



Addressing Daily NAV Pricing Challenges for Hedge Funds

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Industry

Hedge fund industry

Challenge

Calculating timely and accurate daily Net Asset Value (NAV) prices

Solution

The EMC Consulting Asset Management practice

This paper details the business needs and implementation challenges related to calculating timely and accurate daily Net Asset Value (NAV) prices. Net Asset Value is the total value of all of the fund's assets divided by the outstanding shares. Timely and accurate daily NAV prices are required for creating critical P&L statements, analyzing current positions, and developing/enhancing investment strategies.

We'll discuss some of the challenges, including unique characteristics of hedge fund structures, business operations, workflow, reporting, and regulation. We'll also explore significant differentiators within the hedge fund industry such as firm size, strategies employed, and other considerations that lead different hedge funds to pursue markedly different implementation models and priorities.

Key requirements and challenges:

- Timely and accurate daily NAV prices—a need to address issues with data quality, pricing, and mark to market of holdings. Reliance on complex manual processes leading to delays and inaccuracies in NAV prices.
- Ability to audit historical daily NAV prices using consistent methods in calculating NAV prices.
- Automation and integration of the daily NAV process with other critical systems for faster and accurate processing.

Portfolio pricing

Hedge fund managers have long been aware of the need for investors to conduct thorough due diligence when assessing the merits of their investment strategy. As a result, there has been an increase in focus on operational due diligence related to the increasing inflows of institutional capital into hedge funds, and some well publicized fraud cases which have caused losses for even some of the most sophisticated investors in the industry. Regulators are also focusing their attention on hedge funds due to the tremendous growth of this asset class and the increasing demand from retail investors and public pension plans.

Valuation of assets is one of the most frequently discussed topics of operational risk among investors, as this is the area most at risk for manager manipulation. Regulators in the U.S. and UK are also increasing their attention on industry pricing practices, and they are seeking more independence from valuations. There is a risk of using asset valuations to artificially boost fund performance or to smooth “mark to market” losses. The presence and choice of a third-party fund administrator and auditors will be indicative of the independence of these processes from the influence of the manager.

It is important for investors to distinguish valuation risk arising from investment, rather than from operational risk. When the investment strategy trades in thinly traded or illiquid instruments, investors must accept that valuation risk exists, as it is inherent in the nature of the securities traded. In some cases, only the counterparty may be able to provide a price. However, investors can reduce valuation risk, resulting from poor operational controls and procedures surrounding the pricing process, by ensuring that the fund is following transparency, consistency, and independent oversight:

- Valuation transparency addresses the extent to which the investment manager clearly communicates to investors about the specific methods and processes used to value securities when determining the NAV for dealing purposes. While transparency may be a lesser issue for long/short equity funds holding liquid stocks, best practice for more complex funds is to develop a comprehensive, written “Pricing Matrix” which describes in detail the specific methods used to value each type of instrument.

This pricing policy should be maintained by the third-party administrator which, if needed, can be made available to investors at the direction of the manager. Language contained within an offshore fund's prospectus describing NAV calculation is normally too generic for this purpose. Best practice transparency standards may also extend to the application of pre-determined policies and thresholds to challenge and override prices. Formal documentation of valuation exceptions may also involve the use of a valuation committee, which will document changes to policy, pricing, or exceptions that have been included in particular NAVs.

- Price consistency reflects the need for similar securities to be valued in the same way, both at a point in time and over time. If a fund bases daily valuations for certain instruments on broker quotes for example, procedures should be in place to ensure that the source of quotations cannot be “cherry picked” to select the most favorable mark at each period—be it the highest mark, or the sources which best smooth portfolio performance. Equally, if multiple quotes are available, they should be averaged in the same way, across all funds managed by the firm, to ensure consistent sampling of market price dispersion.
- An independent valuation process is a critical factor. Internal to a manager's organization, independence means that the back office should oversee the pricing process, rather than front office personnel. Such control and oversight ensures that managers do not mark their own books without back office verification. External to the manager's organization, the most effective way to ensure independence in the valuation process is for funds to appoint a leading independent third-party administrator who is tasked with oversight over the valuation process. Best practice calls for the administrator to calculate the NAV, incorporating valuations derived exclusively from sources independent of the manager. Such sources include brokers, price vendors, and third-party valuation agents for complex OTC derivatives.

Business needs for timely, accurate daily NAV prices in the hedge fund space

The Daily NAV prices are needed in a timely, accurate, and auditable form.

- **Timely**—The daily prices for assets need to be available as soon as possible so that they can be analyzed and loaded for the valuation process. The timing is critical as the valuation drives the daily P&L and other reporting requirements.
- **Accurate**—It is critical that the NAV prices are accurate and reflect the true price of the asset. Inaccurate prices lead to manual adjustments, potentially over/under valuations, and incorrect P&L reporting.
- **Auditable**—The pricing process needs to be independently auditable by third parties—investors, custodians, administrators, and regulators. This insures that a consistent method is used.

Implementation challenges

Some of the challenges in implementing the calculation of the timely, accurate, and auditable daily NAV prices include the following:

- Among smaller firms, in-house business or technical analyst resources are lacking and the preference is to focus on investment strategies. Other firms outsource technical support or middle/back office processing—this creates a more complex business/data model into which the daily NAV process must be integrated.
- Within larger hedge funds or those with more exotic strategies, there is a broader array of investment types. Examples include various types of swaps (currency, interest rate, credit-default, etc.), inflation adjusted bonds, CDOs, and any number of other structured products.

- Unconventional workflows that are more prevalent in hedge funds (vs. institutional or mutual funds) represent additional challenges. For example, hedge funds look at positions somewhat differently than institutional investors; there is a greater emphasis on how the position is doing relative to the strategy. Often positions are held across managers or accounts with similar or very different investment strategies—position changes may cause the valuation of funds to vary impacting daily NAVs.
- A clean (no duplicates), complete, and accurate set of Security Master Files (SMF) data is the key to ensuring that the appropriate securities are priced, and priced correctly.
- Coordinating pricing cycles concurrent with regional market closings for a hedge fund firm that is working in a 24x7 international environment may present challenges for pricing cycle development, security selection, and production support.

Summary

Larger hedge funds are becoming increasingly similar to large institutional investors, but with more diverse security types as well as specific unique workflows to support complex investment strategies. Workflow for smaller hedge funds is maturing as well, moving from Microsoft® Excel and manual processes to more automated and robust processes. Institutional investors and pension funds are mandating daily NAV prices to mitigate risk.

Automation and controls in the Daily NAV price process add value to the hedge fund business as it provides timely and accurate company-wide reporting internally, and to the clients, on a daily basis.

About EMC Consulting

As part of EMC Corporation, the world's leading developer and provider of information infrastructure technology and solutions, EMC Consulting provides strategic guidance and technology expertise to help organizations exploit information to its maximum potential. With worldwide expertise across organizations' businesses, applications, and infrastructures, as well as deep industry understanding, EMC Consulting guides and delivers revolutionary thinking to help clients realize their ambitions in an information economy. EMC Consulting drives execution for its clients, including more than half of the Global Fortune 500 companies, to transform information into actionable strategies and tangible business results. More information about EMC Consulting can be found at www.EMC.com/consulting.

Take the next step

The EMC Consulting Asset Management practice brings significant expertise and hands-on experience for hedge funds as well as a variety of financial services clients. We have a comprehensive understanding of hedge fund operations, workflow, and data management needs. We offer specific expertise to help hedge fund firms of all sizes streamline and enhance the use of existing lifecycle processes, systems and infrastructure. We can help your firm thrive in an increasingly competitive domestic and global landscape.

Our collective experience enables us to serve hedge funds that utilize a wide range of applications, tools, and technologies.

We believe that our knowledge and expertise provide us with unique credentials for evaluating and enhancing your technology/processing environment. We can tailor an approach, customized to your firm, that enables you to effectively address challenges and substantially increase productivity, reduce risk, and gain outstanding operational efficiencies.



EMC Corporation
Hopkinton
Massachusetts
01748-9103
1-508-435-1000
In North America 1-866-464-7381
www.EMC.com