

## Silver Lining for Valuation Providers

April 21, 2008 By Carol E. Curtis

One likely result of the current credit crisis, say observers, will be increased regulatory attention on financial firms such as investment banks and hedge funds. "More hedge fund oversight and pressure for transparency is definitely coming," said Michael Seidman, senior consultant at Boston-based Citisoft, an investment management advisory firm.

Faced with that prospect, the hedge fund industry has been taking the initiative, beefing up best practices in sensitive areas like transparency, risk management and operations. And a growing movement toward third-party valuation of over-the-counter products like credit default swaps and collateralized debt obligations is generating big business for the sector's handful of providers.

Hedge funds invest in an array of risky, hard-to-value credit products on a highly leveraged basis--assets that can be toxic if they are not carefully monitored. In addition, hedge funds' compensation structure creates a direct link between valuations and manager fees.

"Where value is hidden, there is a lot of wiggle room," Seidman noted. "Pension fund managers are all pushing for more transparency. You need to represent fair value on your balance sheet, and you need transparency to back up its value."

Seidman advises hedge funds to get independent valuations. "In mutual funds, it has been required since 1940," he pointed out. "Now, the marketplace is starting to demand it. Is a third party involved? Is it a consistent process? Boutiques are popping up for individual products. And larger custodians are starting to create relationships with boutique pricing vendors, so they have multiple prices coming in."

The Hedge Fund Working Group (HFWG), comprised of 14 large funds in the U.K., U.S. and Sweden, in October published a paper that highlights the need for more disclosure and recommends that funds have a segregated in-house valuation function or an independent valuation agent, if not both.

Still, a March study by Boston-based research firm Aite Group found that four of 20 funds surveyed did not have any formal, documented valuation process. "Given the general climate and best-practices reports from numerous groups such as the Managed Funds Association and the HFWG, this was surprising," says the study.

### Additional Sources

For products such as credit derivatives, 90 percent of respondents said that broker marks and internal models remain primary valuation sources. Denise Valentine, senior analyst for Aite and co-author of the study, sees plenty of opportunity for vendors. "The demand in the financial marketplace has been increasing," she said in an interview. "Fund administrators have been talking about increasing the number of valuation products. Some fund administrators do not perform valuations, but they are aware of who is out there. Others take responsibility for performing them but they tell me they have expanded the roster of providers and also it is a bit of a check that it is being done correctly--like getting a second opinion."

Currently, noted Valentine, the main valuation providers are large fund administrators including Citigo Fund Services, based in the Cayman Islands; London- and New York-based GlobeOp Financial Services; State Street Corp.'s International Fund Services subsidiary; and LaCrosse Global Fund Services in New York. Increasingly, these administrators are turning to third-party valuation providers, she said, since valuation issues can cause serious delays and call into question managers' credibility.

Continued Valentine, "Institutional investors have a lot of leverage, and a lot of them have said, You have to use a third party for valuations. Tell me about your operations and processes." Such requests are relatively new, she added, popping up only in the past 18 months.

Citisoft's Seidman agrees that hedge funds are creating opportunities for valuation services, particularly for more esoteric instruments. "Vendors definitely have their sweet spots," he said. "Some valuation models get more complicated over time; the work involved may not be economical" for funds to do on their own.

One company that has been capitalizing is London- and New York-based SuperDerivatives, an eight-year-old supplier of options pricing, benchmarking and analytics. Its services include portfolio revaluation and mark-to-market data provided to firms' middle offices, and it counts as clients almost all the major banks.

Dani Weigert, manager of SuperDerivatives' revaluation center, said that "the big demand now is to revalue huge numbers of derivative trades that need to be revalued on a daily basis. Derivatives prices are illiquid, and not traded on a daily basis. We are seeing more and more demand for an automated solution, and also a cross-asset-class solution for interest-rate swaps, credit derivatives, foreign exchange derivatives and equity derivatives."

Other cross-asset-class pricing vendors include London-based Markit Group, Wayne, Pa.-based SunGard Data Systems' Reech solution and Reval in New York. "A big player was Bear Stearns," added Weigert, "so a major player has suddenly dropped out."

Weigert said that SuperDerivatives' tools "give us the ability for an accurate revaluation for a very large number of trades in a very short period of time. The demand is for efficient revaluation on a daily basis, an automated solution, and a one-stop shop."

Valentine agrees that SuperDerivatives is poised for growth. "They have a software tool and an independent valuation process," she said. "They have also established a relationship with NYSE Euronext, creating a one-stop shop that combines both OTC and listed derivatives."

Valentine noted that valuation providers have been taking a broader perspective, looking at the process holistically--how the products are structured and how the company can bring all of the information onto users' desktops, whether they're traders or middle-office personnel.

Regulation is also likely to play a part in shaping the valuation business. "Regulation is probably the predominant way in which things get done quickly," said Valentine. "After the failed hedge fund registration initiative, people went back to their corners to lick their wounds. But looking ahead to 2009 and 2010, there will be more oversight, and maybe more direction regarding valuations. So individual associations have been issuing best practices around valuation. And they recommend using a third party."

Weigert agrees, noting that regulation "is going to occur for funds, banks--everyone with derivative exposure. We are living in an era where everyone will want to take on third-party vendors."