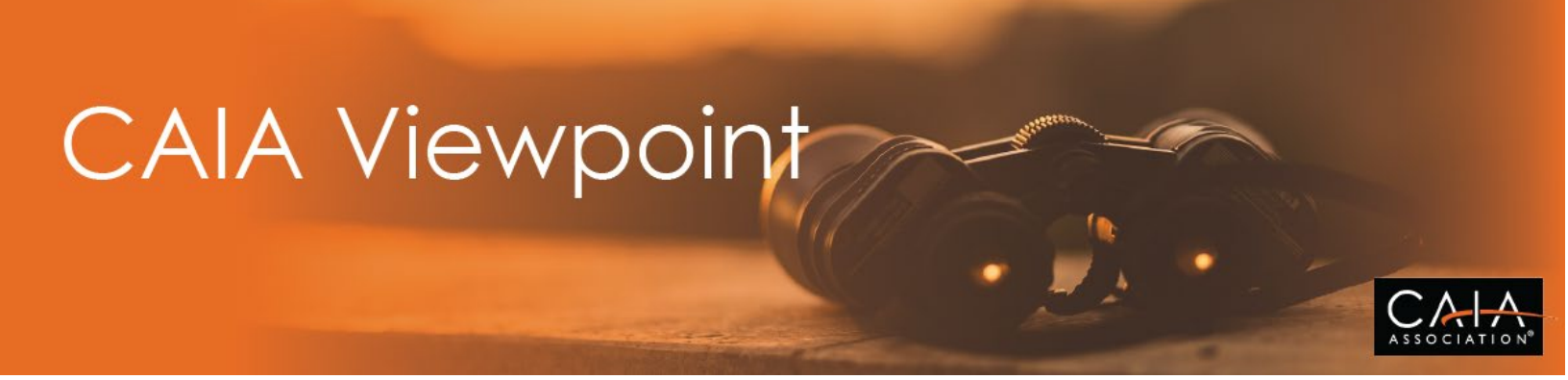

Know What You Own

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The full article may be accessed here.

Central Issue of the Paper

Huge losses suffered by investors in alternative assets during the financial crisis have pushed to the forefront a previously opaque part of the investment universe: the valuation of complex and illiquid assets held by hedge funds.

Investors are demanding increased transparency and stricter controls around the valuation process as mispricing assets can lead to a miscalculation of fees and flawed performance expectations. In addition, inaccuracies in pricing impact redemptions, which are calculated using the net asset values of the investments, to the possible detriment of both redeeming and remaining investors. This intensifying scrutiny has fueled the use of third-party valuation specialists by managers striving to create a robust framework of controls to review and assess the worth of the illiquid assets their funds hold.

In Erin M. Faccone's paper, "The Essential Guide to Third-Party Valuations for Hedge Fund Investors", she explores the challenges of pricing less-liquid or illiquid assets, which typically carry the most valuation risk. She considers engaging third-party experts to value less liquid securities held by hedge funds a best practice in the industry. To this end, a proper understanding of the services required, and the binding or non-binding nature of such pricing guidance is critical to the manager evaluation process.

Approach Employed by Paper

The author observes 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. The paper has the following recommendations to ensure a robust valuation policy: Have it be *Thorough*, *Compliant*, robust *Pricing Sources*, and have a *Valuation Committee*. 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.

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.

Third-party valuation providers typically offer these three services to hedge fund managers: Negative Assurance; Positive Assurance; and Full Valuation. Bear in mind these services do come with some drawbacks: False sense of security; Multiple valuations for same asset; Lack of communication; and Limited accountability. To navigate the pitfalls, the author encourages 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.

Findings of the Paper

The author believes 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 clients to vigorously examine and question their fund managers, so their investments do not fall prey to mispricing.

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