Streamlined access to accurate and consistent portfolio pricing and valuations data is a key requirement for firms striving to add transparency to pricing processes and meet regulatory requirements.

Pricing and Valuations

This report outlines the challenges of portfolio pricing and valuations, and discusses how firms can tackle data management issues including data quality, accuracy and consistency. It also considers what firms can expect from data vendors offering pricing and valuations services. Anthony Belcher, Director, EMEA, Pricing and Reference Data, Interactive Data; Greg Carlin, Vice President of Securities Evaluations, S&P Capital IQ; and Jayme Fagas, Global Head of Valuations and Transparency Services, Pricing and Reference Services, Thomson Reuters, offer insight into these issues.

We hope you find the report useful.

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On a broad scale, what are today's challenges around portfolio pricing and valuations?

Anthony Belcher, Interactive Data: The challenges faced within portfolio pricing are in many ways a mirror image of what the financial industry faces as a whole. The current industry themes of liquidity, transparency, regulation, search for yield and immediacy apply to portfolio pricing as much as they do to other areas.

The ongoing liquidity challenges within the markets can mean pricing is disparate and variable. It is important that those overseeing pricing operations are clear on where a price comes from and what it is based upon, pricing lineage if you like. In addition, they need to have confidence that the pricing is representative of fair value at the time that the data is used. In globalising markets with increased speed of data transfer and use this becomes ever more important.

Regulatory compliance is an ever present focus of the valuation space, especially with recent regulation such as AIFMD, Solvency II and Basel III focusing directly on the valuation function. In addition, upcoming regulation implementation of money market fund reform and MiFID II will increase the need for a demonstrable function that is independent, transparent and timely.

The need to search for yield in the markets has meant an ever widening asset allocation and investments. This requires a focus on new valuation techniques and data sourcing that can be a challenge for some teams, especially given the regulatory oversight mentioned above.

Greg Carlin, S&P Capital IQ: Ongoing regulatory driven disclosures continue to place additional demands on the consumer of valuations as well as on the provider of pricing. Investment continues to be made in capabilities that support practices and procedures to ensure that
data is captured, processed and readily available for reporting purposes. Further, users continue to build out controls that monitor and support validation procedures. The ongoing validation of these controls is essential. Pricing providers have done well in getting price supporting data to clients, it is incumbent upon the user to ensure that the data is supporting transparency and price defensibility needs.

Jayme Fagas, Thomson Reuters’ Pricing and Reference Services: Price transparency and offering a client access to enough supporting market and trade data that defends a price continues to be a challenge. This is especially true for harder-to-value and/or less liquid securities. There is often limited to no trade or transaction data for these types of instruments.

What are the overarching data management issues of pricing and valuation?

Belcher: In many ways, the data management issues faced by pricing teams are a direct consequence of current industry themes. The need to set up and manage the function in light of these requires an upskilling of the function. The time period during which pricing takes place is no longer than before, yet the level of control and oversight needed has increased dramatically. This means investment needs to be made in improved data management technology as well as in data. The ability to focus quickly on specific areas of concern on any particular day requires access to timely, relevant valuation data, as well as in depth transparency into the data. This ensures the function can continually improve output in the face of increased demands.

Carlin: The issues lie in the amount of data required to support an evaluation. It is no longer enough to simply receive a price and mark the book. Price supporting data such as direct observables, comparable transactions, assumptions and other available colour, such as market commentary, needs to be accounted for. To meet these needs, both user and provider continue to alter processes and make investment.

Fagas: Data volume alone can often present challenges. And, as regulations increase, even more data is required. Accessing, storing, mapping and then making all of this market data available to clients is often a large undertaking, but it is, in fact, the job of the pricing vendor today.

In more detail, how can firms ensure data quality, accuracy and consistency in pricing?

Belcher: In order to ensure data quality, accuracy and consistency in pricing, firms need to ensure they have the right tools, processes and people in place to succeed. Clients need to undertake in depth price source due diligence and ensure that their vendor or vendors have scale, control frameworks and third-party control reports in place. When selecting a vendor, clients need to consider how they arrive at their prices as well as their longevity and reputation.

Developing an effective price process control environment is key to quality, accuracy and consistency, and ensures the ability to communicate with other users. The assurance of data quality starts with the selection of a pricing source. Firms need to undertake detailed due diligence on the vendor’s understanding, not just the pricing methodologies. Equally importantly they need to look at issues such as control procedures, compliance departments,
business continuity, staff experience and tenure. This due diligence should not be just an initial review, but a regular review, potentially involving audit firms, compliance departments or even fund board members. As part of the pricing function, organisations also need to ensure they are back testing against market information, as opposed to other vendors, to monitor vendor quality. Finally, firms need to ensure they have an effective challenge process in place to be able to demonstrate to auditors and their compliance teams a centralised process, an audit trail and the ability to produce management reports.

**Carlin:** Firms may take a number of different approaches when evaluating quality and consistency. Many will employ more than one pricing provider in their quality assurance efforts. Firms may build internal validation models as well. Users spend a great deal of time with their primary provider to gain an in depth understanding of the provider’s pricing methodologies and controls, data management capabilities, and quality assurance procedures. Users must have an in depth knowledge of the vendor’s systems and models. Due diligence and deep dives are common interactions.

**Fagas:** Accuracy is highly dependent on good data quality; having access to high quality and robust content and terms and conditions is critical. Garbage in = Garbage out! Having proper staff in place and proper oversight of content and data is imperative. Access to market colour, market events and news is also important for accuracy. Consistency is supported by robust quality controls. We find that our current SOC I Type II report helps – our procedures are sound and consistent, hence, prices are consistent.

**How are data vendors improving their pricing and valuation services?**

**Belcher:** Market challenges are driving the need for increased pricing transparency and established processes within organisations. In response, Interactive Data has developed Vantage, a web application that increases transparency and provides workflow tools to improve operational efficiency and support pricing, trade execution and compliance functions. Additionally, in response to the increasing market trend for on-demand pricing, Interactive Data has introduced a continuous fixed income evaluated pricing service. This service transcends end-of-day pricing and offers clients greater pre-trade transparency support and price discovery capabilities on a continuous basis throughout the trading day.

**Carlin:** Vendors continue to invest in technologies and data that provide for timely, accurate and defensible pricing.

In a market where direct observable inputs are limited or not available, the vendor needs to focus on providing transparency on securities. Granular sectoring and grouping of bonds is required so that observables used to make price decisions across similar groupings can be linked to the securities where no observables exist.

**Fagas:** Transparency around prices and methodologies must be made available. Access to data that meets transparency requirements and allows the vendor and client to defend a price is an improvement. Increasing coverage, adding delivery times and ensuring accuracy can always allow for improvement.
What do firms require in terms of frequency of pricing?

**Belcher:** Market requirements are driving a push towards on-demand delivery as pricing teams have a greater demand for access to evaluated pricing than ever before. The requirement to use relevant prices as close to the net asset value strike time as possible is increasing and there is increased focus on pricing needs for calculating net asset values at times when local markets are closed as well as for intraday fixed income pricing.

The fixed income market structure continues to change post-crisis as new regulatory requirements take effect. Industry surveys and our own research reveal an interest in high quality intraday fixed income pricing data as an input to support trading applications, price discovery and risk management.

**Carlin:** Different customer types will have different frequency needs. Time sensitive clients are asking that prices be delivered several times a day. Users see a number of benefits stemming from this capability. Several snaps a day can support pre-trade price transparency and post-trade analysis. Intraday pricing can support end of day processing in that its availability can assist in managing end-of-day expectations and perhaps expedite end-of-day processing.

**Fagas:** Frequency of pricing can vary from client to client and from region to region. 3pm and 4pm snaps are critical in the US. Multiple, intraday requests are definitely on the rise.

Which regulations are driving the need for pricing and valuations transparency, and to what extent?

**Belcher:** Regulations are increasingly requiring firms to demonstrate not just prices, but where they come from, how they have assessed the prices and who has provided them. In addition, there is an increased requirement to ensure that pricing is independent.

There are valuation requirements within AIFMD, Solvency II, Basel III, Dodd Frank, Topic 820, IFRS 13 and many other regulations. As the regulatory landscape has changed over recent years and will continue to do so in the future, we have seen increased demand for valuations and pricing. In Europe specifically, AIFMD, MiFID and EMIR are driving an increased focus on post-trade transparency.

Money market fund reforms were enacted in the US in July 2014 and are also under consideration in Europe. The focus of these reforms is on the use of daily ‘floating’ or ‘variable’ net asset values, and on the imposition of liquidity fees and gates.

**Carlin:** A number of implemented and pending regulations and standards are significant drivers of transparency needs. Most prominent are ASC Topic 820 and IFRS13. The evolution of these and other regulations is prompting clients to develop more sophisticated price validation controls.

Changing best practices may include an upgrade of staff domain knowledge, a tighter integration of observable markets and the price validation process, and a better understanding of how providers evaluate securities where direct observables are not available. To this point the question becomes, how is relative value assessed and can providers link the comparable observables that led to a price determination? Last, controls and the ongoing validation of those controls is essential to support financial reporting.
Fagas: I often wonder what regulations are not driving the need for pricing valuations and transparency. There are so many that drive this need today. Examples include, but are certainly not limited to, AIFMD, Basel II and III, Solvency II and Form PF.

What approaches are being taken to evaluate complex and illiquid instruments?

Belcher: Complex instruments are normally driven by complexity around their coupon and payment structures. There is a need to have a detailed understanding of the cashflows for these instruments, how to model their likelihood into the future and how this ties into current market information.

As with all financial instruments, the value of complex and illiquid instruments is assessed by linking them to the wider ecosystem. It is important to have the tools and skilled evaluators to understand the environment to arrive at an evaluated price for a specific instrument using information on that instrument, the issuer, and its sector and currency.

Carlin: S&P Capital IQ continues to use a market approach to pricing for most of its evaluated universe.

Using this approach, when a price is being derived on a security, the price is either the result of a direct observable input or an indirect input where a clear relationship exists between the security being evaluated and the security on which the observable exists.

Obviously, in thinly traded markets this may prove challenging and in some cases some securities may not be priced. In thinly traded and quoted markets it is essential that the vendor maintains relationships with multiple dealers that may quote markets regardless of limited transaction volumes.

Fagas: A number of different approaches are being taken to evaluate complex and illiquid instruments. Most approaches must, in some way, follow market convention. Clear insight into the methodology that was used to derive the price must be shared with the client. Any and all data referenced to determine and/or drive a price must also be made available.

How can firms respond to price challenges efficiently?

Belcher: With increasing focus on the oversight of the valuation process and the need for rigorous reporting procedures, it is critical to provide audit trails and compliance reports for a firm’s pricing challenge process. In response to this demand, Interactive Data provides an innovative client management and compliance oversight tool, which is designed to provide audit trails and compliance reports for a firm’s pricing challenges.

Carlin: Independent evaluation providers have made significant investment in developing streamlined price challenge mechanisms. Those investments have been focused on reducing response times, providing price supporting data, and tracking price changes resulting from the challenge process. Providers need flexibility given that clients will have different needs and expectations with regard to response times and supporting data. Incorporating intelligence into the process will be essential as transparency and reporting pressures continue to grow. Linking underlying data that supports the price and minimises evaluator review will provide efficiencies to the process.

Fagas: Efficient response to price challenges is very
closely related to offering increased transparency into a price and increased data exposure. User friendly challenge tools are also helpful. So, too, is interaction with the evaluator.

How can portfolio managers differentiate their pricing capabilities from those of competitors?

Belcher: Pricing for portfolio managers provides an opportunity to ensure they are reflecting the fair value of their investments at the time the net asset value is struck. Effective pricing procedures can help avoid arbitrage opportunities in the fund that disadvantage other investors. In addition, effective pricing promotes trust in the fund and enables clients to invest with confidence. Portfolio managers should focus on their core competencies. Pricing is not necessarily a core function within these organisations and the use of vendors can improve efficiency and provide a cost advantage to investors.

How can pricing vendors differentiate their pricing capabilities from those of competitors?

Fagas: Differentiation can be achieved in different ways, including high levels of coverage, access to key performance indicators, such as transparency around prices and methodologies, and user friendly challenge tools to name a few. It is also quite important that a pricing vendor stays close to the market and on top of market convention. Due diligence meetings offer clients the ability to really get to know their pricing vendor and this often allows the customer to see what is different between the vendors.

What technologies are emerging that could improve portfolio pricing?

Belcher: The three main developments coming to market that we believe could help improve portfolio pricing are new portfolio pricing and validation tools, improved fair value information services, and the continuous evaluated pricing of non-exchange traded instruments. We believe that independent, high quality, intraday evaluations will become a mission critical tool for pre-trade analysis, idea generation, risk management and trading automation.

What advice do you have for firms working to improve pricing and deliver more frequent portfolio valuations?

Belcher: The factors that firms need to focus on are keeping up with new and evolving technology to ensure they are ahead of market demands. It is key for organisations to increase oversight of pricing sources and develop good relationships with vendors that have expertise in pricing and valuations. Finally, it is important for firms to use vendor relationships to complement their core strengths and support their business requirements.