



Fair Value Pricing Survey, Tenth Edition  
Looking back and looking forward: Perspectives  
on fair value — past, present, and future





# A tenth anniversary retrospective on Deloitte's survey

When Deloitte issued its first Fair Value Pricing Survey just over 10 years ago, our goal was to help mutual fund firms benchmark their valuation policies and procedures to others in the industry. We also sought to highlight different approaches to securities valuations within the industry and the reasons behind these differences. Our initial effort in 2001 came after the U.S. Securities and Exchange Commission (SEC) issued its Staff Letter to the Investment Company Institute, dated April 30, 2001, regarding mutual fund fair valuations (the "April 2001 Letter").<sup>1</sup>

Based on the responses to our initial survey, we realized we had hit on something unique: a peer-to-peer forum to help mutual fund firms identify current industry approaches to fair valuation, keep tabs on changes in fair valuation policies and procedures, and measure reactions in the industry to significant market developments.

Since that first survey, Deloitte's Asset Management Services practice has been compiling, analyzing, and discussing industry valuation trends with mutual fund executives, fund board directors, regulators, and many others to help identify effective practices and emerging approaches, as well as capture industry reactions to significant market fluctuations and other events. Today, participation in the survey has grown to 87 U.S. asset management firms, representing more than \$5 trillion in assets under management.

## Tracking industry changes

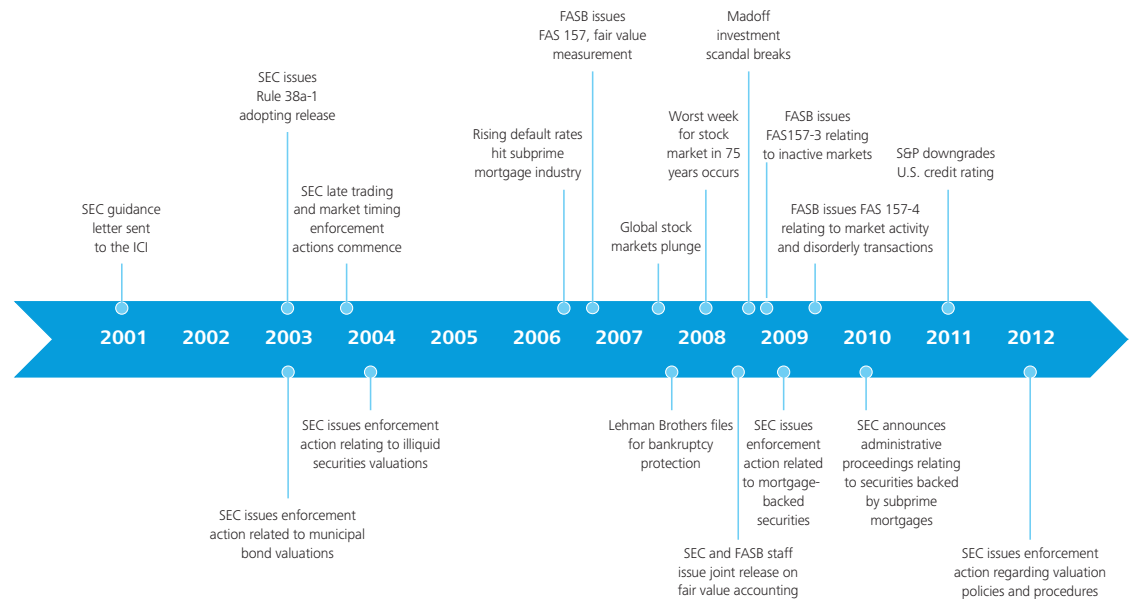
While valuation has remained a perennial hot topic, our survey findings over the years show how far the industry has evolved. These developments include more sophisticated approaches to fair valuations, as well as more controlled, risk-focused valuation processes. For instance, in our first survey, we saw noticeable gaps between large and small fund groups in how they analyzed fair value adjustments. In this regard, only a slight majority of firms had valuation policies and procedures that addressed significant events. Today, these practices are nearly universal.

As industry standards have emerged, our team has continued to pose new questions to help uncover emerging valuation practices. Some examples of the industry's evolution are included in the following table:

A few noteworthy highlights from over the years	
From the early years...	In recent years...
Forty-nine percent of survey participants performed follow-up procedures to analyze fair value adjustments.	Ninety-four percent of survey participants perform back-testing on foreign equities and 76 percent on broker-priced bonds as a control and follow-up procedure.
Seventy percent cited portfolio managers as having primary responsibility for monitoring for "significant events" that could result in a price override.	Sixty percent permit portfolio managers to initiate price challenges, subject to valuation controls, to manage potential conflict-of-interest risks.
Sixty-one percent had valuation policies and procedures that addressed "significant events." However, most fund complexes had not established materiality thresholds and trigger points.	Eighty-eight percent of respondents use proxies, such as the S&P 500 and Russell 1000, in their procedures to monitor for significant events.
Ninety percent of survey participants indicated their fair valuation disclosures took the form of general statements, indicating that the fund can use fair value methodologies to value securities; only 26 percent flagged fair value securities in the portfolio of investments.	With the adoption of Accounting Standards Update 820 <sup>2</sup> , funds now disclose detailed information about their portfolios through the levels disclosure, with 77 percent of survey participants monitoring the appropriateness of the classification of investment levels at least every three months — 8 percent doing so daily, 1 percent weekly, 19 percent monthly, and 49 percent quarterly.
Seventy-two percent of survey participants used foreign exchange rates in their valuation process at a point in time <i>earlier than</i> the 4 p.m. Eastern Standard Time (EST) net asset value (NAV) calculation.	Seventy-nine percent use the 4 p.m. EST foreign currency exchange rate in their valuation process.
Forty-seven percent of survey participants used bid pricing exclusively for fixed income securities.	Fifty-one percent use bid pricing exclusively for fixed income securities and 25 percent use the mean price.

<sup>1</sup> <http://www.sec.gov/divisions/investment/guidance/tyle043001.htm>  
<sup>2</sup> <https://asc.fasb.org/imageRoot/00/7534500.pdf>

**Exhibit 1. The U.S. financial markets, regulatory/legislative developments, and fair value: Where we have been**



Source: Deloitte Development LLC.

### Five key takeaways

While our survey findings have changed over the years, what is most telling is what didn't change: valuation never wavered as a top issue and a top risk for mutual funds.

The industry's focus on valuation is as much a story about the effect of external developments as it is about firms trying to get ahead of the next unforeseen occurrence. As reflected in the accompanying timeline, the industry has been forced to face a number of unusual and largely unexpected events: from the late trading and market timing scandal, to the global economic downturn in 2008 and 2009, to civil unrest in the Middle East and Africa, to the tsunami in Japan. Equally influential has been the heightened regulatory focus on valuation, starting with the SEC's April 2001 Letter and extending through to valuation enforcement cases over the years to the current effort to examine fair value practices relating to vendor pricing.

As we look back on our survey findings over the past decade, five key themes emerge:

- 1. Greater focus on foreign securities:** No investment class covered by our survey has evolved more than the valuation of foreign securities. Valuation practices for foreign securities were completely reengineered in the first six years of the survey. In 2001, fewer than five of the firms surveyed said they adjusted foreign securities prior to their nightly NAV calculations. Today, nearly 100 percent conduct such adjustments, whether they are done immediately through the use of zero triggers, by performing a thorough analysis upon exceeding a certain threshold, or through internal correlation analysis. Similarly, in the survey's first year, third-party pricing vendors were not used to value foreign securities; today, the majority of our respondents observe this practice.

**2. Participation of third-party pricing vendors:** These external providers have continued to step up their game over the 10-year history of our survey. In the early years, many firms viewed the price from a third-party vendor as an input for that night's NAV calculation process. As time has progressed, however, receipt of the vendor's pricing feed has merely started the process. As vendor interactions have moved to an evaluation of a vendor's suggested pricing indication, mutual fund firms have built up their related control processes and procedures. As a result, firms today are more likely to make adjustments or issue challenges to third-party valuations, as well as conduct site visits of pricing vendors. In addition, pricing vendors can now provide fund firms with access to technical inputs and assumptions for asset classes such as collateralized debt obligations, commercial mortgage-backed securities, and derivatives. These developments have provided fund firms with access to additional information and resources, rather than having to fully develop this infrastructure on their own.

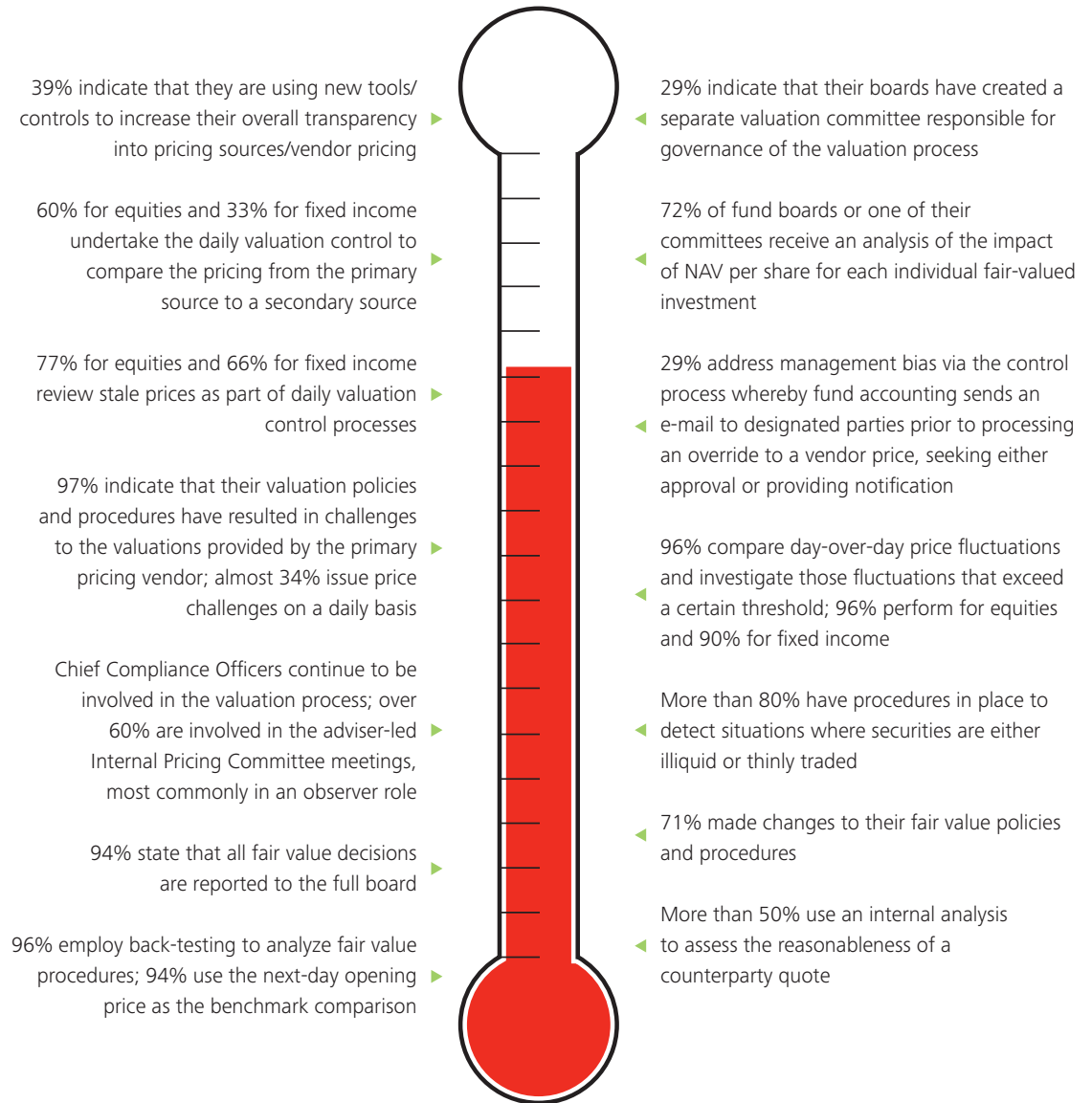
**3. Firm size less of a factor:** In the survey's early years, mutual fund firms with more than \$75 billion in assets under management were more likely than their smaller counterparts to have formalized policies and procedures in place, along with the associated infrastructure. Over the years, that gap has narrowed. Smaller firms have increasingly stepped up their efforts in many valuation areas, including valuation committees at the fund board and management levels, follow-up activities assessing the effect of fair valuation decisions on valuation procedures, and the frequency with which they adjust securities valuations in the event of a "significant event." While no one approach works for all in the valuation context, smaller firms continue to put more emphasis on maintaining adequate levels of valuation resources and governance, and using the expertise of third-party pricing vendors and others to close remaining gaps with larger funds.

**4. Formalization of valuation controls and due diligence:** Since the survey's inception, the industry has continued to advance the valuation process by implementing additional controls and conducting greater due diligence. Some of these changes came in response to regulatory guidance such as the April 2001 Letter, which prompted firms to update their valuation procedures, particularly in connection with the pricing of foreign securities. Other changes have been more forward-looking, such as funds' efforts to account for economic uncertainty by building internal pricing models. The degree of change reached a high-water mark in the wake of the market timing and late trading scandal; 66 percent of participants in our 2004 survey said they altered their valuation policies and procedures, and nearly two-thirds of those characterized their changes as "significant."

**5. Valuation governance a perennial top-of-mind issue:** Fund boards have been keenly focused on key governance questions, particularly since the market timing and late trading scandal and the economic crisis. Today, the boards of more than half of our survey participants have delegated certain valuation oversight responsibilities to one of their committees, and more than half receive an analysis of the per-share effect on NAV for each fair-valued investment individually. The questions board members are asking themselves (and addressed in our survey) show the scope of their efforts: How much time do independent directors spend on valuation matters? What type of committee structures exist? Are any independent directors involved in day-to-day valuation efforts on a real-time basis? With the SEC currently focused on potential bias in the valuation process and the adequacy of pricing source due diligence, we expect the focus on governance by fund boards to continue.

**Exhibit 2. How does your “valuation temperature” compare?**

Shown below are various highlights from our survey over the last ten years. They illustrate inflection or trending points in the history of our survey, some of which have continued to evolve through the course of our survey and, as such, may be different today. The breadth of topics illuminates the importance of developing and maintaining appropriate fair valuation policies and processes as the temperature of global developments moves up and down.



Source: Deloitte Fair Value Pricing Survey  
Deloitte Development LLC.

# Our 2012 survey: Executive summary

As the foregoing retrospective indicates, it has been over 10 years since Deloitte launched its first Fair Value Pricing Survey in 2001. With our tenth anniversary survey in 2012, we are also celebrating a record number of 87 U.S. participating asset managers, representing over \$5 trillion in assets under management. Our retrospective and this year's participant numbers and survey findings all demonstrate that valuation remains a front-and-center topic across the mutual fund industry.

## New questions shed light on governance and oversight, risk management, and resources

While valuation is certainly always an area of focus, it is also an area of evolutionary change. To keep ahead of these changes, we posed a series of new questions this year — from big picture to granular considerations — to continue to shed light on important industry practices and to help fund firms evaluate those practices against their own. Highlights from the new questions we asked as part of our 2012 survey are shared below.

### Governance and oversight

Given the dramatic developments across the globe — from the civil unrest in Africa and in the Middle East to the first ever U.S. debt downgrade to sovereign debt concerns across the European Union — we asked about how these developments impacted valuation discussions between management and board members outside of regularly scheduled meetings. Sixty-four percent of our survey participants noted that such discussions had occurred during the last year. While the U.S. debt downgrade captured the most attention in percentage terms, not surprisingly other developments also garnered significant attention.

- U.S. debt downgrade at 49 percent
- Sovereign debt concerns at 42 percent
- Natural disasters at 32 percent
- Political uncertainty and unrest at 27 percent

The percentages show that many board members are interested in discussing the impact of world and market events on a more real-time basis. What is particularly intriguing, however, is that none of these percentages exceed 50 percent, and more than 35 percent of survey participants did not engage in these types of discussions between regularly scheduled meetings.

For years, management and boards have understood the need to find the balance between providing oversight and real-time involvement. The results of this question may suggest that management and boards are still seeking to determine exactly under what circumstances boards should be involved, which directors should be involved in such discussions, and how exactly they should be involved.

For some fund groups, the discussions have been informal, while others have begun to identify specific circumstances within their policies and procedures that warrant more real-time discussions. It is unclear whether more fund groups will adopt this approach in the future or whether it is really necessary. More than likely, the answer to this partially hinges on a fund group's expectations as to which kind of events pose the greatest valuation risk to the fund group based on the nature of its investments.

Against the backdrop of the developments on the U.S. and world stage noted earlier, we asked for the first time in this year's survey about valuation challenges and board reporting. More than a third of our survey participants — 38 percent — said the full board, a board member, or a board committee receives information regarding pricing challenges. At these fund firms, 69 percent are provided summary information, while 42 percent will receive detailed information on the challenges and actions taken that affect valuation decisions.

### **Risk management**

With risk management being at the forefront of the minds of both management and fund boards coming out of the market downturn, we tackled this topic in the valuation context for the first time. Nearly half of survey participants — 48 percent — said that their fund group has identified the risks associated with the valuation of individual investment types (versus investment risks more generally) as part of their formal Investment Company Act of 1940, Rule 38a-1, or other risk assessment process. All but five percent of those answering in the affirmative said that one or more controls are in place to help manage and so reduce the likelihood of each risk occurring.

Regardless of whether it is part of the formal risk assessment process, fund groups have most likely learned during the credit crisis and through various regulatory actions the importance of better understanding the various inputs and drivers involved in valuing non-exchange-traded investments. We also believe that fund firms understand the importance of collecting more available data, which is generally now accessible electronically.

### **Technology and human resources**

The developments that affect valuations are not always major world occurrences, but instead represent changes in the way the world works. In this vein, we asked about changes in fund firms' use of technology and headcount needs relative to valuation processes.

Some of our respondents reported investing more in technology and in human capital to support their valuation decisions and oversight. More than a quarter said their use of technology to automate the valuation oversight process has increased, while nearly a quarter said they had expanded their headcount over the past year to help execute their valuation policies and procedures.

*Apart from these new insights, we preserved the questions found most helpful in the past in identifying prevailing practices and scoping out emerging ones. As reflected in the following summary of findings, this year's survey results continue to track important year-over-year developments and provide new points of comparison with results from prior years.*





# Our 2012 survey: Other highlights

We have included summaries below of certain noteworthy survey results by four subject areas: valuation governance, general policies and procedures, pricing sources, and specific investment type fair value considerations.

## Valuation governance

- Twenty-nine percent of survey participants indicated that their fund boards have created a separate valuation committee (versus leveraging another board committee) responsible for governance of the valuation process, virtually unchanged from the prior year.
- Seventy-two percent of fund boards or one of their committees receive an analysis of the impact on NAV per share for each fair-valued investment individually, representing a 21 percent increase from the prior year.

## General policies and procedures

- Seventy-one percent of survey participants indicated that they had made changes in the last year, up from 62 percent in our prior survey.
- Fifty-seven percent of survey participants indicated that portfolio managers, analysts, and traders either perform scheduled analysis of all non-exchange-traded security prices each day and communicate results to fund accounting and/or fund officers, or do not perform a scheduled analysis but are responsible for notifying fund accounting or management if they become aware of any market or issue-specific events that have occurred and may affect pricing. The remaining 43 percent of survey participants indicated that such parties did not have a daily responsibility.
- Forty-nine percent of survey participants indicated that portfolio managers, analysts, and traders performing the analysis described above must provide daily affirmation of such analysis either verbally or in writing prior to the striking of the daily NAV, up from approximately 25 percent in the prior year.

## Pricing sources

- Sixty-three percent and 25 percent of survey participants indicated that they approve annually pricing vendors and brokers, respectively.
- Seventy-nine percent of survey participants indicated that they use different pricing sources depending on the asset class.

- More than 50 percent of survey participants use a pricing threshold to evaluate when to challenge a price.
- Thirty-nine percent of survey participants indicated that they are now using new tools/controls to increase their overall transparency into pricing sources/vendor pricing.
- Twenty-nine percent of survey participants indicated that they had updated their onsite due diligence visit objectives and questionnaires to respond to communications (speeches and information requests) from the SEC.

## Fair value considerations for specific investment types

### Equities

- Seventy-seven percent of survey participants indicated that they compare every day equity prices received from their primary pricing source to a secondary source, compared to 61 percent in the prior year.
- The S&P 500 Index (either directly or through the use of S&P 500 futures contracts) remains the most common proxy used to identify situations in which the closing price for equities trading on foreign exchanges may require adjustment.
- Thirty-six percent of respondents use zero triggers for evaluating the impact of market fluctuations on the value of foreign equities, and we noted little movement in the use of zero triggers from the prior survey.

### Fixed income

- Fifty-one percent of survey participants use bid-pricing exclusively; 25 percent use mean pricing exclusively.
- Less than 30 percent of survey participants indicated that they compare every day fixed income prices received from their primary pricing source to a secondary source, which is similar to the prior year.
- Forty-three percent and 48 percent of survey participants apply fair value policies to review for significant events for foreign corporate debt and sovereign debt, respectively, compared to 30 percent and 40 percent, respectively, in the prior year.

### Derivative contracts

- At least 75 percent of survey participants use a third-party pricing vendor for valuing interest rate swaps and credit default swaps.

# A forward view: From a reactive to a proactive stance

As we embark on our next decade of conducting Deloitte's Fair Value Pricing Survey, it will be interesting to see how our survey questions continue to evolve. Rest assured that we will continue to hone our focus and look for new ways to ensure the survey remains a valuable industry yardstick for monitoring and reporting the latest in fair valuation practices.

Over the next 10 years, we expect fund firms to continue to refine their fair valuation practices and procedures, especially as external events inevitably force the industry to react. But we also believe the industry is moving to a new era — taking proactive measures on valuation. In the future, firms may increasingly embed valuation topics into their risk management regimes, enabling them to get a better handle on determining whether their existing procedures, internal controls, and governance activities effectively address valuation risks. As these approaches develop, firms may seek better ways to employ technology, where advances may likely pave the way for new valuation capabilities and higher levels of precision.

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Ten years from now, we are confident that our next survey retrospective should find the industry just as focused on valuation as it is today. Stakeholders and regulators will likely demand it and — more importantly — mutual fund firms and fund boards will drive it. We look forward, as always, to capturing and sharing the valuation data points and trends that will help the industry get ahead of the many changes that are expected to come.

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