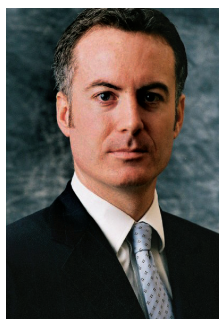


What's It Worth?

Determining the Valuation of Hard-to-Price Instruments



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Valuation – under a brighter-than-ever spotlight as a primary topic of the President’s Working Group on Financial Markets and due to the implementation of FAS 157– is attracting intense attention. Under particular scrutiny are hard-to-value instruments such as OTC derivatives and complex securities, because a number of leading hedge funds have been exposed with highly leveraged portfolios full of these complex assets. In an economic environment in which the practice of marking-to-market has sometimes been depicted as “marking-to-myth,” the credibility of valuation becomes paramount.

The events of the past year have shifted many investors’ priorities as they demand proof of visibility and control as well as a guarantee that their money is being managed properly. Investors are increasingly wary of pricing that only relies on counterparties. For hedge funds keen to retain investor confidence, it has never been more important to demonstrate transparency in the valuation of OTC assets. In this context, independent valuations are a must, as is the ability to analyze, compare and question prices, models and controls. Managers whose administrators possess these skills are well positioned to capitalize on the opportunities that emerge as the industry rebuilds.

Another way to demonstrate transparency is by establishing a valuation committee, as recommended by a committee of asset managers established by The President’s Working Group. One of the hedge fund industry “best practices” recommended by this committee is the establishment by the investment manager of a valuation committee or similar governance mechanism to oversee the manager’s valuation policies and methodologies. Although the recommendations don’t specify a particular strategy that would mandate the requirement for a valuation committee, the likelihood increases with the complexity of the fund. There is a good chance that there will be some discrepancy between what the manager of the fund views as the true value of the portfolio versus the administrator’s independent calculation based on price information supplied by one or more third party vendors. Having a governance model in place that can interact with the administrator and provide the voice of the manager of the fund to the administrator would be extremely valuable.

The need for robust risk management within the financial services industry cannot be overstated. Our hedge fund administration clients have been afforded an extra risk management tool via Citi’s Complex Pricing Group (CPG), which provides independent valuations for OTC derivatives and hard-to-price securities. In brief, CGP acts as a quality filter, serving as a second review of our clients’ valuations. CPG checks both the integrity of the data used by valuation providers and the structure of the models used by the companies chosen to provide independent valuation.

Citi’s CPG team sources data from an ever-expanding range of independent valuation providers, using scrubbed prices to ensure deep and transparent coverage. Those prices are compared with secondary pricing sources, such as those from an investment manager. Where differences exceed pre-determined tolerance levels, an analyst reviews the underlying market data and valuation model to determine the root of any price challenge. The CPG team then applies each client’s specific risk management rules and valuation policies to ensure no price goes unreviewed. Only when a price has passed through this rigorous review will the price be submitted to the client.

This entire process is underpinned by Citi’s global operating platform that integrates with each client’s systems to provide a consistent level of reporting data across the full breadth of fund types and legal vehicles. With our ability to offer a complete suite of solutions across the investment value chain, we at Citi ensure our clients can maximize their presence while leveraging our local and global strengths in execution and comprehensive custody and fund administration services, so managers can meet the demands of their investors and the market.

