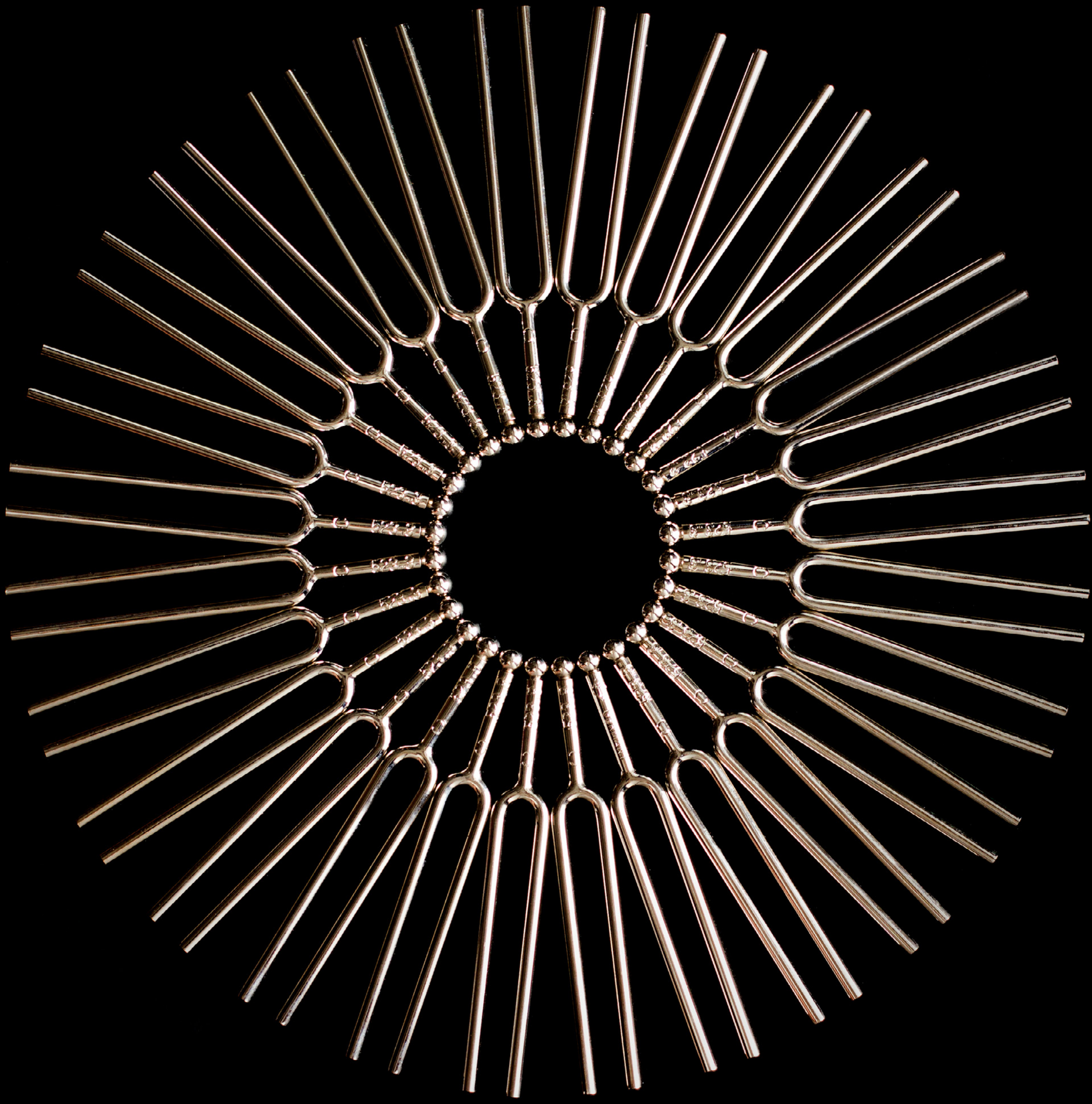


# Tuning up for tomorrow

## Investment managers hone their valuation practices ahead of regulatory considerations and market changes

Fair Valuation Pricing Survey Executive Summary
Fifteenth Edition

# Contents

# Introduction

The last 12 months have been filled with major political, military, and environmental concerns and events, including the devastation from a spate of hurricanes across the Caribbean and southern US. However, the results of the 15th edition of the Deloitte Fair Valuation Pricing Survey suggest that these types of matters have not had a major impact on the normal process used by investment companies to value their investments. For example, 28 percent of fund boards ("Boards") held a valuation discussion with management outside of a regularly scheduled meeting in the past twelve months, down from 39 percent a year earlier. Just 8 percent of participants in this year's survey indicated that political uncertainty associated with the US presidential election prompted discussion between members of management and a member of the Board outside of a regularly scheduled meeting. Valuation issues that did prompt an "ad hoc' Board discussion included the impact of Brexit, trading halts, suspensions, market disruptions, and the use of a new or updated pricing methodology, pricing vendor or broker.

However, beyond these headlines, the past year has brought no shortage of valuation issues for investment managers to consider. The US Securities and Exchange Commission's (SEC) reporting modernization[1] and liquidity risk management[2] rules have consumed large amounts of time for accounting, operations, risk, and compliance personnel, as well as to industry service providers including fund services firms, pricing services, and advisory professionals. This will likely continue to be the case for the near future. While neither of these issues seems to have had a direct impact on the valuation of securities, the industry may see some downstream effects and stresses on the valuation process. Additionally, the SEC has taken on a new look from a personnel perspective, with the appointment of a new SEC chairman this year and a new Division of Investment Management director now in place.

Public comments and directives from regulators, as always, have also given investment managers more to digest. Former SEC Chairman Mary Jo White made two speeches in 2016 that specifically highlighted valuation-related challenges. One targeted billion-dollar startups commonly called "unicorns" and venture capital investments,[3] and the other honed in on complex or less liquid investments lacking trading volume and how investment managers and pricing vendors were handling them.[4] These speeches appear to demonstrate the SEC's ongoing interest in investment valuation for less liquid asset classes. Additionally, an SEC administrative order[5] relating to odd-lot trading and valuation punctuated a discussion point that had been ongoing in many circles in recent years.

Whether these subjects will continue to be of ongoing interest to the SEC is unknown. What we do know is that these issues have the potential to impact the industry's valuation policies and procedures. So it's not surprising that many investment managers are starting to consider future valuation risks linked to changes in market conditions, private equity valuations, odd-lot trades, and pricing vendors.

1 https://www.sec.gov/rules/final/2016/33-10231.pdf

2 https://www.sec.gov/rules/final/2016/33-10233.pdf

3 https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html

4 https://www.sec.gov/news/speech/white-speech-keynote-address-ici-052016.html

5 https://www.sec.gov/litigation/admin/2016/ia-4577.pdf

# Preparing for change

Investment managers did not sit still during this recent period of relative market calm and fewer valuation challenges. Rather, many focused on enhancing the governance process, considering or acting upon automation opportunities, and reviewing their valuation policies and procedures.

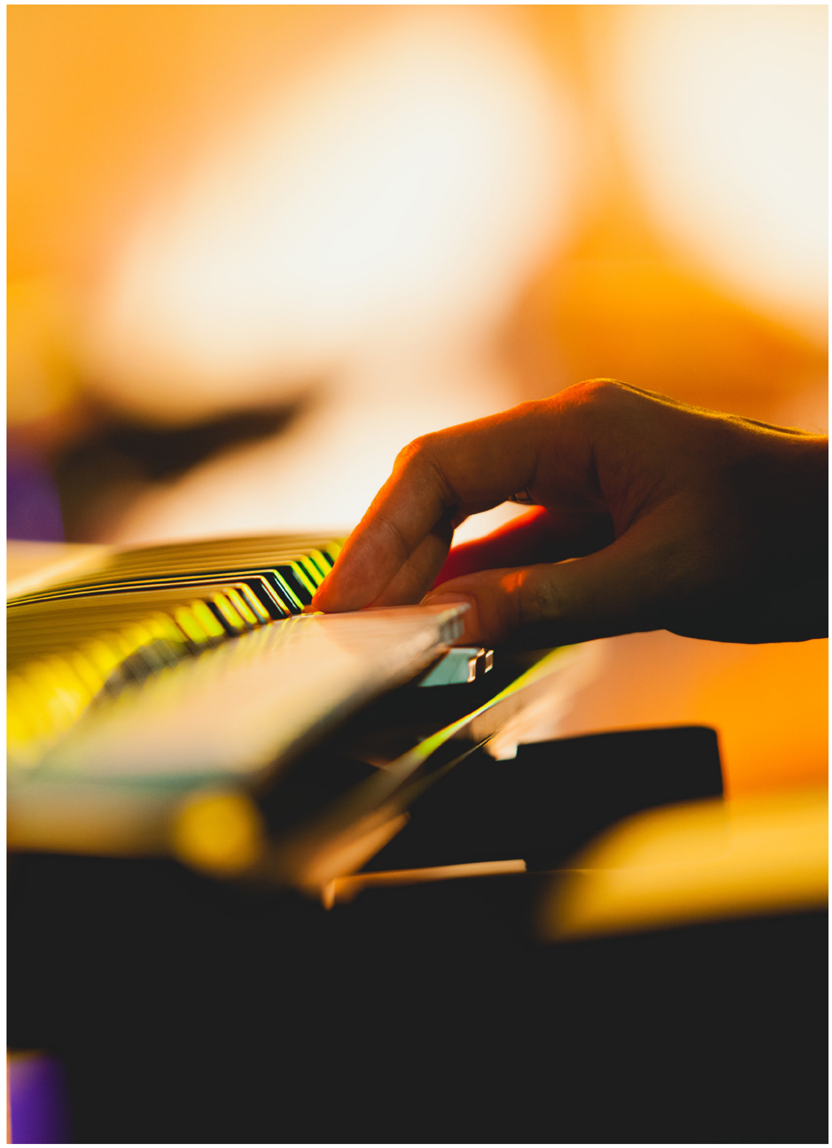
Consistent with last year's survey, 63 percent of survey participants changed their valuation policies and procedures over the past year. Of those, 25 percent changed daily internal controls that impact the valuation process, while 31 percent enhanced policies and procedure language for certain hard-to-value investments such as private equities, structured securities, and/or derivatives. An equal proportion made changes to their pricing committee composition, responsibilities, and/or meeting frequency.

On the governance side we saw an increase in the number of survey participants—to 39 percent this year compared to 32 percent a year ago—that include in their written policies and procedures circumstances in which one or more non-interested Board members "must be notified." The two most frequently identified circumstances were when a predetermined threshold is exceeded for any internally fair-valued holding and when an unforeseen country, industry, or issuer event occurs that requires management to challenge the validity of the existing valuation policies and procedures. Having the Board's upfront involvement may help investment managers manage any similar future crises and navigate through the market volatility and liquidity challenges of tomorrow.

There was also a slight increase to 56 percent of survey participants either having developed or being in the process of developing risk dashboards to oversee the valuation process. This compares to 51 percent in the prior year, indicating a maturing trend. Key valuation indicators continued to evolve, but the key valuation indicators most tracked continued to be the percentage of portfolio positions using, broker-priced portfolio positions (number and percentage of

portfolio), unchanged portfolio positions (stale prices as percentage of portfolio and number), back-testing results , percentage of level 3 investments, and illiquid investments held. Using risk valuation dashboards containing key valuation indicators may provide an early warning of changing market conditions and may highlight when price uncertainty enters the markets. However, the findings point to key valuation indicators as valuable tools for managing valuation risk, in that they allow investment companies and their Boards to get the right team to the table and proactively discuss and document fair valuations decisions that are in the best interest of their shareholders.

The survey also shows that technology continues to play a bigger role. Twenty percent of survey participants indicated that their use of automation in the valuation process increased during the past 12 months. This finding is consistent with the prior year, when we saw automation process improvements increase to the tune of 24 percent. Highlights of the automation improvements made include the development of pricing tools to improve vendor pricing comparisons and to enhance reporting of such comparisons to secondary and tertiary sources; the creation of databases to house valuation and pricing data points to facilitate real-time analysis, comparisons and reporting; the development of more automated reporting for stale report tracking, and the creation of Board reports and risk valuation dashboards. These enhancements to the valuation process seem very consistent with the continued use of data analytics across the industry. To this end, 21 percent of survey participants indicated that they are exploring how data analytics, offshoring, or robotics process automation (RPA) can enhance the valuation process.



# Private equity valuation

Properly valuing private investments is of interest to more than half of the participants in our survey, as 58 percent indicated they have investments in private equites. Determining the best estimate of value is a challenge no matter how much exposure an investment manager has to such investments. That challenge arises as soon as the investment company acquires the investment. At the date of purchase, investment companies have to conclude whether the initial acquisition price is reflective of fair value and when to use other means to assist in determining fair value. Eighty-four percent of survey participants with private equity investments indicated that they put their investments through their full valuation process within one quarter after acquisition, with the remaining 16 percent doing so within six months. This is the first time since we have asked this question that all of the survey participants noted that they utilize their full valuation process within six months of making a private investment, illustrating a maturing trend relating to the move away from reliance on the acquisition price as the sole measure of fair value.

As investment companies migrate away from the acquisition price, calibration techniques can make post-acquisition fair values stronger. US GAAP includes an expectation that valuation techniques used subsequent to an acquisition be calibrated to the acquisition price, as shown below:

> *If the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. [FASB ASC 820-10-35-24C]*

Calibration can be a powerful aid, often helping an entity determine initial discounts or premiums when using a market-multiples approach or when determining the company-specific risk that is embedded in a discount rate. The same can be said of recalibration upon updated rounds of financing, which can also be very useful for ensuring the appropriateness of valuation techniques and embedded assumptions.

As our past surveys have shown, diversity in practice exists relative to private equity valuations. Regardless, certain elements are foundational to a good process:

- **Structure that works** – Each private equity investment may be unique in terms of capital structure, industry, and maturity. When multiple private equities are held, investment companies first need to evaluate whether to use standard models and assumptions for each investment. In some instances, different individuals may prepare the valuations for certain investments based on sector expertise or for other reasons, and the survey showed that the look and feel of the calculations supporting the valuation differed by investment for 56 percent of survey participants with private equity holdings. Perhaps more important than the format is that an investment company needs to feel comfortable it is maintaining a reasonable level of consistency relative to its process for valuing all of its private equities. It also needs to be able to demonstrate that consistency through good documentation; lack thereof may undercut the ability of those tasked with overseeing the process from knowing whether policies and procedures are being followed on a regular basis.
- **Identifying trigger points** – Generally, having very prescriptive policies and procedures relative to private equities can be difficult because each private investment may be very different. Even so, we have witnessed a shift in the survey results over the last four years regarding specificity in private equity valuation policies and procedures and the factors that would trigger an investment company to re-evaluate an investment valuation on any given day. As shown in the chart on page 5, an increasing number of survey participants pointed to certain triggering factors that are explicitly identified in their policies and procedures. This practice suggests that some investment companies have inserted more structure into their policies and procedures, perhaps to enhance consistency in approach, even if many of these factors have always been generally considered during the valuation process.

| Factors | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|
| Developments affecting the specific industry of the respective portfolio company | 70% | 57% | 56% | 50% |
| Changes in debt structure of the portfolio company | 63% | 50% | 52% | 41% |
| Changes in members of management of the portfolio company | 50% | 39% | 32% | 36% |
| Performance of broad-based indices | 43% | 29% | 36% | 27% |

- **Access to the right information** – A lack of information—public or even nonpublic—can be a major barrier to the valuation of private securities, especially for unicorns and other earlier-stage companies. Twenty-five percent of survey participants who indicated that they hold unicorns said they employ a different valuation process relative to the use and consideration of transactional information, models, data projections, and published news for these investments, compared to "non-unicorn" holdings. Regardless of whether the process is different, an investment company may wish to define upfront the information and data it expects to be available, along with the events and other changes from the date of acquisition that will be used on a go-forward basis as part of the valuation process. A key is getting comfortable with the process in place, and, in the case of outside stakeholders, being able to demonstrate that the investment company's consideration has been sufficiently robust to address a perceived informational gap.

# Odd-lot valuation

Odd-lot positions pose a particularly thorny valuation problem for investment companies. First, those responsible for valuation have to be able to recognize from the start that a position is an odd-lot. In order to recognize an odd-lot, one has to be able to define it and work within the organization to obtain adequate information to do so. It is clear from this latest survey that a universal definition for odd-lots does not currently exist. While most survey participants appear to tag odd-lots as being $1 million or less, 24 percent of survey participants said that they believe the size would differ based on asset class.

Secondly, the responsible parties need access to information and data that suggest whether the odd-lot's valuation should be the same or should be different from the round-lot price received from a pricing vendor or other pricing source. The findings show this is an active, ongoing discussion within the industry:

- Sixty percent of survey participants have had conversations with their pricing vendor regarding the ability to provide discounts/evaluations on odd-lots, up from 37 percent in the prior year.
- Forty-seven percent of survey participants have performed an analysis to determine whether odd-lots should be valued at an amount different than the price used for a round-lot, compared to 26 percent in the prior year. Fifty-three percent of those participants reported that there was not a noticeable difference in price between round-lots and odd-lots for all investment types, and 36 percent reported that the results were mixed or were inconclusive. This compares to 29 percent and 38 percent, respectively, reported last year.
- Four percent of survey participants reported they always make an adjustment to the round-lot price when valuing an odd-lot.
- Twenty-two percent of survey participants indicated they made changes to their policies, procedures, practices, or internal controls relating to odd-lots.

Regardless of whether an adjustment is made, the last bullet point is likely an important point of consideration for investment companies. The SEC's administrative order highlighted earlier suggests the need to have "sufficient objective checks or guidance for elevating pricing issues to the Pricing Committee or Valuation Committee."[6] All investment companies, irrespective of whether they hold any odd-lots, may want to reconsider if their valuation policies and procedures are sufficient to meet that objective for all investment types held and priced, regardless of whether such prices are from an internal source or from an external source such as a pricing vendor.

6 https://www.sec.gov/litigation/admin/2016/ia-4577.pdf

# Consideration of pricing sources

Pricing vendors are always on the minds of investment managers, and, for some investment companies, the level of interest has grown as a result of merger activity between pricing vendors. Twenty-five percent of survey participants in the latest survey concluded that recent vendor consolidation has created a lack of primary sources for certain portfolio asset classes, such as municipal bonds.

Year-after-year, the survey results demonstrate a willingness by participants to make changes to their pricing sources, as well as a willingness to re-evaluate their sources. This year, the survey captured a significant rise in those adding or changing their secondary pricing sources for certain securities, as shown in the chart below. This approach could very well be the result of merger activity.

As in the past, over 50 percent of survey participants visit all pricing vendors annually, and 64 percent keep formal records and documentation of such visits. The involvement of the Board in this process is consistent year over year, with only two percent of the survey participants reporting that a Board member attends all visits and 16 percent of the survey participants indicating that a Board member attends periodically at least one visit. In 19 percent of the cases, the non-interested Board members review management's pricing vendor due diligence questionnaire/checklist before management conducts its visit. Also, pricing vendor due diligence and contingency planning continue to be top of mind as well. Recent questions around "fourth-party" vendors who are supplying pricing and/or data to the pricing vendors proves that managing the risks of the mutual fund service providers does not stop at the pricing vendor. Investment managers may wish to consider including in their due diligence meetings agendas with pricing vendor questions about their internal controls and business continuity plans.

| Changes to sources for fixed-income securities | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|
| We have changed our primary pricing source for certain securities | 20% | 16% | 16% | 22% |
| We have added or changed secondary pricing sources for certain securities | 47% | 24% | 30% | 34% |

# Other key findings

This year's survey brought to light some other notable findings relating to valuation policies and procedures, Board governance, and specific investment types, to name a few.

## Valuation policies and procedures

- Fifty-three percent of survey participants indicated they would only initiate a price challenge when they have conflicting market data that suggests the price is not accurate. Seventy-five percent of survey participants may change a price if they believe it is not accurate even if they have not received a response from the pricing vendor.

## Board governance

- Sixty-seven percent of survey participants reported that the full board, a committee of the Board, or one or more Board members receive information regarding price challenges. This practice has grown considerably from the 40 percent reporting such in the survey five years ago.
- Twenty-five percent of survey participants reported that the percentage of the overall board agenda dedicated to valuation increased over the past year, while two percent of survey participants indicated that it decreased.
- Twelve percent of Boards, up from 11 percent in the prior year, engaged a third-party consultant in the past year to perform an independent valuation. Of those Boards that did engage a third-party consultant, 73 percent engaged a consultant to assist with private equity investments.

We also noted that some survey participants made changes over the last year in other areas of Board governance. The percentage of survey participants making a change relative to certain governance aspects are shown below, along with the comparative statistics for the prior two years:

| Aspect of board governance changed | 2017 | 2016 | 2015 |
|---|---|---|---|
| Level of detail provided to the Board | 28% | 30% | 45% |
| New types of materials provided to the Board | 15% | 15% | 38% |
| Frequency of Board discussions on valuation | 11% | 10% | 13% |
| Delegation of responsibilities by the Board | 1% | 2% | 3% |

## Fair valuation considerations for specific investment types

- Survey participants reported different pricing approaches in the event of an unscheduled New York Stock Exchange (NYSE) closure. Twenty-nine percent said that they would use a composite price, 23 percent would designate another exchange on which the security trades and use the price on that exchange, 21 percent reported that they would use the most recent NYSE price, and the remainder said that they would rely on another alternatives.
- Forty percent of survey participants reported using zero triggers to fair value foreign equities, down from 48 percent in the prior year and the lowest percentage we have observed in several years. That said, none of our survey participants reported increasing their trigger percentages, suggesting that the percentage change has more to do with who participated in the survey than a shift away from zero triggers. In fact, five percent reported they moved to a zero trigger over the last year.
- For those using triggers, the S&P 500 (most commonly with a 50 basis-point trigger) and S&P 500 futures (most commonly with a 75 basis-point trigger) are the most frequently used proxies, just as they were in the prior year.
- Thirty-five percent of survey participants indicated they receive and apply a standard factor provided by a pricing vendor when adjusting the closing exchange price on foreign equities held in their passively managed exchange-traded funds, compared to 47 percent in the prior year.
- Twenty percent of survey participants have contracted with a vendor to provide security liquidity data/factors/bucketing.
- Twenty-nine percent of survey participants reported that they primarily use clearinghouse prices to determine the valuation for cleared swaps, down from 37 percent in the prior year. Sixty-two percent of survey participants primarily value cleared swaps using a price calculated by a pricing vendor, up from 55 percent in the prior year.

## Other considerations

- Sixty-one percent of survey participants reported they have an employee who has specific responsibility to manage and oversee the fund group's valuation process, nearly unchanged from the 58 percent reporting such last year.
- Fourteen percent of survey participants noted that they had fair-valued cash balances in currency-controlled countries during the last 12 months, compared to nine percent last year.
- Eighty-one percent of survey participants reported that the disclosure in the notes to the financial statements regarding how holdings are valued is essentially the same as that shown in the registration statement (as amended), compared to 73 percent last year.

# Looking ahead

Investment companies continue to focus on having the right people and processes in place to achieve their best estimates of fair value for each investment and their shareholders. Over the coming year, the following may be points of special focus:

### New ways to meet objectives

Increased technological capabilities in almost all facets of life continue to put pressure on participants to find new ways to meet objectives affecting investment managers. Naturally, some investment companies are considering the impact of these capabilities on the valuation function. For example, 30 percent of survey participants reported that they have looked for ways to improve the efficiency of the valuation process and to reduce redundancies. Twenty percent indicated they have increased the use of automation over the last 12 months. We expect these trends to continue for the next twelve months.

Additionally, as noted earlier, 21 percent of survey participants noted that their fund complex is exploring how to use data analytics, offshoring, or robotics process automation to improve the efficiency, costs, and effectiveness of the valuation process. Whether the valuation space will be invaded by “bots” is uncertain, but change certainly appears to be looming on the horizon.

### Governance matters

Even with the leadership changes at the SEC, it is unlikely that the regulator will stop looking at Boards as key stakeholders relative to the valuation of portfolio securities. Boards have continued to see their agenda and responsibilities expand and have risen to the occasion.

To meet these demands, Boards should continue to look for opportunities to facilitate their record of continuous oversight of the valuation process. Governance trends that support these efforts could include enhancing the valuation policies and procedures to include those “moments that matter” in which the Board “must be involved” or “must be notified” to address changing valuation issues, initiating and documenting ad hoc valuation discussions when issuer, industry, country or political events occur, and challenging the Board reporting to ensure that information and data received from management is precise and concise enough to advise the Board of changing market conditions and/or changes in asset classes that will impact existing pricing methodology. Here, the use of risk valuation dashboards, key valuation indicators, data analytics, and automation can help improve Board reporting materials.

## Understanding nuances of available investments

Technological advances will lead to an increasing number of investment opportunities in emerging industries that are driven by higher demand for Fintech and new payment methods, such as cryptocurrencies. As it relates to private equities, access to information on newer investments may be less than what investment companies are used to having at their disposal. Scrutinizing such new investments in advance and understanding how they will be valued will be crucial to meeting the objectives of fair valuation.

## Implications of new regulation

With the adoption of the mutual fund modernization rule and the liquidity rule, there could be several stress points to the valuation process. First, with the modernization rule, external parties will be able to compare valuations across investment managers as well as within the fund complex.  We would expect investment managers to have some risk-sensing capabilities to front-run potential inquiries and build the discovery of valuation outliers into the overall valuation challenge process. The liquidity rule presents more of a direct valuation challenge as the very nature of selling a large portfolio position has an impact on valuation. Given the increased transparency and reporting that is required under the liquidity rule, the question of how liquidity determinations impact the value of an asset class will likely crop up more and more. Investment managers and Boards should keep a close eye on the SEC's point of view on this topic, as a change in practice to adjust for liquidity might impact valuations and, in turn, fund NAVs— and suggest the need to communicate to mutual fund stakeholders.

## Industry challenges

Investment managers have been challenged in the past several years in ways previously unseen in the mutual fund industry. Margin compression, talent outsourcing and retention, technology adoption and disruption, reduced expected returns and the shift to passive versus active investing, and the resulting impact on management fees are all combining to add new pressures to the investment management industry. Thus, now more than ever, investment managers need to keep a close eye on controls to stay on top of management bias and conflicts of interest. The importance of investment valuation to the calculation of performance and NAV, and the resulting impact on compensation and financial results, make it critical that robust and transparent controls are in place to manage these risks.

# Let's talk

Deloitte's 15th annual Fair Valuation Pricing Survey aggregates the views of 89 mutual fund firms with assets under management in excess of $5.6 trillion. The population of survey participants represents a diverse mix of mutual fund firms encompassing various sizes, asset classes, and geographies. The survey was conducted between July and August 2017.

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