



Are Hedge Fund and Private Equity Interests Misreported to Investors? Implications for Fiduciaries and Their Auditors

By

**Stanley Jay Feldman, Ph.D., Chairman and Chief Valuation Officer,
Axiom Valuation Solutions**

Background

During the last two decades, retirement plans, endowment funds, and funds managed by not-for-profit organizations have significantly increased their exposure to hedge funds and private equity (PE). These investments along with other illiquid and opaque investments are generally referred to as alternative investments (AI). Based on research conducted by Axiom Valuation, the average percentage of AI across all types of funds is well over 10% with some institutional investors having exposures that are well north of 50%. Since many funds have assets in excess of a billion dollars, even a 10% allocation to AI translates to a sizeable dollar exposure. Such large exposure would not ordinarily be an issue except for four factors. These are:

1. The Madoff scandal and the use of feeder networks including fund-of-funds that obscure the nature of AI managers' underlying investments;
2. AI managers self report returns and values to investors;
3. Insufficient disclosure and in some cases non-disclosure of AI investments; and
4. The inherent illiquidity of AI interests.

The consequence of these factors is that there is a high degree of transparency risk associated with AI interests. Transparency risk is the uncertainty that the asset values that are self-reported by AI investment managers are correct. Unlike publicly traded securities, AI interests are opaque making the values self-reported by AI managers to fiduciaries almost impossible to substantiate in light of both the fair value standard and AICPA guidance set down in the AI Practice Guide. Yet best practice and fiduciary responsibility require that this be done as a pre-condition to an audit sign-off.

Is There Evidence of Misreporting by AI Managers?

While the recent financial crisis has unearthed an abundance of anecdotal evidence on the potential misreporting of performance by PE and hedge funds, there is a growing literature that empirically examines the issue using large samples. The issue of hedge fund reporting assumes significance as managers have discretion in reporting fund performance, and because capital inflows and fund performance are strongly related. For instance, Bollen and Pool (2009) report

that a 1% increase in one-period, lagged fund return leads to a 15 basis point increase in fund inflow. Thus, if better performance leads to incremental fund inflow, then managers that self-report returns face a significant conflict of interest which of course raises the question: Are valuations reported by AI managers correct and are they consistent with fair value?

Bollen and Pool (2009) specifically focus on the returns reported by hedge funds. They report several pieces of evidence suggesting that hedge funds appear to overstate their reported returns. First, examining a histogram of the distribution of hedge fund returns, they find a sharp discontinuity in the distribution near zero. Specifically, they find a greater than expected frequency of returns just above zero and a lower than expected frequency of returns that are just below zero. Moreover, in contrast to these findings, they do not find such a pattern in the distribution of mutual fund returns.

Second, they find evidence of return reversals. Funds with returns just above zero report average subsequent returns that are lower than those of funds reporting returns just below zero. This result indicates return reversal for funds reporting small positive returns. The authors conclude that the sharp discontinuity in hedge fund returns around zero is due to overstatement of returns rather than the skillful avoidance of losses by fund managers.

Phalippou and Gottschalg (2009) examine the performance of private equity funds. A key finding in the study that is relevant for fiduciaries is that a large part of the investment performance reported by PE funds is attributable to inflated accounting valuations applied to the Net Asset Values (NAVs) of the underlying assets. This over-reporting contributes to the author's conclusion that private equity funds underperform the S&P 500 Index by 3 percent (see also Kaplan and Schoar, (2005)). The authors conclude:

The performance of private equity funds as reported by industry associations and previous research is overstated. A large part of performance is driven by inflated accounting valuation of ongoing investments and we find a bias toward better performing funds in the data. We find an average net-of-fees fund performance of 3% per year below that of the S&P 500. Adjusting for risk brings the underperformance to 6% per year. We estimate fees to be 6% per year. We discuss several misleading aspects of performance reporting and some side benefits as a first step toward an explanation.

The results from this study are consistent with PE fund managers having both the incentive and ability to inflate the reported valuations regardless of economic conditions.

What Do These Findings Imply for AI Values Reported to Fiduciaries?

The uncertainties regarding valuations arise principally because Alternative Investments are at best opaque and illiquid. While AI may serve to diversify a portfolio due to low correlations with the rest of the market, the price being paid is lack of liquidity and limited informational transparency both of which pose significant oversight problems for both fiduciaries and their auditors.

First, as recent events indicate, investors exposed to AI face the risk of fraudulent reporting.

Second, while the vast majority of funds may not engage in fraudulent reporting, investors face valuation related risks because AI managers are typically compensated based on the amount of funds they attract and manage. As such, these fund managers have incentives to inflate the valuations of illiquid underlying assets in order to attract more funds, and thereby increase their compensation.¹

Third, as the underlying assets are often illiquid and have no publicly available information, there is a large gap between the levels of information AI managers have regarding the distribution of underlying cash flows versus that available to investors. As a result, investors do not have a mechanism by which they can readily verify the valuations associated with the underlying assets. These risks are not sufficiently mitigated by the fact that AI managers have audited financial statements since auditors for AI managers are not signing off on the reported investment values. They are signing off on whether the valuation process followed by an AI manager appears reasonable. The auditor cannot and therefore does not provide third-party independent valuations. Audit sign off on an oversight process is a much lower standard than attesting that the reported asset values are correct.

Fourth, alternative sources of valuations for thinly traded and illiquid assets are quotes posted by brokers/dealers. For instance, broker/dealer posted prices are often reported by commercial pricing services. However, these prices are neither verified, nor vetted, by the pricing services. It is typically not clear whether a posted price reflects a price at which a transaction can reasonably be expected to take place, which meets the fair value standard, or whether it is simply a price posting that contains no market information and would not meet the fair value standard. The risk of relying on such posted prices is that broker/dealers often face conflicts of interest due to their regular business transactions with AI managers and their firms. The problem arises because broker/dealers tradeoff the cost of getting fewer orders from investment managers in return for reporting lower valuations of assets owned by these funds versus the benefits of getting more orders by reporting valuations that are favorable to fund managers. Thus, conflicts of interest faced by broker/dealers create uncertainty regarding their posted prices for illiquid assets and securities.²

Overall, the academic and empirical evidence supports the conclusion that there is a high degree of transparency risk associated with AI. In the current environment, fiduciaries and their auditors need to assure fund stakeholders that a robust process has been followed to properly value assets and that the methods used are consistent with fair value measurement.³

¹ See Skeel and Partnoy (2007).

² Abdulali (2006) notes that managers can distort returns by opportunistically selecting favorable broker quotes. This phenomenon has also been reported in the popular press. Finally, it is common practice for custodians to use price quotes from broker/dealers and/or pricing services to price illiquid securities. In most instances, these prices are not vetted as to whether they meet the fair value standard.

³ Fiduciaries often recognize the possibility that AI values may be misreported but if they have not been hurt, they often attribute this to their due diligence process. When the SEC was considering increased oversight of hedge funds, Commissioners Cynthia Glassman and Paul Atkins argued that no such oversight was needed since fraud cases were so few. See *Registration Under the Advisors Act of Certain Hedge Fund Advisors*, File No. S7-30-04. It is not likely that both Commissioners would dissent as they did in 2004 if they knew that a Madoff scandal was about to occur. The point is that there is a difference between information due diligence and a robust oversight process designed to flag misreporting and/or fraud. Fiduciaries that confuse these two are opening themselves to a significant contingent liability.

Do These Findings Change a Fiduciary's Due Diligence Requirements and an Auditor's Oversight Responsibilities?

Events have not changed what a fiduciary or their auditor is responsible for. What has changed is the level of scrutiny that needs to take place to ensure that asset values are properly reported. Put differently, the bar for what is best practice has been significantly raised and the reporting burden placed on each fiduciary has increased accordingly. The role of the auditor is to ensure that this higher level of manager scrutiny is represented by a formal oversight process that is consistent over time and is easily auditable. Any process that does not meet these guidelines does not meet the best practice standard.

The AICPA AI Practice Aid states:

Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, *management* needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.

Is there a Method for Validating Self-Reported AI Values?

The answer is yes. The methodology is known as The Replicating Portfolio (TRP) TM⁴. The system is based on arbitrage pricing theory. TRP identifies the return factor structures that generate the returns reported by the AI manager. What makes AI so opaque is that managers will not indicate what they are specifically invested in; however, our experience indicates they will disclose information related to asset type, geography and perhaps industry distribution. Based on this information and simple quarterly returns provided by the AI manager, TRP uses a set of publicly traded securities that have the same asset, geographical and industry distribution as the AI portfolio to replicate the returns reported by the AI manager. A portfolio replicates when its beta is unity and its alpha is zero with respect to the AI portfolio.

The beauty of the TRP method is that it meets the AICPA guideline that requires the establishment of a formal, quantifiable and auditable process for determining whether self-reported investment values are proper and meets the fair value standard. From both the fiduciary's and auditor's perspectives the major benefit of TRP is not that it allows for the replication of returns but rather what happens when returns are not replicated. In this circumstance, TRP requires that AI managers provide additional information or correct information that was initially provided. One example might be that a private equity manager

⁴ The Replicating Portfolio TM is a trademark of Axiom Valuation Solutions.

failed to indicate that a portfolio firm was sold during the measurement period and depending on the number and type of firms in the portfolio, not knowing this would prevent creation of TRP. In other cases, not being able to replicate indicates that self-reported AI values are not correct. This could result from a number of factors including fraud, but in our experience the reasons are more related to AI managers not following fair value measurement standards. Based on our experience, about 20% of AI investment values are not reported properly.⁵

In cases where a fund's audit year does not match the audit year of its AI managers, the fiduciary has what is termed the "roll forward problem". Although AI managers may provide non-audit values to investors, these values cannot be accepted as fair value. In these cases, the TRP method can be directly used to roll forward the last audit value if TRP has demonstrated that it is consistent with fair value. TRP weightings and factor returns are updated for the reporting period in question and TRP is then solved for the return the AI manager should have produced for the measurement period. This return and the last audited investment value adjusted for investor cash inflows and outflows and liquidity adjustments yields the fair value of the AI investment interest at the measurement date.

What Have We Learned?

At this point several things should be very clear:

1. Academic research indicates that self-reported AI values may not be consistent with fair value. The reasons are varied but several factors stand out: significant conflicts of interest, resistance of AI managers to disclose the methods used to determine AI values reported, and Madoff type fraud.
2. The best practice bar has been raised for fiduciaries and their auditors. Best practice requires a formal reporting process that uses quantifiable methods to validate AI values, seeks additional information when validation cannot initially be determined, and then uses additional data obtained as input to the oversight framework to conclude whether AI values can be validated. Informational due diligence while necessary does not meet the best practice standard. This standard is met when a robust process is in place that is fully transparent, produces results that are reproducible by an independent party and is therefore auditable, and is designed to both validate self-reported AI interests and uncover improperly reported AI values.
3. Since AI interests reflect ownership of a portion of a portfolio, one can use the principles of portfolio theory to determine the fair value of AI interests without knowing the underlying individual investments. The method is TRP, The Replicating Portfolio™. TRP creates a formal process that meets the best practice standard for fiduciaries and their auditors and ensures that fund asset values are correct.

⁵ This conclusion is only based on Axiom's experience, although we believe it is representative of AI in general. The reason we think this characterizes AI overall is because the 80/20 rule appears to hold for each new engagement where ten or more AI interests are fair valued.

Bibliography

Abdulali, A. (2006). "The Bias Ratio: Measuring the Shape of Fraud". *Protégé Partners Quarterly Letter*

Bollen, N. and Pool, V. (2009). "Conditional Return Smoothing in the Hedge Fund Industry". *Journal of Financial Quantitative Analysis forthcoming*

Kaplan, S. and Schoar, A. (2005) "Private Equity Performance: Returns, Persistence, and Capital Flows". *The Journal of Finance* Vol LX, No. 4, 1791-1823.

Palippou, L. and Gottschalg, O. (2009). " The Performance of Private Equity Funds". *The Review of Financial Studies* 22, 1747-1777.

Skeel, D. and F. Partnoy. (2007) "The Promise and Perils of Credit Derivatives". *University of Cincinnati Law Review* 75 154-178.