



Setting the Mark

Best practices for fund boards'
oversight of valuation



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Board 

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Introduction

Funds have learned many lessons from the credit crisis. But none of those lessons has been as important as this: Liquidity can dramatically impact a fund's ability to value the securities that it holds on a daily basis. Valuation — the process a fund uses to determine how much its holdings are worth when it strikes a daily net asset value — became brutally difficult when fixed-income markets froze solid in the fall of 2008.

Fixed-income securities have always posed challenges to valuation. Unlike most equities, approximately 1% of fixed-income securities trade on any given day in normal markets, and the markets lack price and trade transparency. Without a last sale or closing price, funds sometimes have to use other methods to determine the value of fixed-income securities in their portfolios.

When fixed-income and other markets freeze, some equities — especially international and

small-cap securities — can also experience significant reductions in trading volume. And then there are various derivative products that some fund managers added to their portfolios and valued using models that failed to account for extreme events. Finally, there are equities for which there is no public market price readily available and/or for which trading restrictions may apply, such as 144a securities.

To help boards understand how they can assist their funds in ensuring that valuation issues don't cause huge problems, *BoardIQ* assembled a panel of experienced mutual fund trustees and industry experts. Together, they brainstormed how boards should best oversee the valuation process. The results of this session are detailed in this report. Read it to learn what these experts have to say about how funds can develop strategies to deal with this thorny issue on a daily basis.



PHOTOS BY: JEFFREY HOLMES

WHO'S WHO

BoardIQ's Roundtable



Elizabeth Duggan is managing director, Global Evaluations for Interactive Data's Pricing and Reference Data business. She has more than 20 years of experience in market data services, working with investment companies, investment advisers, broker-dealers and other financial institutions. Duggan oversees key initiatives related to enhancing and expanding the company's global evaluated pricing services, broadening overall market coverage and providing increased transparency to evaluation services. Prior to joining Interactive Data in 1999, Duggan served as a senior vice president of Thomson Financial Securities Management.



Louis (Lou) Ferrante is an independent trustee of the CRM Funds, LLC. He has more than 20 years of investment management experience including co-managing Citigroup's \$10 billion pension fund, investing in a broad variety of asset classes. Prior to Citigroup, Ferrante was a senior manager in Ernst & Young's investment management group serving a variety of investment firms. In addition, he has also been a CFO/COO with a private investment firm. Ferrante holds both the CFA and CPA designations.



Gary L. French is senior vice president, Fund Administration for State Street Corporation. Prior to joining State Street, he was a managing director in charge of Deutsche Bank's fund operations unit, and president of UAM Fund Services. Earlier in his career, he was with Fidelity Investments, where he served as senior vice president of Fund Accounting and as treasurer of the Fidelity Group of mutual funds.



Alison M. Fuller is a partner in Stradley Ronon's Investment Management/ Mutual Funds Practice Group, where she counsels investment companies, investment advisers and fund trustees on regulatory issues arising under federal and state securities laws. Previously, Fuller served for 10 years in the Securities and Exchange Commission's Division of Investment Management, including eight as assistant chief counsel. At the SEC, she received an award for supervisory excellence and Capital Markets Awards as a member of the 2005 Asset-Backed Securities Rulemaking Team and the September 11, 2001, Recovery Team.



Burton J. Greenwald is lead independent trustee of Franklin Managed Trust and Franklin Value Investors Trust, and also serves as an independent director of Franklin Mutual Series Funds, Franklin Mutual Recovery Fund and offshore funds sponsored by Franklin Templeton. He was previously president and director of two mutual fund management companies, a governor of the Investment Company Institute and chairman of its Public Information Committee. Currently, Greenwald is CEO of B.J. Greenwald Associates, management consultants to the financial services industry.



Jeffrey Laikind is an independent board member of RiverSource Funds. He is also the former managing director of Shikar Asset Management and before that was co-founder and managing director of Prudential Securities Asset Management. Previously he had been founder and managing director of Furman Selz Asset Management.



Sean McKee is KPMG's audit sector leader for the Investment Management Practice responsible for the timely identification, development and dissemination of industry-specific accounting and auditing information. For nearly 19 years, McKee has served such clients as mutual funds, hedge funds, private equity funds, infrastructure funds, commodity pools and asset managers. McKee is also an instructor and developer of KPMG's audit and investment management national training courses. He also writes concurring reviews of SEC registrants. McKee is a member of the AICPA and Nicsa.



Garry L. Moody is an independent director of AllianceBernstein Funds and chairman of its audit committee. Formerly, he was a vice chairman and partner at Deloitte & Touche LLP as well as the U.S. and global managing partner of its Investment Management Services Group from 1995 to 2008. Before that, Moody was president of Fidelity Accounting and Custody Services Company from 1993 to 1995 and a partner at Ernst & Young LLP, as its national director of Investment Management Tax Services from 1975 to 1993.



George W. Morriss is a director/trustee of the Neuberger Berman Mutual Funds. He chairs the Closed-End Funds Committee, is the vice chair of the Audit Committee and is a member of the Portfolio Transactions and Pricing Committee. He is also a member of the board of managers of the Old Mutual funds of hedge funds. Morriss retired from People's Bank in Bridgeport, Conn., as executive vice president and chief financial officer. He was a member of Nasdaq's Issuers' Affairs Committee and is a member of the CFA Institute.

ACTION STEP 1

Gather the right people.

The law is very careful in delineating what a board can and cannot delegate. As directors, you get help with fund asset valuations generally. But you are specifically not able to delegate away all the responsibility for fair valuation — the process for setting a price on a security when market quotations are not readily available. Directors can, however, delegate responsibility for making determinations of securities' values to a valuation or pricing committee for day-to-day pricing decisions, as long as it operates under established, board-approved methodologies.

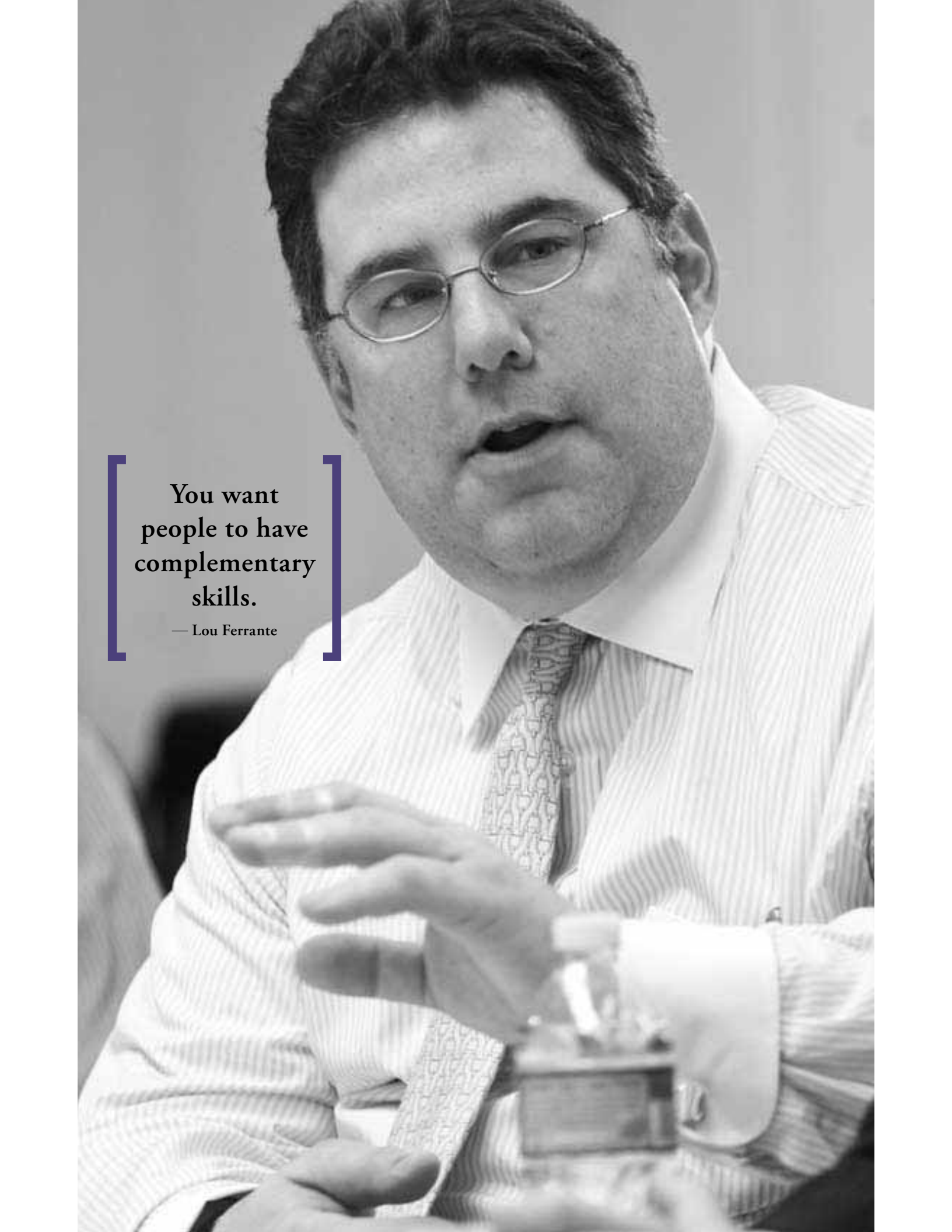
The board has to develop comfort with all the players in this process. Some directors may have limited knowledge about valuation issues, so they need to develop an understanding of the process and personnel needed to effectively value the assets held by the funds — especially the adviser's pricing group for daily pricing and the adviser's valuation committee.

Some larger fund groups have board-level committees that review the work of the adviser's valuation committee (and sometimes this duty is assigned to the audit committee). Directors need to have confidence in fellow directors selected for such a committee. Knowledge of capital markets can help, but with all the changes in the past 20 years, that knowledge can become seriously outdated. Directors will serve their funds best in those roles when they periodically review the procedures surrounding the valuation process and continually ask the adviser penetrating questions about the procedures and any valuation issues that may arise.

The staffing of the adviser's valuation committee — apart and separate from any board valuation committee — is crucial. Trustees should be confident that the adviser has identified someone for that committee (not directly involved in the portfolio management process due to potential conflicts of interest) who knows capital markets and has had substantial valuation experience. Although it may be more difficult to find those skills in one person at a smaller shop, they are very helpful in finding potential holes in the process and in challenging unreliable valuations.

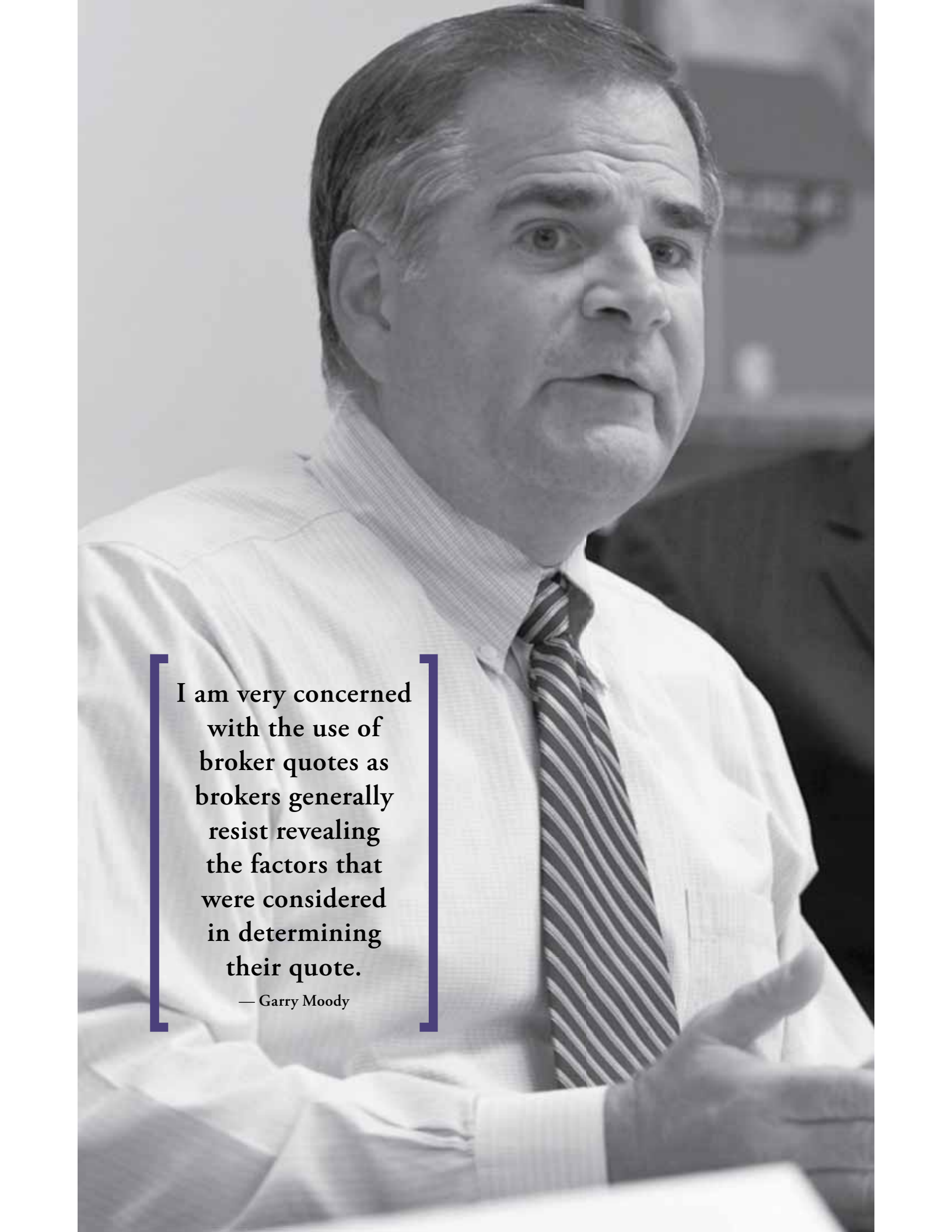
This level of knowledge may not be held by the funds' treasurer or the adviser's general counsel, although both of these individuals should participate as voting members of the committee. Another voting member should be someone from risk management.

The committee should also tap other participants. Portfolio managers (PMs) generally have vested interests in the values assigned to securities, so the board should consider how much weight they carry in the committee, whether as a member or just a consultative resource. Boards should ensure that managers — especially star managers — don't have undue clout over the committee in valuing securities. PMs should not vote, but should be able to provide input and color.



**You want
people to have
complementary
skills.**

— Lou Ferrante



I am very concerned
with the use of
broker quotes as
brokers generally
resist revealing
the factors that
were considered
in determining
their quote.

— Garry Moody

Another non-voting member of the committee should be the chief compliance officer. The CCO should attend as many committee meetings as possible to help assure that valuation is conducted in accordance with valuation policy and procedures (see Action Step 2).

Directors can gain comfort with the process being used by the adviser's valuation committee through periodic dialogue with the committee. Those discussions may allow the committee to see the current investment environment in the same way that directors do. By its actions and support, the board can also empower the committee — and through it, the entire organization — to raise an issue on pricing, whether it comes from the portfolio manager, the trading desk or the middle office. You want everyone in the organization to speak out if they see something odd. And the board should encourage the valuation committee to seek out additional expertise, either within the adviser's organization or at the pricing vendor, to address specific valuations appropriately.

To help the committee understand the importance of their task, one director suggests that directors give members of the board and adviser valuation committees copies of the Evergreen and Heartland valuation cases. Reading those decisions will help them understand the significance of their actions and how regulators and courts view the valuation process. Directors could then ask manage-

ment to specifically explain why “this” could never happen to its funds.

And finally, directors should also make sure that they have the right outside resources. They should meet periodically with the pricing vendors that the fund uses to help it value portfolio securities, particularly for fixed-income funds. Some boards see great benefits in visiting pricing vendors that are significant to the fund, to meet their people and see their facilities.

PANELIST CONCLUSIONS

- 1** Identify a seasoned expert to participate on the valuation committee
- 2** Tap the CCO to be involved
- 3** Make sure that portfolio managers cannot act unilaterally, and that their involvement is overseen by others who are not making asset management decisions
- 4** Bring independence into the process from within the firm (e.g., the seasoned lawyer, treasurer and someone from operations)
- 5** Maintain regular dialogue with the adviser's committee
- 6** Make sure the committee members have the skills and character to challenge the value of any security
- 7** Meet with pricing vendors to educate the board on valuation issues and processes

ACTION STEP 2

Build a solid process.

The valuation process captures an over-the-counter (OTC) market, which is very different from a liquid, transparent equity market. The fund is trying to ascribe a specific price for a security that has not been traded recently. An accurate assessment might indicate a range of possibilities, even as the valuation committee determines a specific value so the fund can strike its daily NAV. The process must reflect a sincere and honest analysis to determine the amount the fund might reasonably expect to receive for that security upon its current sale.

One key to avoiding trouble down the road is having a solid, consistent process that produces reasonable results. A big change since the credit crisis began gathering steam in 2007 is that, when circumstances warrant, some advisers' valuation committees will meet far more frequently — as often as daily. And when valuation committees deviate from a process — for example, when a market goes haywire — the board must have already vetted that deviation and approved it.

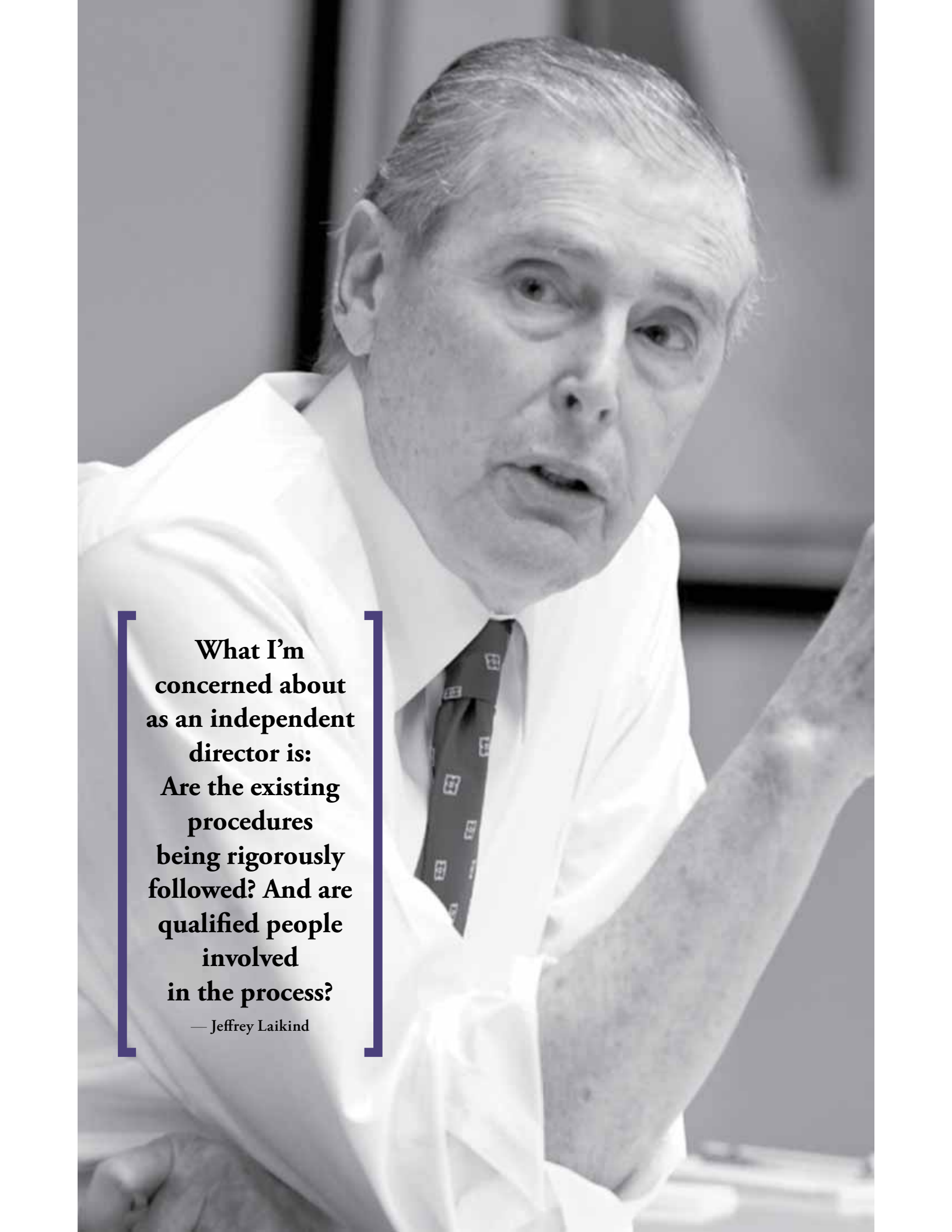
These committees should also consider using multiple sources, generally two to three, to get quotes from pricing services for securities that are thinly traded. Roundtable participants were particularly cautious about broker quotes — which are often used when an evaluation is not available from a fund's pricing services. The board needs to know the process for how the adviser selects brokers and assesses the validity of the process used by the broker to determine their quotes. Does the adviser have experienced traders who have relationships with the brokers? Do the traders know what went into the quote? Is the price an

indication of level or a workable bid? When was the quote taken? (Fixed-income markets, for example, tend to change a lot in the afternoon, so a 10 a.m. quote might not be accurate for a 4 p.m. NAV.) Does the committee ask traders to seek a number of quotes and then eliminate those that are clearly out of range to arrive at an average? These “desktop practices” aren't necessarily written into the valuation procedures, but the board should know the process and the CCO should be ensuring that it is consistently applied.

The procedures should detail a pricing hierarchy that is tailored to a particular investment with a custom “what if” scenario. At what point do you go to your backup pricing options? What is your process if neither can provide a price? At what point do you move to fair value the security? Compliance needs to monitor whether the process is applied consistently.

But pricing isn't about just whether you can get a quote, but how you handle quotes that provide significantly different values for a security. However the valuation committee determines how to balance two divergent quotes during fair valuation, it needs to document its approach thoroughly so auditors and regulators can review it later. The board should get a list of differences in pricing between securities at each board meeting with detailed explanations for them.

There are several reasons why managers might resort to fair valuing a security. They might be unable to get a quote of any kind, they might have evidence that the quotes reflect fire sales,



**What I'm
concerned about
as an independent
director is:
Are the existing
procedures
being rigorously
followed? And are
qualified people
involved
in the process?**

— Jeffrey Laikind

HEARTLAND AND EVERGREEN

If your adviser wonders why the board is being so particular about following up on requests for information related to fair valuation, have them read the SEC's case against Heartland Funds. The regulator placed Heartland's High-Yield Municipal Bond Fund and Short Duration High-Yield Municipal Fund in receivership in 2001 after significant drops in their NAVs.

Before those drops, Heartland's board had asked management for information on how the funds were being managed and the appropriateness of the methodology in place to price the bonds held by the funds. The directors never received the information. The SEC found that the directors were too hands-off in overseeing their funds' fair valuation. It filed fraud charges against four independent directors.

The case of Evergreen Investment Management indicates the financial consequences for managers. The SEC fined the firm \$40 million for valuation activities in its Evergreen Ultra Short Opportunities Fund.

Evergreen's investment committee accepted a PM's suggestion that they use a quote from a single Florida broker to override the value suggested by the pricing vendor. The fund's policies and procedures explicitly said that the pricing vendor's value was preferred.

Worse, the valuation committee had neither reviewed nor approved the broker's valuation approach. The result was an expensive lesson for the adviser — and a good cautionary tale for all directors.

or they might be trying to strike an NAV by 4:00 p.m. EST (the time that most U.S. mutual funds designate in their prospectuses) for a fund that includes an Asian equity that was last priced on its exchange hours before. That price may not reflect later significant events (including market events) between the close of such an Asian market and 4:00 pm EST.

Among the issues to look for: Does the value of a security include a sale that could be a distressed sale? If so, should the security be fair valued? Does the model weigh each of the factors in a manner that provides the fairest estimate of what a buyer would be willing to pay for the security?

Roundtable participants noted that fair valuation processes have improved dramatically since the crisis. But fair value is likely to always be an area for continuous improvement. The board must ensure that reports are generated to gauge how accurate fair value was as soon as more data is available. For example, the fair value of that Asian equity should be compared against the security's price at the next day's open. If the fair valuation process is producing prices inconsistent with other market data, the board should assure that there are procedures in place that require the valuation committee to reexamine any discrepancies carefully and report its findings to the board.

Directors must insist that all aspects of valuation — including why a decision has been made to fair value a security — must be thoroughly documented. Directors should receive a report on all fair valued securities by date and compare that to a sale price or an accepted third-party pricing service level. They should also receive detailed reports on all securities for which there's no active market. A drop in the quality and content of reports about securities, obfuscating what went on, could indicate concerns. A report on the FAS 157 (now Topic 820) status of your funds' assets can also help. (See sidebar on FAS 157.) The FAS 157 levels can provide focus on spe-

cific instruments for which greater attention is warranted.

And although by doing so it edges into the investment process, the adviser should also be tying these valuation reports back into risk assessments, especially with derivative products. Has an investment that is hard to price and hard to account for — and that has negative tax consequences and adds volatility to the portfolio — added the “alpha” needed to justify the investment?

And the key lesson from the Heartland case is that directors cannot just raise these questions. They must follow through. (See sidebar.)

PANELIST CONCLUSIONS

- 1** Valuation committee should consider meeting as frequently as necessary, if the fund invests in securities that don't trade regularly on an established exchange
- 2** Question the process for the use of broker quotes or get your adviser to establish it, if one is not already in place
- 3** Develop a pricing hierarchy specific to an individual type of security
- 4** The board should set parameters for invoking the fair value process and understand when it needs to be invoked
- 5** Make sure your fair value process has a feedback loop that reconciles fair value prices versus the next available market data or sales price
- 6** Require that the adviser document all decisions so auditors and regulators can reconstruct the process that was followed
- 7** Follow up on any requests that you make for the adviser to provide more information

ACTION STEP 3

Keep your review ongoing.

A fund's CCO plays a crucial role keeping the board apprised of what's happening with the adviser's valuation committee. Although the CCO often does not have a voting role on the committee, his or her duties include ensuring that policies are being properly followed on a day-to-day basis. CCOs can have an ongoing role because they are on the ground when directors can't be.

The CCO should track all instances when the portfolio manager seeks to override the price quoted for a security by the pricing vendor. PMs and traders should not be able to unilaterally override market quotations or vendor prices. Overriding the pricing vendor's quote — supposedly that fund's preferred valuation approach — was the problem that caused the SEC to take action against Evergreen Investment Management in a case last year. Again, contemporaneous documentation will back up the decision or cause directors to raise more questions. Also, the ongoing compliance paper trail provides the details necessary to draw a bigger picture about whether the valuation process is working well.

The Evergreen case highlights the need to think through your procedures and detail a response for various actions. (See the sidebar "Red Flags" for the roundtable's list of areas for concern.) Exceptions, or overrides, are just one spot that can cause troubles, especially frequent overrides or overrides relating to significant positions.

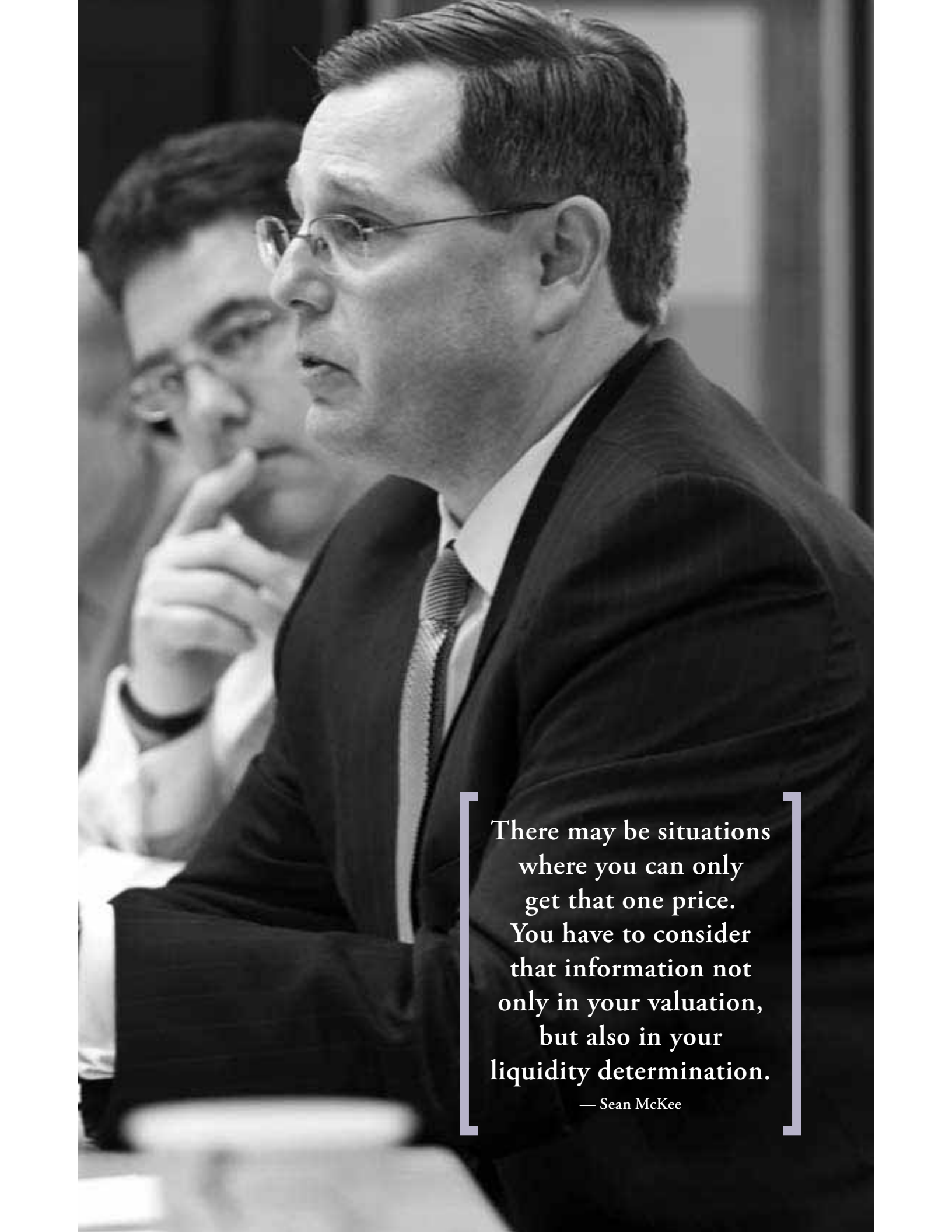
Boards should demand a robust discussion of fair valuations in the minutes they receive from the committee. And committee mem-

bers should be prepared for hard questions from the directors about those reports. In extraordinary circumstances, as faced by Heartland when it could not meet redemption requests, the board should hold regular meetings with the adviser's valuation committee. Normally, this meeting would be directed by the board's own valuation committee. If the board doesn't have such a committee, then directors should identify two to four trustees to act on their behalf. In addition, you might consider inviting the fund's legal counsel to attend. Auditors should be asked to attend such meetings to facilitate their audit test work. The goal of the meeting is, with the benefit of hindsight, to determine where you would tweak the procedures.

You want to determine whether the procedures and people are holding up. By regularly asking "How are we doing?" you'll know when people or policies need to change.

PANELIST CONCLUSIONS

- 1** Tap the CCO to keep you up-to-date on any day-to-day issues that raise concern
- 2** Look for patterns of problems, especially with manager overrides of quotes
- 3** When circumstances warrant, be prepared to hold more frequent meetings with the adviser's valuation committee to review valuation policies and procedures

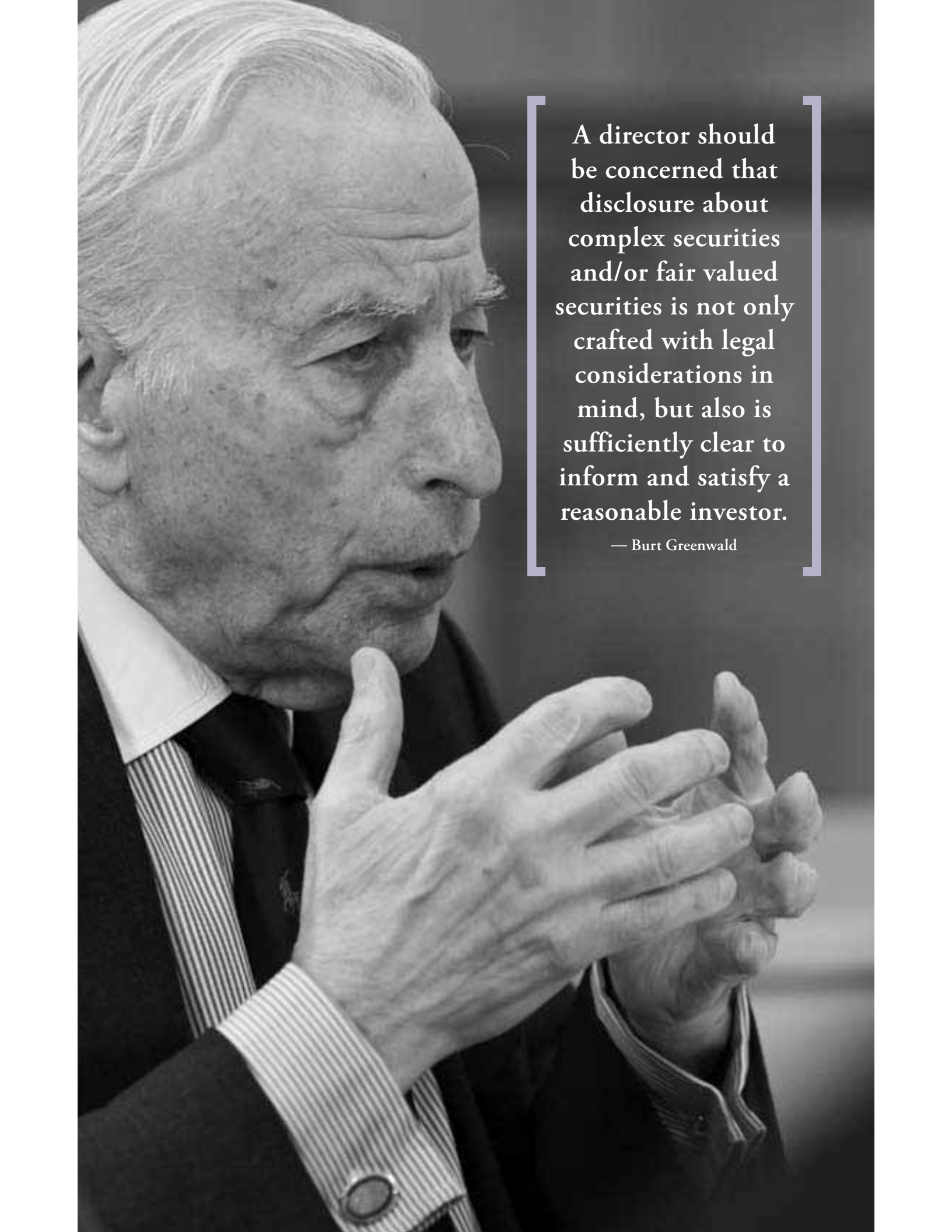


**There may be situations
where you can only
get that one price.
You have to consider
that information not
only in your valuation,
but also in your
liquidity determination.**

— Sean McKee

VALUATION RED FLAGS

- A short list of modest valuation differences provided by the auditor suddenly balloons into a long list of substantial differences.
- The auditor notes that material inputs for the models being used by the pricing committee are changing dramatically.
- Significant increase in the number of fair values when the market doesn't seem to demand it.
- Quality and content of manager reporting doesn't keep up with difficulties in the marketplace.
- The portfolio manager frequently challenges prices provided by a pricing vendor without adequate support for the challenge.
- Back-testing demonstrates wide variations between fair valuations and next price, particularly for significant positions that are material.
- When the market declines, your fund is OK even though the holdings do not seem to support that result.
- Sudden shifts from significantly lagging a benchmark to being way ahead.
- Portfolio managers aren't comfortable with the way things are being priced or with rating agency assessments.
- Unusual end-of-quarter or year-end activities, such as an increase in securities being fair valued and sales prices of such securities being meaningfully different from their fair value.
- Use of a single, regional broker for significant portfolio positions, à la Evergreen.
- The counterparty is the sole source of pricing information, and is not bound by contract to close the position at the price quoted.
- Frequent breakdowns involving complex securities between the adviser and fund service providers that assist in valuing assets and striking the fund's NAV.



A director should be concerned that disclosure about complex securities and/or fair valued securities is not only crafted with legal considerations in mind, but also is sufficiently clear to inform and satisfy a reasonable investor.

— Burt Greenwald

Build the right portfolio manager rapport.

Portfolio managers (PMs) can be a help or a hindrance when it comes to the valuation process. Because investment management can be art as well as science, portfolio managers can achieve an aura of knowledge and power that can intimidate peers working in less visible or influential positions for the adviser. Even directors can feel buffaloed into accepting a PM's defense of a string of valuation overrides based on a long-term track record. (As one roundtable member put it, "You don't know if he or she's just blowing smoke.")

Ensuring that PMs do not control the outcomes of the valuation committee is one check that helps balance the power equation. If at all possible, the PM should not have a vote on the committee. Voting members of the adviser's valuation committee must not be afraid to challenge a price, whether advocated by the PM or even a pricing service. By adding a capital market-savvy professional to the committee, you'll provide an intellectual balance to the process.

You need to make sure that members of the committee have good discussions with the PMs. That's one of the items for board members to check when a PM is present during their periodic meetings with the valuation committee. Watch the way the manager discusses the prices. Having the CIO sit in on

the meetings occasionally is another means of enhancing the discussion. The CCO can also provide boards with color on what the ongoing discussion is like day-to-day.

Managers can also add value to the valuation process. The board should confirm that PMs take responsibility for valuations and that they look over their portfolio every day, as they have a deeper understanding of its securities and how they trade. Their input can help explain difficulties that arise in valuation — prices that move in unusual ways or don't move when, perhaps, they should. The board wants PMs and traders to challenge low and high prices. Ask whether the price challenges go in both directions and have the CCO follow up when challenges all go one way.

PANELIST CONCLUSIONS

- 1** Limit the involvement of PMs in the valuation process to providing information and insights
- 2** Balance PMs' input with independent analysis and judgments by knowledgeable individuals
- 3** Ensure that the manager and the valuation committee have constructive discussions
- 4** Require that managers share all information that may affect a price with relevant parties, including pricing vendors

Portfolio managers also have access to myriad sources of information. The board should make sure that they're using those sources as they prove their case and document their reasoning. Their judgment should be supported by external — and more objective — inputs into the process, wherever such information is available.

When PMs or traders uncover any information that may affect the price of the security, they should communicate it to the treasurer, the pricing committee and third-party pricing vendors.

Valuation is a reflection of the quality of the investment adviser. The ability to value is the flip side of the ability to invest.

— Alison Fuller



Tap your auditors – judiciously.

On an annual basis, the board’s audit committee should meet with independent auditors to understand their audit approach with respect to investment valuation. The audit committee should make sure that the audit adequately addresses any concerns and/or risk areas identified by the board and any of its other committees. The audit committee should understand the breadth of substantive and internal control test work and provide the auditor with feedback on the audit approach.

For example, your auditors will investigate any material differences between the valuation used by a manager and their own valuations. If they uncover a problem, the auditors will report to the audit committee.

The auditor can also talk with management about the quality of its price sources. The auditor will communicate with the audit committee about material problems. In turn, encourage the auditor to report to the audit committee more generally about these issues. Push your auditor on why management is turning to the same sources.

When the composition of the fund’s portfolio warrants it, the board’s audit committee should consider asking the independent auditors to conduct a review of market data inputs on a sample of portfolio securities. Ask them to look at the pricing and report back

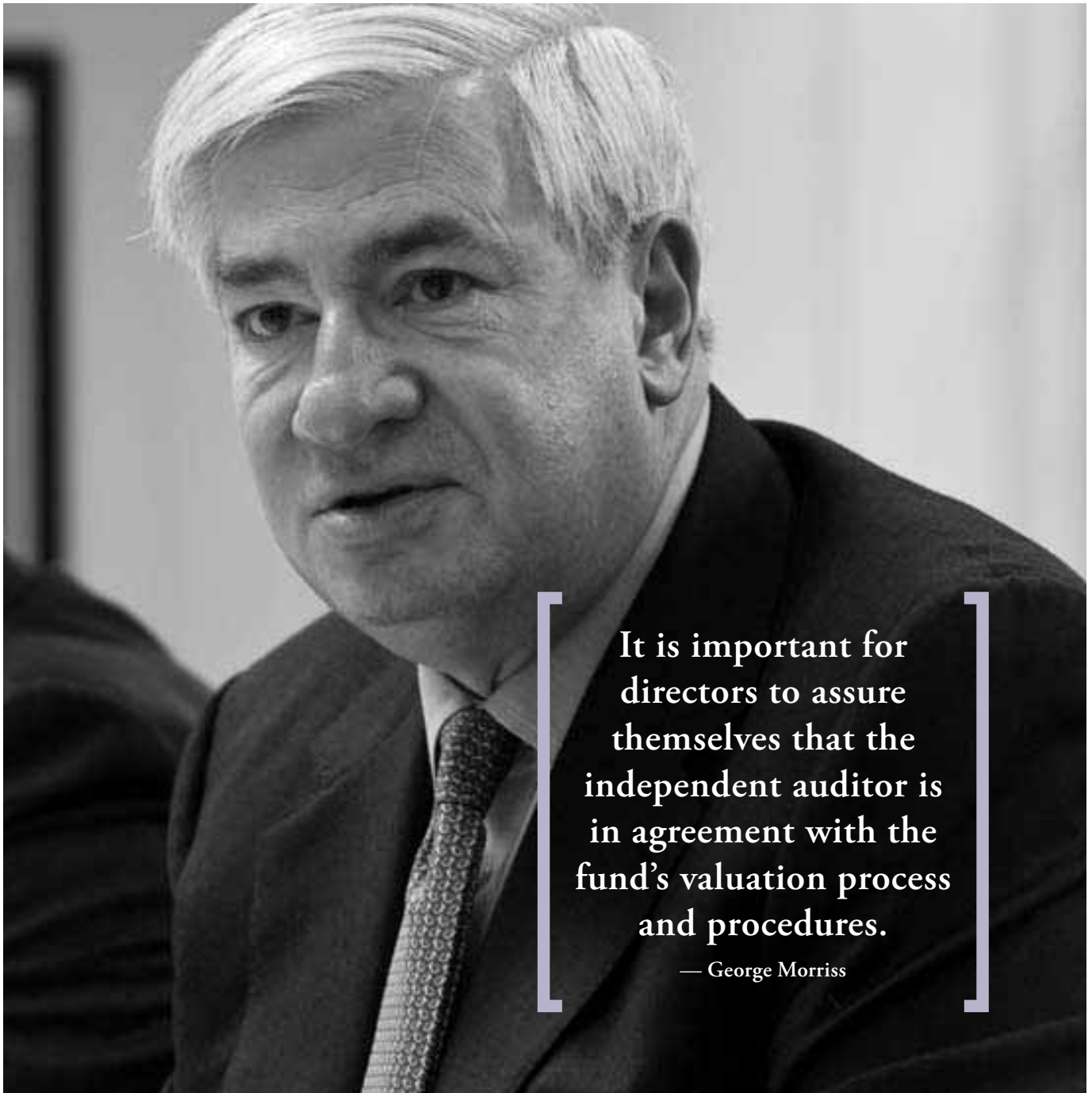
to the audit committee on how their valuation compares with the valuation committee’s. Remember that it’s typically the board’s role to be concerned with whether the proper controls are in place and are being followed. Therefore, this process will likely take the form of an “agreed-upon procedures” report and will come at some relatively modest incremental cost to your fund group. It could be a worthwhile investment. The reports can identify patterns of problems that suggest control or valuation problems.

PANELIST CONCLUSIONS

- 1** Meet with your independent auditors to understand their audit approach with respect to investment valuation and make sure that it adequately addresses any concerns and/or risk areas identified by the audit committee and any other committees
- 2** In connection with the annual audit, consider asking auditors to review in depth the valuations for a sample of difficult-to-value securities as a control on the valuation process
- 3** Remember that while a pricing discrepancy may not cause an issue on the financial statements due to materiality, it may be indicative of a control issue on which the board should follow up
- 4** Determine if and why the auditor is relying on the same source for broker quotes as the manager for a material percentage of a fund’s portfolio

Communicate with your auditor to see if it is using the same source for pricing that the manager used. Ideally, they should use an independent source when possible. The significant use of same source prices used by the

auditor should raise concerns. Push your auditor on why it is turning to the same sources. Understand and consider your auditor's valuation results and determine if those results warrant further consideration or action.



It is important for directors to assure themselves that the independent auditor is in agreement with the fund's valuation process and procedures.

— George Morris

Vet new products and securities.

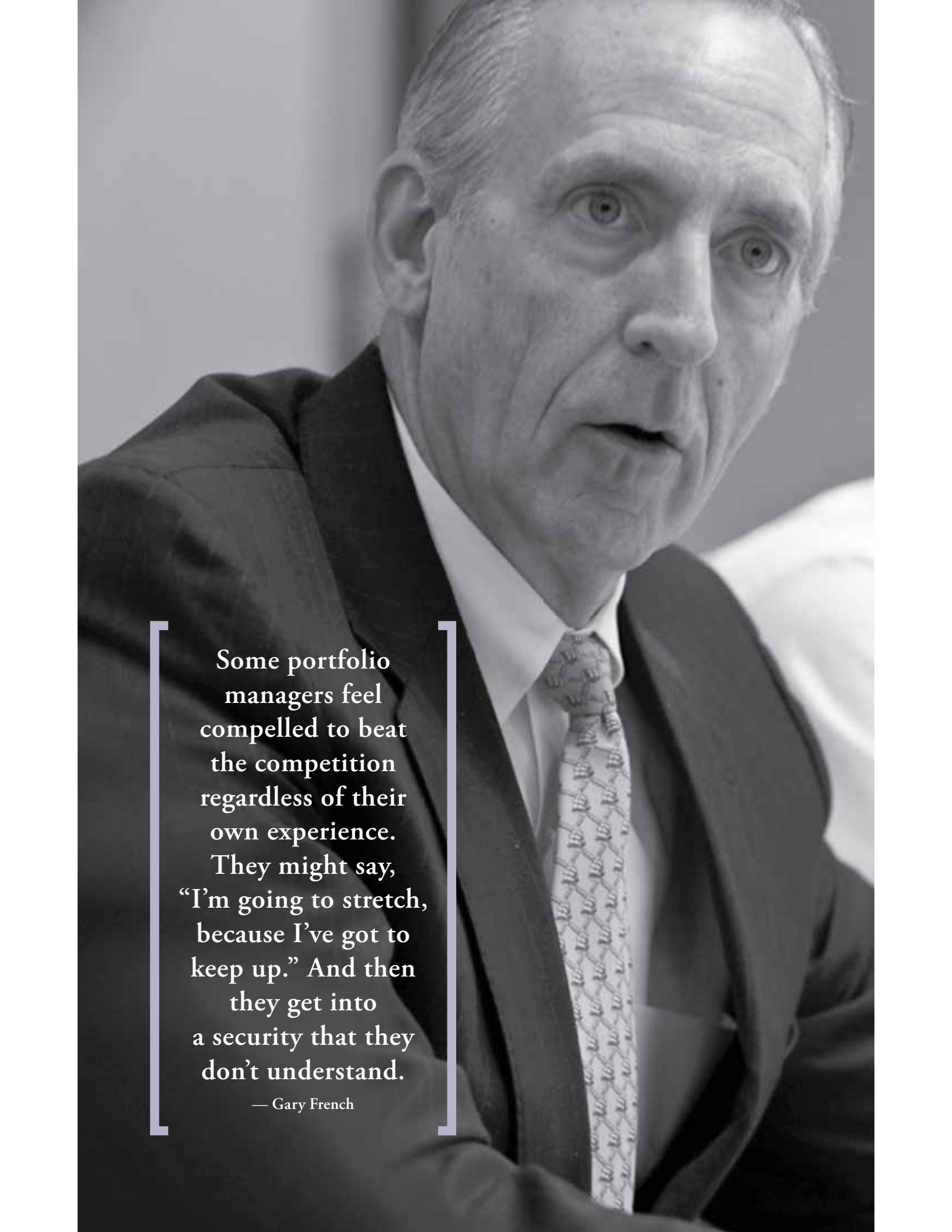
Many of the valuation problems during the recent credit crunch related to using new products. Derivatives in their various flavors such as swap contracts and other instruments including leveraged loans and miscellaneous tranches of mortgage-backed securities have been blamed, fairly or not, for much of the mess. The problem for funds is that when these securities became illiquid, some advisers lacked the means to properly value them.

Boards at firms that invested in these new structures learned an important lesson. Understand the security and make sure that your adviser can handle it in all aspects of managing the fund — including in operations, but especially in valuation. Boards should refer these investment vehicles and any proposed new funds built around them to a new products or complex securities committee. If there isn't such a review committee, the full board should vet the instrument and pay particular attention to its pricing.

You should get detailed presentations on the procedures and people involved in the pricing of these securities. The vetting should also cover the entire scope of how the security will be integrated into the company: operations, compliance systems, accounting and taxes, as well as valuation. The key is to ask the right questions so you push the adviser to confirm that it has thought of everything with regard to the instrument.


Among the questions that you should get answered are:

- Can you price it now? What about when there is market stress?
- What will its pricing hierarchy be?
- Do you understand the accounting and tax consequences?
- Can your fund accounting software properly account for the investment, or will the investment need to be tracked on a separate spreadsheet and then input into the fund accounting system manually?
- Does the portfolio manager have the qualifications to invest in that type of security?
- Do you understand the counterparty risk?



Some portfolio managers feel compelled to beat the competition regardless of their own experience. They might say, “I’m going to stretch, because I’ve got to keep up.” And then they get into a security that they don’t understand.

— Gary French

A black and white photograph of Liz Duggan, a woman with long, wavy hair, wearing a dark blazer over a collared shirt. She is looking slightly to the right with a serious expression. The background is blurred, suggesting an outdoor setting with trees.

In the structured world, which is really where all the dynamite was in the last 18 months, there's no real indication of what is liquid and what's not liquid.

— Liz Duggan

- Is the counterparty the sole source of pricing information?
- Can you handle it operationally, for instance regarding trade settlement and confirmation?
- Are your fund service providers working well with the adviser's operations?
- When and how will the fund and its counterparty post any required collateral?
- What might go wrong in a Black Swan event for such a product?
- Do the directors understand how it works and what its purpose is?

You should also make sure that the adviser can properly value the instrument in a set of worst-case scenarios. If you don't get satisfactory answers, don't allow the adviser to move forward using the security. And in your rejecting investment in a new security for any of these reasons, portfolio managers should know that you are leaving the door open for approval if they fix the deficiencies.

PANELIST CONCLUSIONS

- 1** Clear use of all new securities through a new product review committee
- 2** Review the new instrument's use through all aspects of the fund — including the adviser's various operational functions
- 3** The adviser should be able to deal with all aspects of the instrument, from purchase to sale, including lifecycle events like any collateral calls
- 4** If you don't get satisfactory answers to your questions, reject the use of the instrument until the adviser shows that it has fixed any deficiencies

A REFRESHER ON LEVEL 1, 2, 3 ASSETS

The Financial Account Standard Board's statement FAS 157 (now officially called Topic 820) has impacted money managers as well as other financial institutions. The rule creates a fair value hierarchy that prioritizes into three broad levels the inputs to valuation techniques used to measure fair value. These levels provide important information on the degree of reliability of the investment valuation:

Level 1 Inputs

Inputs for which a manager can obtain a price quote from an active market such as equities on the New York Stock Exchange.

Level 2 Inputs

Inputs obtained by the manager that are observable to market participants. For instance, a municipal bond's value can be observed from a similar bond's trades.

Level 3 Inputs

Inputs obtained by a manager that include a significant input that is unobservable to other market participants. The manager's assumptions play a central role in these valuations—for example, some residential and commercial loans, securities and derivatives.

ACTION STEP 7

Take action.

If the board has serious concerns about valuations, they need to take action. They should first meet the manager's valuation committee to ask them what their opinion is on any pricing issues. They should also consider getting a third party involved to determine if the approach is right or wrong.

If all the concerns focus on one portfolio manager or one area of an asset class, the board should delve deeper to determine the reasons: What needs to change in the pricing system? Does the investment adviser have the right people at the portfolio level? Does the valuation committee have the requisite talent to identify red flags? Can they differentiate between problems with the valuation process itself (identified by the red flags) and screw-ups in following the process? The board should meet in person with the adviser's management. Among those involved will have to be the CIO or whoever oversees the investment process.

When you encounter recurring incidents, you need to determine whether your people can fix the process. And then the board needs to verify that the process has, in fact, been fixed.

Don't forget, especially when you move to fair value a security, that there is often significant subjective judgment involved. You can have a regular framework consistently and properly applied yet still come out with an answer that is different from another process. Although you mark to a specific price or point, you are really seeking to be within a range of reasonable prices. The process should recognize that models can have flaws and can produce unreliable fair values.

Ultimately, the board must be satisfied, given the volume of either fair valued or complex securities in the portfolio, that disclosure in the prospectus reflects the true nature of the portfolio. Is the disclosure about these complex securities and/or fair valued securities sufficient in the prospectus to satisfy a reasonable investor? And often the fact is that "You could lose everything" is the only suitable disclosure for a portfolio stocked with certain derivatives. Ask management to explore ways to make disclosure more meaningful.

Therefore, when there's only one price to be had for a significant holding, the board might question whether the security is appropriate for an open-ended mutual fund. You might have to insist that the adviser desist from using it going forward.

PANELIST CONCLUSIONS

- 1** When you've got serious concerns, bring in the adviser's valuation committee, and follow up on all of your questions and requests
- 2** Identify whether it's a process or a people problem
- 3** If it's a people problem, meet with the adviser — including the CIO
- 4** If a large position is consistently difficult to value, consider whether it's still an appropriate vehicle for your fund, and ask for verification of the quality of the fund's disclosures

Conclusion

Valuation is a process that produces no single answer — but if you are going to be responsible for an answer, it should be done in an environment with a controlled and consistent process that continuously evolves. At the end of the day, in an open-end fund, shareholders are buying and redeeming shares in a fund each day. And a closed-end fund pays its manager based on its NAV. Getting the NAV right is essential. Here are the steps that you should take to ensure your funds are getting valuation right for them:

The seven action steps

- 1** Gather the right people.
- 2** Build a solid process.
- 3** Keep your review ongoing.
- 4** Build the right portfolio manager rapport.
- 5** Tap your auditors – judiciously.
- 6** Vet new products and securities.
- 7** Take action.

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