

# OTC Derivatives Valuations -Trust, but Verify

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*Investors, and the fund managers they invest with, have this year turned a sharper eye toward valuations. The spotlight is especially focused on OTC derivative valuation, due to their complex combination of multiple pricing models and data sources compared to the transparency and observable pricing of exchange-traded securities. Transparency into the price determination process is now a requirement for every sophisticated investor. References to “valuation policies”, “manager marks” and “single source pricing” are now routine during investor due diligence and when making investment allocation decisions. “Appropriateness”, “consistency” and “verification” are the new watch words. GlobeOp highlights recent OTC derivative valuation trends and their implications.*

After riding the steep drops and sharp turns of the rollercoaster that was 2008, there is a distinct and certain change on the 2009 horizon. The days when investors simply trusted the veracity of their investor statements are over.

Investment committees that previously focused on analyzing alpha and risk from investment managers' figures now demand increased comfort around the accuracy of the positions and valuations underpinning net asset value (NAV) statements. Are the positions real? Are the valuations that drive NAV reflective of the market? The quest for alpha has become in part the quest for confidence.

“Trust, but verify” became a mantra in 2009. Investors performing due diligence now regularly seek proof that positions are being scrupulously and independently checked with custodians, prime brokers and counterparties.

But how can investors be confident about a fund's portfolio valuations?

For instruments traded on an exchange, supply meets demand and an observable clearing price is objectively determined. But for OTC valuations, price determination is more subjective:

- Timing, information disparities or position biases can produce wide divergence in price quotes from traditional sell-side dealers
- Non-standard products create unique pricing challenges
- Consistent pricing from multiple dealers on hard-to-value securities may conceal the fact that each dealer's view of these prices can be traced to a single market maker
- Prices derived from underlying data can be influenced by choices of data source and model implementation



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- External vendor valuations can be affected by data control maintenance and vendor expertise
- Dealers may be influenced by their own positions.

Arriving at fair value can be a painstaking process requiring significant expertise and generating much debate. Ultimately, when all sources have been gathered and vendors results are provided, derivative prices can resemble a collection of opinions - judgment is required to determine which to rely upon. An independent valuation specialist can offer the manager guidance and support, and provide transparency into the process for investors and managers alike.

#### **Valuation policies: Assuring best practices and adherence**

To bring order to chaos and respond to investor transparency demands, an increasing number of funds are implementing valuation policies. Committing to a pricing policy establishes a fund blueprint for consistently applying pricing methodologies and hierarchies, tolerance limits and a process for managing price exceptions. An independent valuation service should review the draft policy against best practices. Both the policy and service provider should be accessible to investors performing due diligence.

## **“Independence, clarity, consistency & transparency are key.”**

Valuation policies are not absolute, however. First, they must be viewed in the context of the investment strategy. A fund manager employing a relative-value strategy may appropriately price positions in relation to an underlying benchmark or hedge instrument, while a long-only fund would price the same positions referencing absolute price quotes. Because best practices don't exist in a vacuum, the valuations policy should be independently assessed in the context of a fund's strategy and the relative size of its positions and market liquidity.

Second, valuation policies should be updated frequently. Additional data sources, specialized product valuation vendors and market analysts continuously provide new information and perspectives to the valuation process. Moreover, though valuation policies are designed to apply consistent rules, those rules must be measured against the valuations that result. For example, if the rules result in over-reliance on manager marks, even in compliance with policy, independent verification can identify and report this. Increasingly, fund directors and boards are requesting independent review, timely reporting and guidance from their valuation service.

### **Price Verification**

The process of independent price verification should be clearly distinguished from the role played by valuation vendors.

Pricing vendors are used to provide third-party prices for a specific set of products, and often use proprietary data.

Independent valuation services combine this data with other pricing information obtained directly from sources such as counterparties and prime brokers, as well as from the fund manager.

As a control against third-party pricing, the valuation verification agent should, whenever possible, also calculate its own prices using information obtained independently as well as positions verified directly with counterparties.

The valuation service then analyzes all price data to identify discrepancies, stale prices or specific directional bias for individual instrument types. Tolerance checks can detect unsupported price changes and disparity among instruments. These differences, or breaks, can be assessed for their impact on the value of the fund.

Most importantly, by aggregating all prices on all instruments, the independent valuation specialist facilitates an objective assessment of their total impact on the performance of the fund. Similarly, statistics such as single-source prices and pricing exceptions can be analyzed for their impact on the portfolio's valuation.

### **Independence and Transparency**

Trust, but verify. Today's investors and fund directors increasingly demand that funds have these independent checks and balances in place to facilitate accurate

valuations. Fund managers are therefore seeking robust solutions that demonstrate strengthened oversight and transparency.

Independence alone is, however, not sufficient. For example, simple solutions such as relying solely on dealer or counterparty marks for independence have proven to be deficient. In the autumn of 2008, hard-to-value securities that exhibited price consistency and stability over time often masked unreliable valuations that changed precipitously when the largest dealer had a change of heart, forced by market exigencies or capital requirements. A rigorous and comprehensive verification process would check prices for consistency with similar securities in the same sector, or compare them to trades observed in the market.

In addition to independence, clarity, consistency and transparency are key requirements of both fund managers and their investors. On-demand web-based technology can bring fund managers closer to their data, providing granular trade and valuation details. Traders and risk managers, as well as fund directors, can also benefit from improved transparency into the valuation process.

### **Conclusion**

The emergence of new instruments such as carbon offset and life insurance-based derivatives prove that derivatives remain an important vehicle for alpha generation. Investor awareness of valuation risk offers fund managers an opportunity to differentiate their funds through clearly delineated valuation policies and a demonstrated commitment to the highest standards of governance. The derivatives industry is realizing that all the pillars of derivative trade processing support each other. Centralized, integrated, straight-through processes and transparent data are key. Independent valuation policy monitoring and price verification are proactive steps that reassure investors. Fund managers can then continue to focus on alpha generation. ■

### **AN OTC DERIVATIVE VALUATION BEST PRACTICE CHECKLIST**

A defined fund valuations policy, regularly reviewed at board level and by an independent valuation specialist, would include current best practices such as

- ✓ Independent valuation
- ✓ Comparative analyses from multiple pricing sources when available
- ✓ Defined tolerance limits, testing and resolution procedures
- ✓ A valuation committee responsible to the board, with defined responsibilities and authority
- ✓ Employing single valuation experts across multiple managed accounts to
  - perform consolidated valuation checks across all accounts, and
  - verify consistent pricing across different account managers.
- ✓ Measurement of valuation policies against results achieved.