

What Every Trustee Should Know: The Five Myths about the Fair Value of Alternative Investments

Introduction: Financial Accounting Standard 157, also known as the fair value standard, has changed the requirements for demonstrating that a Fund's investments are measured at fair value. Based on conversations with Trustees and their auditors, it appears that several myths have developed around the application of the fair value standard to alternative investments (AI). Perhaps the biggest disconnect relates to the relationship between accurately assessing the fair value of a Fund's alternative investments and a Trustee's fiduciary responsibility. This note responds to the myths that have emerged in the hope of bringing clarity to the issues that the myths reflect.

Myth 1. Alternative investments do not include traditional asset classes.

Answer: AI includes traditional asset classes: private equity (common and preferred stock issued by private firms) and fixed income securities. The real difference between AI and marketable securities is that the former do not trade on an exchange or on over-the-counter markets where quoted transaction prices are readily available. AI by their nature are generally illiquid and even where a quoted price is available it may be "stale" and therefore the price may not reflect fair value as defined in Financial Accounting Standard (FAS) 157. Alternative investments include: stable value funds (e.g. Guaranteed Investment Contracts (GIC), private convertible and straight debt, hedge fund investments, collateralized mortgage obligations (CMOs), collateralized debt obligations (CDOs), some types of mortgage back securities (MBSs), real estate funds, and private equity funds to name the most typical alternative investment categories.

Myth 2. Auditors have not required that the FAS 157 standards be rigorously applied to Pension Fund investments.

Answer: The audit guidelines are quite clear that FAS 157 standards be applied to all asset classes. The standard is critical to all plans that are audited independent of whether a full or limited scope audit is performed. While public plans are governed by the Government Accounting Standards Board (GASB), GASB is on a near-term path to adopt a version of FAS 157. The pressure to adopt a version of FAS 157 stems from the public's requirement that the financial condition of public plans be fully transparent: **For defined benefit plans asset prices should reflect their market values at the measurement date relative to the present value of expected liabilities.** Although FAS 157 does not say when the fair value standard needs to be applied, it does indicate what inputs must be used to establish it. *Although fair value reporting has been in*

*place for a while, the difference between stating an asset is measured at fair value and demonstrating this is the essential change created by the adoption of FAS 157. Market prices at the valuation date are the best measure of fair value. The problem is that prices may not be available, may be stale if they are, and a current price quote from a dealer may not reflect an actual transaction. **A price provided by a vendor that does not reflect an actual security transaction does not represent fair value unless it is demonstrated that the price quote is consistent with market participant assumptions at the measurement date.***

Myth 3. Asset classes like AI that represent a small percentage of a Fund's portfolio do not have to meet the rigorous fair value standards established by FAS 157.

Answer: The short answer is they do. Furthermore, by not properly fair valuing all assets, Trustees may pursue an investment strategy that is inconsistent with the Fund's long-term investment objectives. To see this, consider a Fund valued at \$1.0 billion at year end 2008 where 10% of the Fund is invested in illiquid fixed income and equity securities- its long-term target. Based on the performance of stock and bond markets during the first quarter of 2009, the value of the Fund's marketable securities declined by 50% as of March 31, 2009. If the fair value of AI did not decline, then the percentage of the fund allocated to AI rises to 18% which in this case is well above its 10% target. If 90/10 is the desired long-term mix and the Fund is required to rebalance when values significantly deviate from long-term targets, then the scenario outlined above means that either no money is allocated to AI or some portion of this asset class needs to be sold. However, if AI investments did decline in value, something a FAS 157 analysis would uncover, then reducing exposure to AI investments may not be the correct investment strategy. Indeed, depending on the fair value decline, the appropriate strategy may be to purchase more AI and marketable securities. **The point here is that a FAS 157 analysis would not only indicate the fair value of the Fund's assets but inform the Trustees about the Fund's true investment position relative to the Fund's long-term investment objectives.**

Myth 4. We do not need to fair value our AI since the fund does not intend to sell these investments.

Answer: The purpose of fair value reporting is to obtain a clear picture of the Fund's financial condition. Aside from the fact that the Fund's asset allocation is likely to be off the mark by not properly fair valuing AI, there are many circumstances where not knowing the fair value of AI may result in throwing "good money" after bad. Let us say

that the Fund has purchased several GICs from a well known insurance company with an AA credit rating. Several years after the GICs are purchased the bonds issued by the same insurance company are trading at yields that indicate market participants believe the insurance company's credit risk is likely to be down graded, although no downgrade has been announced. Applying FAS 157 standards would uncover this disparity. This not only provides the Trustees with a more accurate assessment of the Fund's risk profile, it also allows them to make more informed decisions about which insurance companies to purchase GICs from and/or the magnitude of the interest rate guarantee. Applying the fair value standards set down in FAS 157 allows the Trustees to effectively carry out their fiduciary responsibility.

Myth 5. Applying the standards set down in FAS 157 is expensive relative to the incremental benefit derived.

Answer: The major benefit to applying FAS157 standards is transparency—understanding not only what something is worth, its fair value, but clarity about the process and inputs used to determine an asset's fair value. Transparency is consistent with the three building blocks that define Trustee fiduciary responsibility: clarity about the Fund's investment risk profile, informed about how the Fund's investment objectives are determined and finally providing oversight to ensure that the relationship between risk and investment objectives are continuously consistent. ***The real cost of not applying FAS 157 is not the dollars paid to a firm that has the expertise to do the job right but rather the potential penalties associated with not doing it.***

About Axiom Valuation Solutions

- *Axiom Valuation Solutions (Axiom) is a financial security and business valuation firm specializing in the application of fair value for financial reporting purposes. The company is headquartered in the Boston suburb of Wakefield, MA. The company's websites include www.axiomvaluation.com, www.hedgefundvalue.com, and www.fairvalue157.com*
- *Dr. Stan Feldman is Axiom's Chairman and Chief Valuation Officer. He has a Ph.D. in economics from NYU, and he is an Associate Professor of Finance at Bentley University. He was a member of the Financial Accounting Standards Board Valuation Resource Group. Dr. Feldman is the author of Principles of Private Firm Valuation (Wiley). He was formerly a Senior Vice President of Industry Analysis for DRI/Standard & Poor's.*
- *Today's valuation assignments are technically complex requiring a knowledge base in finance, statistical and econometric analysis, as well as an in-depth knowledge of accounting and financial statement analysis. Axiom's staff is highly skilled, enabling it to undertake valuation assignments for globally diverse entities, and has valued complex financial securities including derivatives and debt and equity with embedded options. Axiom's staff regularly interacts with the valuation teams of the top accounting firms on these assignments.*