ODD IN FOCUS: VALUATION

Robust valuation practices are a critical focus of operational due diligence (ODD), as they underpin accurate fund net asset values (NAV), fair fee calculations, and effective risk management. Improper or misstated valuations—whether due to weak controls or intentional fraud—can lead to significant financial losses, regulatory penalties, and reputational damage, especially in open-end, evergreen, hedge, private, and long-only funds. The ODD team assesses the strength of a manager's valuation policies, oversight, and governance, ensuring these are tailored to the fund's strategy and regularly updated. Key controls include clear documentation, independent oversight, and back-testing of valuation methodologies. The importance of these controls is underscored by real-world failures, such as the collapse of a fund due to fraudulent valuation practices, demonstrating the high risk and potential investor impact when proper safeguards are lacking. Investors should prioritize managers with transparent, well-governed, and independently validated valuation processes to mitigate these risks.

Role of Operational Due Diligence

A crucial component of ODD is understanding a manager's valuation practices. The ODD team's lens while evaluating valuation is not to audit or underwrite specific asset valuations, but rather to assess a manager's controls, policy, oversight, and governance within the context of the strategy, fee structure, liquidity, and regulatory requirements.

WHY

- Misstated valuations can have far-reaching consequences, particularly for open-end and evergreen funds, where transactions are based on the fund's NAV. Investments that are not valued accurately can result in inflated or misstated NAVs, which may mislead potential investors or cause existing investors to subscribe or redeem at incorrect values.
- Fee calculations rely on accurate valuations. Management and performance fees often reference NAV or cost minus write-offs. Overstated valuations can result in collecting outsized fees.
- Accurate valuations are also essential for effective risk management. Sizing, liquidity, and other risk criteria depend on reliable pricing to ensure controlled decision making.
- Audit and regulatory scrutiny further underscore the importance of robust valuation practices. Auditors may issue a qualified opinion or emphasis of matter, signaling unreliable financial statements. Regulatory scrutiny may result in deficiencies carrying significant financial penalties and leading to reputational harm.

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HOW	■ Valuations may be determined internally using models developed by the manager, or externally by relying on observable inputs such as exchange prices, broker quotes, mark-to-market services, or independent valuation agents. The non-investment team oversees this work to mitigate potential conflicts of interest. As instruments move up the scale of illiquidity and complexity, more discretion is required to value the investment, heightening risk. ■ Valuation responsibility lies with the internal finance team or independent fund administrator. Oversight is provided by financial leadership, a valuation committee, fund auditors, and the board of directors or similar governance.
ODD RISK POTENTIAL: HIGH	■ Improper valuation practices, whether inadvertent or intentional, can directly result in financial loss and loss of investor confidence. Investors rely on the manager to value assets accurately and conservatively. Valuation errors can be indicative of weak internal checks and balances, or a more serious transgression, such as fraud. ■ The manager must prudently adapt and refine its valuation policy and techniques to reflect current regulatory or industry guidance and any changes to the fund's investment strategies, instruments transacted, or liquidity terms.

Manager Relevance

Valuation practices play a critical role in ODD across all types of investment strategies underwritten by Cambridge Associates. The importance of robust processes varies by asset class, with unique considerations for hedge funds, private investments, and long-only strategies.

HEDGE FUND MANAGERS: Hedge funds often invest in complicated financial instruments that require nuanced valuation techniques. Performance fees also reference unrealized performance gains that directly ties to asset valuations. More funds now mix in private or illiquid investments, which increases valuation complexity. These investments are ideally segregated in a side pocket account to reduce the potential impact of discretionary manager valuations on investor transactions and fee calculations.

PRIVATE FUND MANAGERS: Private fund managers must value their investments often without being able to directly reference a public market price. Instead, they typically base valuations on recent funding rounds, comparisons to similar public companies, and how well the business is meeting performance goals. Investors rely on managers to recognize when an investment has entirely lost its value and to remove it from the portfolio's cost basis. Accurate valuations are essential to investors to allow them to assess their investment's performance and determine whether to support the manager in future fundraising efforts.

LONG-ONLY FUND MANAGERS: Long-only managers also face challenges when valuing their investments, though certain long-only fund structures—particularly undertakings for collective investment in transferable securities (UCITS) and US mutual funds—have stricter rules to mitigate potential valuation risk. Valuations become especially nuanced for strategies that invest in less frequently traded securities or in emerging markets. These situations may require extra care to ensure valuations are accurate and reliable.

Key Control Review

A thorough review of key controls is essential to ensure that valuation practices are reliable and consistent. Three main areas of focus are incorporated into reviews: clear documentation of valuation policies, strong oversight mechanisms, and regular back-testing of outcomes. By examining these controls, we can better assess whether a manager's process meets industry standards and protects investor interests.

#1 DOCUMENTATION OF POLICIES

- The Valuation Policy and valuation language in governing legal documents should be tailored to the manager's strategy and outline the specific pricing sources and valuation techniques applied, which personnel are tasked with each step of the process, required approval, challenge or dispute thresholds, and Valuation Committee composition.
- The policy should be reviewed and updated at least annually by the Valuation Committee, CCO, and the Board of Directors or LP Advisory Committee.
- Valuation Committee meetings and decisions should be documented in written minutes that are stored with supporting documentation, including valuation memos, models, and independent assessments.

#2 OVERSIGHT

- For publicly traded strategies, valuation responsibility primarily sits with the fund administrator, middle office, and non-investment team.
- For private investment strategies, the investment and non-investment teams typically collaborate on compiling data and constructing valuation models.
- Cambridge Associates has seen a proliferation in use of independent valuation agents that are engaged for illiquid securities to provide specific asset marks, a range of values, or positive assurance over valuation practices. This provides an independent validation of internal valuation approaches.
- The Valuation Committee plays an important oversight role and should be made up mostly of members who are not part of the investment team. This group is responsible for addressing valuation challenges, providing final approval, and overseeing any updates to the written policies.

#3 BACK-TESTING

- The valuation methodology and process should be back-tested by comparing investment realization values against preceding valuations, allowing the manager to better refine the process.
- As part of the annual fund audit, the auditor is responsible for reviewing valuation practices and portfolio valuations for compliance with the written policy guidelines and accounting principles. Some auditors may use a specialized valuation team to conduct this review.

Case Study: Asset Manager 1

Case studies offer valuable lessons on the real-world impact of valuation controls. In this example, weaknesses in valuation oversight and basic controls contributed to the collapse of a fund. These insights highlight the importance of strong valuation practices in protecting both investors and fund managers.

SUMMARY	DESCRIPTION OF CONTROLS
■ Asset Manager 1 (AM1) collapsed after their Chief Investment Officer (CIO) fraudulently mispriced derivative assets in the firm's funds over several years. ■ Affected investors were ultimately only able to recover a fraction of their assets from the wholesale portfolio liquidation.	⊖ The fraud exposed serious breakdowns in internal controls. The CIO was unilaterally able to manipulate the valuation process by altering third-party pricing models, falsifying valuation data, choosing inappropriate valuation methods, and even fabricating committee minutes and valuation language in governing documents, all compounded by providing forged term sheets to the fund auditor. ⊖ The complex illiquid derivatives involved made up a large portion of the portfolio, heightening the importance of proper controls around their valuations and accelerating the impact of the fallout once the fraud was discovered.

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