point value within that range used to strike the fund's NAV? Is there ever a case where the point value used for the NAV is outside the provided range?

Conclusion: Trust but Verify

We believe using third-party valuation services is a best practice for hedge funds with any illiquid exposure and strongly encourage this as part of operational reviews. To the extent clients are individually visiting investment managers, this paper can serve as a starting point for discussing valuation. Our mantra, trust but verify, is of the utmost importance in this area of due diligence; even the most seemingly detailed valuation policies are subject to discretion. We encourage our clients to vigorously examine and question their fund managers so their investments do not fall prey to mispricing.

Disclaimers and Disclosures

- *Past performance is no guarantee of future results.*
- *All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.*
- *The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.*
- *The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.*

Author Bio

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Erin joined NEPC in January 2011 and is currently the Director of Research Operations. Previously, she was a Senior Consultant on the Operational Due Diligence team at NEPC, conducting in-depth analysis of hedge funds including all aspects of a fund's infrastructure, trading and reconciliation, risk management, compliance, and management.

Prior to NEPC she was a Senior Research & Portfolio Analyst with KStone Partners, a startup hedge fund-of-funds manager. In this capacity, she was responsible for all aspects of fund-of-hedge-fund portfolio management including manager sourcing, research, due diligence, presentation to the Investment Committee and liquidity management. She maintained close contact with a portfolio of over thirty invested funds, monitoring portfolio investments, P&L, risks and operational issues.

Erin graduated Magna Cum Laude from Loyola College in Maryland with a B.B.A. degree concentrated in Finance and a minor in Political Science. She is a member of 100 Women in Hedge Funds. Erin holds the Chartered Alternative Investment Analyst (CAIA) and the Chartered Financial Analyst designations.