Valuing Hard-to-Value Assets

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Topics Covered

• DOL position
• Marking to market
• Why is this important and what is the impact?
• Using level I, II, and III asset categorization
• Handling assets that do not have a secondary market
DOL Position

• Auditor must follow generally accepted auditing standards (GAAS)
• One audit standard is that the plan must use generally accepted accounting principles (GAAP)
• GAAP requires asset valuation at market value
Legal Considerations

- Trustee Responsibility
  - Fiduciary status
  - Establishing and understanding investment policy
  - Selection of investments
  - Continued monitoring of investment policy
  - Continued monitoring of managers
Who Is a Fiduciary?

- State/Non-Federal Government Plans
  - Determination will be generally controlled by local or state law
  - Generally will include the same classes of persons, most states borrow from ERISA in this respect
Your Fiduciary Duties

The Basics

• **Exclusive Interest:** Act in the exclusive interest of the participants and beneficiaries
• **Prudent Person Standard:** Act “with the care, skill, prudence and diligence under the circumstances prevailing that a prudent person acting in a like capacity” would act.
• **Diversify Investments.** Don’t put all of your eggs in one basket.
• **Act in Accordance with Plan Documents.** Follow the plan, unless it conflicts with ERISA.
Your Fiduciary Duties

• **Common Question:** Alternative assets in particular are complex and very difficult to understand. How am I as a trustee to meet my fiduciary obligations when I am not an investment manager, accountant, actuary and attorney all rolled into one person?
Your Fiduciary Duties

• **Answer:** Get help! ERISA allows you to select and hire providers to advise you and assist you in performing your fiduciary duties. The law allows you to rely upon their expertise and recommendations when making decisions regarding operation of the Plan. You can also delegate elements of plan operation to them. Some (typically administrators or investment consultants) may even have full discretion, meaning their decisions do not have to be approved by you.

**BUT . . .**
Your Fiduciary Duties

- **Selection (hiring) is a fiduciary function!**
- Use a request for proposal (RFP) process
- When selecting a provider, each should be given identical information about the services required
- All compensation (direct and indirect) must be disclosed
- Obtain background information on the provider
- Document your selection process

**BUT . . .**
Duty to Monitor

• Hiring a provider does not mean your job is done! Your fiduciary duties are about **more** than just what **YOU** do. You also have a duty to monitor your service providers. Hiring service providers does **not** mean your plan is now on “autopilot”.
Duty to Monitor

- **Common Question:** Ok, so I have this duty to monitor my service providers. But, I am back to my original question. I am not an investment manager, so how am I supposed to monitor what my consultant and managers are doing with the plan?
Duty to Monitor

**Answer:** There are many ways to satisfy your duty to monitor:

- Stay educated and informed
- Review their performance
- Read their reports
- Verify the fees being charged
- Ask about policies and practices
- Follow up on participant comments/complaints
Everything about your fund’s investment will be controlled by the governing documents. It is important to have them thoroughly reviewed by your consultant and the fund’s legal counsel.
Questions to Consider

• Does this investment fit within our investment policy statement?

• What is the benchmark? Any soft dollar fees? Any performance “kickers”?

• If the investment is an alternative (i.e., real estate, private equity, hedge fund) is it appropriate for our type of fund and the size of our fund?

• What are the reporting requirements—both to and by our fund?
Questions to Consider

• Does the investment have an “escape” clause, or do we have to leave our money in for a fixed period of time?
• If our money will be tied up for a long time, is that appropriate for us? Do we have liquidity concerns?
Trustee Best Practices

- Request that legal counsel and/or your consultant provide a written certification that the documents do not reveal any material problems or instances of legal non-compliance.
- The consultant should also certify in their letter, or at a minimum in the minutes, that the investment is recommended and fits within your fund’s investment guidelines.
Trustee Best Practices

• If your consultant does not opine on alternative investments, seek out a special consultant for this purpose.

• The bottom line is evaluating all fund investments, not just the hard to value ones, is a team effort! Your professionals need to work with you and together to help you meet your fiduciary obligations.
Typical Hard-To-Value Assets

• Real Estate
  – Commercial
  – Residential
  – Mortgages
• Hedge Funds
• Private Equities
• Limited Partnerships
Typical Footnote for Hard-To-Value-Assets

- The net asset value is used as a practical expedient to estimate fair value. The net asset value is based on the fair value of the underlying investments held by the fund, less its liability.
You Must Understand Possible Additional Reporting Requirements

- Foreign Bank and Financial Accounts (FBAR)
- Form 926 U.S. Transfers to Foreign Corporation
- Form 990 Exempt Organization Business Income Tax
- Form 8865 Foreign Partnerships
- Form 5471 Foreign Corporations
Discrimination on Form 5500 Question 4g

- Current value is neither readily determinable on an established market, nor set by an independent third party appraiser
- Exclude:
  - Guaranteed investment contracts
  - Participant directed accounts (404c)
  - Participant loans
- Trustee responsibility
Financial Statement Fair Value Measurement Disclosure

- Level 1—unadjusted quoted prices in active markets for identical assets (stocks, mutual funds)
- Level 2—quoted market prices for similar assets in active markets or for identical or similar assets in markets that aren’t active (bonds, government securities)
- Level 3—valuation is based on significant unobservable inputs (real estate)
- Net Asset Value (NAV) —valuation is based on the fair value of underlying assets (fund of funds, private funds, real estate funds)
## Financial Statement Fair Value Measurement Disclosure

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<th>Level 1</th>
<th>Level 2</th>
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Contractual Considerations

- Reports—what kind, who gets them, how often
- In the governing documents:
  - Fee Considerations
    - Performance “kickers”
    - “Soft dollar” payments or indirect compensation
    - Benchmark for performance
  - Valuation; how is your plan’s account valued?
  - Termination/cash out provisions
  - Is there an entry or exit que and how long is it?
  - Custody arrangement—who will custody the investment?
Common Hurdles

• Many hard value assets have documents common to all investors, so managers will almost never agree to change them

• Solution = try to get a “side letter”. This memorializes a special arrangement between an investor and the investment fund
What Should Trustees/Investment Committees Do Periodically

- Understand how these investments are valued
- Understand who is responsible for valuing the investment
- Inquire about the consistency of the valuation process
- Understand how prior valuations and actual sales compare to one another
- How does the manager oversee the investment?
- Are there environmental, legislative or other non-financial influences that may or should impact valuation?
1. Describe, in detail, the fair value techniques and methodologies used to determine fair value. Please describe how often these techniques are utilized and describe the internal controls that exist over the determination and review of fair value. Please provide the name of the individual(s) responsible for fair value and how long they have been employed by the investment.
Questions for Managers of Hard-To-Value Assets

2. Have you made any changes to the process or underlying assumptions used in valuing investments? If so, what are the changes and what created the change?

3. Please describe which steps of independence exists within the valuation process?

4. How often are valuations prepared and who prepares them?
Questions for Managers of Hard-To-Value Assets

5. What can be done to accommodate an investor who has a different year end?

6. How often are fair value estimates compared to actual dispositions and what process is used to communicate these differences to investors?

7. Can you provide a schedule comparing recent dispositions to sales prices received?
Questions for Managers of Hard-To-Value Assets

8. What firm performs the independent audit for the investment and what was the auditor’s report date for the most recent audit?

9. Were there any internal control weaknesses communicated by the auditor?

10. Were there any management letter comments regarding valuation practices or procedures?
Questions for Managers of Hard-To-Value Assets

11. Describe how the investment’s independent auditor is selected.
12. Who selects the independent auditor?
13. When did the last change in independent auditors occur and what was the reason for the change?
14. Does the investment provide a SSAE No. 16 SOC 1 report, who performs this service for the investment and when was the most recent report released?
Questions for Managers of
Hard-To-Value Assets

15. What were the findings from the most recent SSAE No. 16 SOC 1 report?

16. Describe how the individuals’ who are responsible for determining fair value are compensated.

17. Describe the reporting structure within the firm of the individuals’ who are responsible for determining fair value.
Questions for Managers of Hard-To-Value Assets

18. Describe the ownership of the firm
19. How are disputes over asset valuations resolved?
20. How is the timing of write-downs arrived at?
21. Describe how derivatives and leverage are used by your firm.
22. Describe the risk management process for monitoring counterparty risk, leverage and investment exposures.
Questions for Managers of Hard-To-Value Assets

23. Please provide a description of your firm’s E&O coverage and what it covers.

24. Have there been any disputes with your auditors over asset valuations?

25. Why do you believe that the method that you used to value assets provides a reasonable approximation of their fair value?
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