

Vital hedge fund valuation principles

As market events have recently highlighted, valuation is key for the hedge fund industry. On going development of sophisticated instruments requires the industry to continually examine and develop appropriate fair valuation tools and models.



Rapid growth has increased the focus on the valuation of hedge funds

The hedge fund industry has grown substantially over the last decade. Assets in the global hedge fund industry have almost doubled in the last five years to just over US\$2 trillion. In Europe the industry has grown to over US\$450 billion.

This rapid growth has increased the focus on the valuation of hedge funds. Institutional investors, governments, regulators and fiscal authorities are all paying attention to this ever-growing industry. Comments on hedge funds are a daily occurrence in the press.

Regulators around the globe are reappraising their duties to investors and the market. One of the first issues being tackled is to establish a clear benchmark in relation to the valuations of the investments of hedge funds. Meanwhile, the industry itself through bodies such as the Alternative Investment Management Association (AIMA) has a desire to react to the increased focus in a responsive and realistic manner.

The enormous growth in the popularity of hedge funds, coupled with increasing investor concerns as investments become more illiquid and strategies more complex, has resulted in a specific interest in the valuations of investments held by hedge funds. The recent turbulence in financial markets has only added to this.

AIMA and the International Organization of Securities Commissions (IOSCO) have both produced reports covering suggested principles for the valuation of hedge fund investments. Taken together, these are setting a standard as to the expected processes and procedures to be followed in hedge fund valuations.

AIMA's –Guide to sound practices for hedge fund valuation

The key objectives of *AIMA's guide to sound practices for hedge fund valuation* are to reflect the changes in the industry, and to update and enhance existing recommendations.

This Guide has been developed to bring clarity to the process and procedures employed by the vast majority of players in the global hedge fund industry. It contains 15 recommendations offering principles-based guidelines for sound valuation practices. It covers all aspects of the valuation spectrum – from governance, transparency, procedures, processes and systems, to sources and the use of models for hedge fund asset valuations. It also includes an outline of a Policy Valuation Document for use by hedge funds and consideration by their investors.

Some of the issues covered include defining the asset pricing methodology with reference to sources, cut-off times for pricing and tolerance variances. Other areas discussed in the guidelines include how to define the responsibilities of different players in the valuation process and oversight matters, and setting out an escalation process to settle how a dispute about a particular asset price is resolved.

While recognising that a "one size fits all" approach is not appropriate for hedge funds, the Guide seeks to provide practical direction with working examples for each recommendation.



The focus on valuation is an area that is expected to remain under review

IOSCO's Principles for the valuation of hedge funds portfolios

IOSCO's principles for the valuation of hedge fund portfolios in turn approaches these issues in a similar way. The nine IOSCO principles are meant to be a practical tool for hedge fund managers and governing bodies, and those involved in the valuation process. They may also be helpful for institutional and sophisticated investors and their representatives.

The principles describe techniques which should strengthen the valuation process thereby making it more likely that the resulting valuation is appropriate. They emphasise the importance of clear written procedures which are consistently operated and regularly reviewed, and which provide for an appropriate degree of independence to deliver effective checks and controls.

Due to the wide range of business structures adopted by hedge funds and the international mobility of capital, IOSCO believes it would be beneficial to promote a single set of valuation principles that are applicable across a wide range of jurisdictions and hedge funds business models as possible.

The future of the valuation process

The hedge fund industry is committed to increasing transparency and these guides aim to assist regulators, investors, government agencies, trustees and the industry in deepening their understanding of this important topic of valuation.

Announcing a set of valuation principles/recommendations is all very well but their effect on the hedge fund market depends on whether or not they are taken up. These principles and recommendations represent good practice in the industry and many hedge funds and their managers already adhere to practices that are consistent with them. The wider application of such practices should help to build strong processes and procedures in the valuation of hedge funds.

An internationally accepted set of good principles for the valuation of hedge fund illiquid and complex assets should assist hedge fund counterparties in evaluating and controlling their exposures to hedge funds. These principles will also increase valuation transparency and disclosure for investors.

This focus on valuation, and especially the identification of potential conflicts in the process, is an area that will be expected to remain under review.

AIMA has stated that it will continue to work closely alongside IOSCO and other regulatory bodies worldwide on this hot topic of valuation and other issues as the hedge fund industry continues to evolve.

Contact Name

Olwyn Alexander
Tel: +353 (01) 792 8719