

Funds-of-Funds Valuation 2009

Update: On June 8, 2009, the FASB amended the guidance discussed in this Element and now proposes that the NAV of an underlying fund can generally be used for valuation without further adjustment, "if the net asset value per share of the investment is determined in accordance with the [AICPA Audit and Accounting Guide for Investment Companies] as of the reporting entity's measurement date." The proposal (which may be found at <http://www.alpsinc.com/email/FASB.pdf>) is open for comments through July 8, 2009. This Element will be updated after the guidance is finalized.

The AICPA has recently published a draft issues paper about the valuation of interests in hedge funds and other private funds. Contained within it is the observation that:

"Staff believes that it would be inconsistent with Statement 157 to presume that NAV automatically equals fair value."

Accordingly, the draft presents some issues and challenges for many, if not all, funds-of-funds, which have historically relied on the net asset values reported by the underlying managers. This Element explores those issues and contains a checklist that may be helpful in the audit process.

Please note that the Draft¹ is a 21 page document, so any short discussion such as this will, by necessity, be incomplete.

Redeemable and Nonredeemable Interests

The Draft makes the distinction between the "redeemable interests" in hedge funds and "nonredeemable interests" in private equity, VC and real estate funds. Because funds in the latter category are generally structured to have a short

period for subscriptions followed years later by distributions as investments are liquidated, interim valuations are usually of less consequence. In hedge funds however, valuations are much more critical because of the relatively frequent opportunities for investors to add or withdraw capital. In addition, valuation information in private equity, for example, is difficult for an investor to act upon, while valuation in a hedge fund can influence decisions to buy, hold or sell at the next subscription or redemption date.

While some funds-of-funds may be hybrids, i.e. they own both redeemable and non-redeemable interests, the structural issues and choices addressing that dual nature is beyond the scope of this discussion. Our focus is on the valuation issues for a fund holding interests in hedge funds.

The Two Big Questions

The Draft advises that valuation is a process guided by two basic questions. The first question for the fund-of-funds manager is, "Is the number reported by the underlying fund accurate?" Secondly, "If deemed accurate, are there other reasons to make an adjustment?"

Question #1 – Is the number reported to me accurate? In short, the Draft states that management needs to independently evaluate and either accept or challenge the NAV determined by the underlying fund manager. Some of the pertinent questions might be:

- Are reported results reasonable given the strategy of the underlying fund and the relevant market conditions during the period?
- Is there any reason to question the valuation methods of the underlying fund?
- Does the underlying fund own hard-to-value assets?
- If so, are hard-to-value assets independently valued?

¹ see http://www.aicpa.org/download/acctstd/Alternative_Investments_Draft_Issues_Paper-01-09-09-FINAL.pdf

The Two Big Questions continued

- Is the auditor a credible firm?
- Does the audit report contain qualifying statements?
- Is there evidence that the reported NAV is based on application of FASB Statement No. 157 as of its calculation date?
- Is there a history of significant adjustments to reported valuations, either as a result of the annual audit or otherwise?
- Are there other reports or sources that might indicate inadequacy of financial controls?

If such questions are adequately addressed, the Draft suggests that NAV is an appropriate “starting point” for determining valuations. The second question, “Are additional adjustments appropriate?” is discussed in both factual and hypothetical terms. Let’s first discuss the hypothetical considerations, since they would appear to be overly theoretical for funds-of-funds that are themselves redeemable funds.

Hypothetical Valuation Issues

The Draft makes the following sequence of arguments:

1. “Paragraph 7 of FASB Statement No. 157 refers to a fair value measurement assuming that *‘the asset or liability is exchanged in an orderly transaction between market participants...’*”
2. “[V]irtually all alternative investments do not permit the transfer of interests without the approval of the fund or its adviser...”
3. “[When] no marketplace exists in which transactions in redeemable interests occur directly between market participants... *‘a hypothetical market often must be assumed.’*”

We would argue that the fact that a fund-of-funds is itself a redeemable fund undercuts the argument for taking into account a “hypothetical market.” If “hypothetical market” reasoning leads to a hedge fund interest being valued at either a premium or discount to NAV, when the fund-of-funds either sends new money to that hedge fund or makes a withdrawal, the actual fund value will insert itself at that time. Few fund-of-funds managers would agree that it was fair to investors to have had the discount or premium in the prior periods. Accordingly, it is difficult to imagine the following observations from the Draft actually being relevant for most funds-of-funds:

- The Draft suggests that closure of the fund to new investments might indicate that a current interest in the fund might theoretically be valued at a premium.
- The Draft suggests that a change in the financial condition of the underlying investment manager might affect valuation, even in redeemable funds. (We would note that, in reality, if fund valuations are currently accurate and if the interest is redeemable, investors who have such concerns can still vote with their feet and obtain stated NAV.)
- The Draft suggests that funds currently experiencing only new subscriptions might be valued at a premium and those currently experiencing only redemptions might be discounted.

While these “hypothetical market” arguments would likely be problematic for funds-of-funds, that is not to say that other types of entities should not explore the issues suggested by the Draft. However, for funds-of-funds, the discussion items we have categorized as “factual” would appear to be more relevant.

Factual Considerations

Factual considerations are those that may be objectively determined and which could reasonably be expected to affect the net proceeds of a redemption. They would include such things as:

- The valuation is “stale” and valuations of the underlying fund’s securities have likely changed as of the date of the financial statements of the fund-of-funds.
 - The fact that a fund does not, as a regular course of business, redeem at NAV. This might occur if redemptions are effectuated at a non-GAAP valuation, for example, as a result of amortization policies regarding formation costs.
 - The reported fund NAV does not reflect actual redemption value, such as reallocation of incentive compensation to the underlying fund manager.
 - The NAV is a general valuation that does not reflect the valuation of this particular investment, e.g., the report is not customized for each participant.
 - If the fund has imposed a “gate” (limiting ordinarily permissible withdrawals), should that warrant an illiquidity discount? (Note that the Draft states the mere presence of “gate” language – not actually imposed – would not be an argument for a discount.)
 - If the fund has active side pockets, are those side pockets valued properly in terms of their illiquidity and properly attributed to capital accounts?
 - If a fund is experiencing significant net withdrawals, is there any indication the underlying liquidity of the fund’s assets is being impaired?
- If a redemption has been requested and such redemption would cause the imposition of an early redemption fee, is the redemption fee netted from the current valuation?
 - Are there any allegations of fraud that would impugn the credibility of the reported NAV?

A Practical Guide

It is likely that an advance review of the relevant questions will accelerate the audit processes for most funds-of-funds. The following checklist is intended as a starting point for fund managers undertaking that review. Note that many of the identified issues will require additional fact-checking and possible solicitation of expanded information from underlying funds, so managers should allocate appropriate resources.

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Fund Valuation Checklist

Fund Name: _____ **Date:** _____

Percentage of fund-of-fund's assets in this fund: _____

A. Is reported NAV an appropriate starting point for valuation?

- Publicly available information does not create a red flag. Either:
 - There are no known benchmarks, indexes or other industry returns that appear relevant (note that composite returns for some eclectic strategies, such as "long-short equity" may not provide useful comparisons).
 - Fund performance is deemed reasonable in light of information received from the fund manager and in the context of relevant benchmarks, indexes or other industry returns.
- There are no general reasons to question the valuation methods of the underlying fund.
- The underlying fund either (a) does not own significant hard-to-value assets, or (b) owns significant hard-to-value assets and the fund and its auditor have adequately represented that such assets are valued independently.
- The auditor _____ is reasonably believed to be competent and reputable.
- The audit report does not contain qualifying statements that cause concern about valuation.
- There is adequate evidence that the reported NAV is based on application of FASB Statement No. 157 as of its calculation date.
- There is no history of significant adjustments to reported valuations, either as a result of the annual audit or otherwise.
- There are no other reports indicating inadequacy of financial controls.

B. If NAV is an appropriate starting point, are there factual reasons to adjust?

- The valuation date of the underlying fund aligns with the date of our fund-of-fund's valuation.
- The fund, as a regular course of business, redeems at NAV.
- The fund NAV reflects actual liquidation value, and is net of incentive compensation to the underlying fund manager.
- The valuation obtained reflects the valuation of this particular investment.
- Gate issues are resolved. Either:
 - The fund has not imposed a "gate."
 - The fund has imposed a gate and a pricing policy has been prepared assessing the impact and an illiquidity adjustment, if any.
- Fund net redemptions have been evaluated.
 - Percent of assets withdrawn as of the date of valuation: _____; determined to be:
 - Not material to fund valuation; or
 - A pricing policy has been prepared assessing the impact and an illiquidity adjustment, if any.
- Redemption fees do not apply; or, if they apply, are in the amount of _____.
- Are side pockets properly valued, in terms of illiquidity?
- There are no known allegations of fraud that would impugn the credibility of the reported NAV.

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