Timing Is Everything
... when it comes to pricing an alternative investment portfolio

As a San Franciscan who has daily contact with people in New York and throughout the world, I’ve learned to qualify all communication regarding ‘time’ with a date and time zone. When I do that, I experience smooth conference calls, and when I forget, I receive an unexpected phone call in the middle of a sound sleep. I appreciate that it is not our different perspectives on the current time that is the problem, but rather our lack of identifying and respecting those differences.

Similarly, if you are responsible for pricing a portfolio of alternative investments at an endowment, family office, fund of hedge fund, or other institution, you are aware of the differences in valuation timing and qualification that come from the managers, compared to your own. This in itself isn’t a problem, but there are most definitely challenges around identifying and respecting these differences. If you handle these differences well, you have consistency in your reporting; if you don’t, then it becomes very difficult to clearly report performance numbers to your stakeholders, to your portfolio management team and to your fund accounting team.

A clear vocabulary around valuation timing is the first step in articulating and addressing the challenge. Primary areas that warrant attention include:

- **Data Quality** – Hedge funds and private equity funds may provide pricing sporadically during the month, followed by a month-end estimate valuation and later by a month-end final valuation. Mid-month estimates come weekly, if at all. Month-end estimates come 1 – 15 days after month-end, and month-end final valuation can come anywhere from 5 days to 6 months after the month-end. As an investor into these managers, you need to note the quality of any price you collect, and be prepared to account for any non-final prices you have used in striking your own NAV.

- **Net/Gross** – You should be aware of whether the valuations you receive are gross or net of fees. Managers often send estimate valuation as gross returns, and month-end final valuation as net returns, after charged or accrued fees. If you are given gross valuations, you should be doing your own calculation of the fees in order to use net valuation for your own NAV. This involves tracking high-water-mark and fee structure on each lot, which is not a trivial task.

- **Timing Relative to Your NAV** – Final manager prices may come to you in a timely manner so that you can allocate unrealized income to the correct investors, but they can also come after you have already closed your fund for the month. Closing your fund on manager estimates creates challenges around investor allocations, manager performance tracking, and subsequent period transactions.
- **Investor allocations** – You will need to book true-up income in a period later than when it was earned, so you need a clear policy on how you allocate this true-up income to investors.

- **Manager performance tracking** – If you compare managers to peers or to benchmarks, then you should track the manager’s true performance for each month, which is now different from your accounting view of their performance. The true performance is based on the manager’s final valuation, even though you didn’t use that in accounting.

- **Subsequent period transactions** – Subsequent period transactions are based on the manager’s closing final price, not on the estimate you used to close your fund. If you book a redemption in the subsequent month, it cannot be at the estimate price you closed on, but rather on the final price which the manager published as their NAV. You need to account for this discrepancy before processing the transactions.

If final pricing for a fund comes in three months after month-end, and you have long since closed the period and reported performance, one could argue about the relevancy of such a price – but let’s leave that discussion for a subsequent paper.

While there is no one right way to handle valuation timing, a fund must have a consistent valuation policy with corresponding operational process, supporting technology that implements the policy and procedures, and transparent reporting to its investors.

**Price Drift reports**

The timing issues around pricing necessitate some good reporting on the price drift across time.

- **Manager Drift** tracks how a manager fund’s estimates compares to its finals. A historical view of manager drift identifies managers who consistently have unreliable estimates, and identifies if the manager final comes in time for the final fund NAV, or as a future month true-up.

- **Portfolio Drift** tracks valuation changes between two NAVs for your own fund. For example, if a funds strikes its own estimate on EOM+5, and its final NAV at EOM+25, a portfolio drift view shows the investments that changed value from one point in time to the next, and how much each one contributed to the overall change in the fund’s NAV.

- **Accounting Drift** tracks the difference between accounting and portfolio’s view of valuations. A manager’s true return is the change from last month’s final to this month’s final, regardless of the
valuation you used when closing your own fund. You calculate a manager’s true return by starting with the accounting numbers, then backing out any prior month true-up booked in the current period, and including current month true-up booked in future periods. This drift report or a historical view of the true manager return is interesting for peer comparison.

Cogency Insight

Cogency Insight is Cogency Software’s fund accounting and portfolio management solution for endowments, family-offices, fund of hedge funds, and other multi-manager investors. It was designed to handle the complexity of pricing described herein, with some of these key features:

- **Price quality** – Cogency stores the data quality with every position price, and allows any number and sources of prices to be tracked for each position, each period.
- **Portfolio snapshots** – Cogency automatically takes a snapshot of all prices used in a fund valuation, so you always have documentation of the prices and data qualities used to strike a NAV.
- **Post-close price true-up** – Cogency allows you to book post-close valuation true-up in subsequent periods, identifying it as a true-up of a specified prior period.
- **Sequenced transactions** – Cogency allows you to sequence investment transactions, and automatically applies true-up income before any other beginning of month transactions.
- **Customizable price drift reports** – With all of the above information stored in a secure and centralized database, you can now run all manner of drift reports to understand the effect of timing on your portfolio, your investors, and on the manager returns you track.

Conclusion

Valuation timing will be an ongoing challenge to investors into hedge funds and private equity funds. It is part of a healthy dialogue that shapes the ongoing evolution of how we invest. The nature of the underlying investments will always create different valuation timings – the long/short hedge funds may report final valuation within 10 days, while distressed hedge funds or PE funds will likely continue to report finals far beyond month-end.

Firms with portfolios of alternative investments must implement consistent standards to handle these differences with regards to their own NAV, their performance reporting vis-à-vis benchmarks, and their portfolio analysis. This paper identifies many of the relevant issues – it is up to the firms to choose a process and technology that helps address them.