IRISH FUNDS INDUSTRY ASSOCIATION

Portfolio Valuations: Perspectives, Roles & Responsibilities

28th January 2010

Agenda

- 2:30 – 2:40 Welcome
- 2:40 – 3:00 Portfolio Valuations: Academic Developments
  - Prof. Paolo Guasoni (Dept of Mathematical Finance, Dublin City University)
- 3:00 – 3:20 Portfolio Valuations: An Investor's Perspective
  - Peter Carney, Abbey Capital
- 3:20 – 4:10 Panel Discussion - Portfolio Valuations: Roles & Responsibilities
  - Olwyn Alexander - PwC (Chair)
  - Shaun Brick - CQS
  - Mike Kirby - KB Associates
  - Eoin Motherway – BNY Mellon
- 4:10 – 4:30 Portfolio Valuations: The Views of a Litigator
  - Kieran Cowhey – Dillon Eustace

Academic Innovations in Portfolio Valuations

Paolo Guasoni

Boston University and Dublin City University

Irish Funds Industry Association
Valuation – Roles and Responsibilities
January 28th, 2010

Outline

- FMC^2
- Valuation Issues

What is FMC^2

- Financial Mathematics and Computation Cluster
- First Finance initiative of Science Foundation Ireland
- Brings together:
  - University College Dublin
  - Dublin City University
  - National University of Ireland at Maynooth
  - Industry:

    Pioneer Investments, Ryan Capital, Institute of Bankers

    More partners wanted
- Goal:

  Advance Finance research in Ireland.

  Step up training in the Finance profession.

Who is FMC^2

- Prof. Anthony Brabazon (UCD), Principal Investigator
- Prof. John Cotter (UCD)
- Dr. Michael O'Neill (UCD)
- Dr. David Edelman (UCD)
- Prof. Gregory Connor (NUIM)
- Prof. Paolo Guasoni (DCU)
- Financial...
    - Mathematics
    - Economics
    - Computation

Growing Together

- What FMC^2 can do for you?
  - Bring new ideas to old problems.
  - Help develop new valuation models.
  - Work with you on problems of mutual interest.
  - Increase industry knowledge of future graduates.
- What FMC^2 cannot do
  - Fix short term problems.
  - Perform routine implementations.
  - Develop production software.

Valuation and Liquidity

- What is the Price when there is no Market?
  Pricing illiquid positions in Hedge Fund portfolios.
- Liquidity: one word, many meanings.
  - Tightness?
    how close are the bid and the ask?
  - Resiliency?
    how quickly do prices recover from a large trade?
  - Depth?
    how large an order can you execute at quoted prices?
- Still more aspects for valuations
- Asymmetric information and Incentives central.

What’s in a NAV?

- Affects:
  - Subscriptions and Redemptions
  - Performance Measures (e.g. Sharpe ratio)
  - Performance Fees and High-Water Marks.

- Consequences of accounting practices.

- Fair Value for whom?
  - Existing Investors
  - New Investors
  - Managers

Cost Accounting

- Looks at past trades. No (or little) guesswork.
- May not reflect current value.

  Opposite mispricings for subscriptions and redemptions.

  Fund runs in a crisis?

- Affects performance measures and fees. Incentives?

- I expect a position to lose value, but valuation is near.

  If I close the position now, the loss is small, but reduces my performance fees.

  Or I can leave it open, and value it at cost. The loss may be bigger in the future, but current fees are not affected.

Manager’s Valuations

- More informed or more accurate? Incentives again.
- Smoothing returns.

  Several small returns makes your Sharpe ratio better.

  One big price change makes it worse.
- Lower valuations when redemptions expected?
- Wishful thinking?

Mark to Model

- No alternatives for complex derivatives. Model risk?
- Which Model? And which parameters?
- Consistency.
  Same model, with same parameters used to price similar contracts?
- Overfitting.
  Torture a model long enough and it will tell you anything.
- Thus do they all.
  Popularity is not accuracy. Gaussian Copulas and CDOs.

An Investor's Perspective on Portfolio Valuations

Peter Carney, CFO, Abbey Capital

28th January 2010

Abbey Capital

- Founded in Dublin, Ireland in May 2000
- Excess of $2.4Billion allocated to managed futures and FX managers (CTAs) across two fund vehicles
- Investment allocators that have expertise as successful traders and also managing trading teams for an average of over 20 years each
- Full transparency of positions - daily liquidity for Abbey Capital’s fund investors
- Multi-Manager Portfolios - allocate to each manager at a targeted volatility level
- Portfolio includes different strategies that target a reduction in overall portfolio volatility

Hedge Funds in the Limelight!

- Recent scandals show deficiencies in due diligence/regulatory oversight
- Credit crunch and focus on hedge funds
- Regulator response - push for additional regulation
- Renewed focus on transparency and liquidity since 2008
- Investors need to know where their money is at all times
- The case for mark to market investments

What are the Key Concerns with Hedge Fund Investing for Investors?

- What are the key concerns associated with hedge fund investing?
  - Valuation
  - Fraud
  - Liquidity
  - Transparency
  - Risk control
  - Credit risk
  - Gates / Lock ups
- Additional concerns when allocating to CTAs
  - Unauthorized trading
  - Style drift

Valuation – Who is Responsible?

- Prospectus - Directors
- Directors – delegate responsibility to Administrator
- Administrator – keeps the books and records
- Administrator – seeks approval on NAV from Investment Manager
- Investment Manager – member of the Board of Fund
- Segregation of Duties – collective responsibilities
- Valuation error – the investor will look for the Fund for re-imbursement
- The Fund will seek recourse from the source of the valuation error – Administrator or Pricing Vendor

Valuation – Abbey Capital Approach

- Independent calculation of daily NAV by Investment Manager
- Portfolio is mark to market daily
- Instruments traded offer daily liquidity – pass this to investors
- Perform 3 way reconciliation between administrator, broker and Abbey
- All trade breaks confirmed daily
- Ability to liquidate account immediately*
- Monitor CTA trades on a daily basis
- Conduct in-depth risk analysis
- Keep third party service providers honest!

**Liquidation of contracts is subject to market conditions.*

Due Diligence Process – What do investors expect

- Objective
  - **Ensure the manager has adequate infrastructure and control environment in place to support trading activities**
- Process
  - Verification of portfolio valuation
  - On-site due diligence visit by an operation’s profession
  - Assessment of the employee skill set of the teams supporting the business
  - Walk through of the systems and controls in place at each Manager
  - Look for weakness in internal controls
  - Complete Annual update visit
  - Prepare detailed report for review by the Investment Professional

Control of the Funds Assets – What do investors want

- Objective
  - **Safeguard client assets through diversification of counterparty and credit risk.**
- Process
  - Review of counterparty credit ratings
  - Diversification of counterparty risk – understanding these risks
  - Use of an independent Custodian for all client assets
  - Selection of bank owned clearing brokers operating in highly regulated jurisdictions
  - Maintenance of minimum excess margin balances with the clearing brokers
  - Segregated accounts

AbbeyCapital

Summary – What Investors Want

- Mark to market
- Liquidity
- Transparency
- Effective risk management
- Manager to deliver strong risk adjusted returns over the long term horizon

For further information

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Panel Discussion - Portfolio Valuations: Roles & Responsibilities

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Thank you