4.3 WHITE PAPER

Managing and monitoring alternative asset allocations

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Increasing insurance portfolio exposures to alternative assets brings the need for increased diligence in managing ever-increasing internal and external influences.

Ask an institutional investor about their alternative asset portfolio and they will likely tell you that a 15% allocation requires 50% of their time. Many will also see that ratio as optimistic, with the number and complexity of stressors increasing.

Alternative assets, such as private equity, real assets, and hedge funds, used to be the somewhat sleepy corner of the diversified investment portfolio. In simpler times they often did not receive much attention after the initial due diligence. But with increasing allocations, accounting rule changes, greater audit demands, and regulatory changes, the level of ongoing diligence and required servicing has increased exponentially.

Many of the challenges are due to the manager being the source of information for most alternative assets. With most alternative assets, the manager determines the fair value of the investment, often on an appraisal basis absent a market exchange. In some alternative assets, such as private equity, the manager (the general partner, or GP) also has control over when contributions are made in the form of capital calls, and when money is returned to the investments in the form of distributions after the GP exits a fund investment. Alternative assets activity and valuations are reported in various statement formats, often requiring the investor and service providers to “scrape and normalize” information across investments for accounting and analysis. The same opacity and inefficiencies that promise extraordinary returns combine to defy traditional conventions of accounting, performance analysis, and risk management as well as create administrative demands unseen with public markets investments.

However, the world of alternative assets is evolving. Prior to certain high profile fraud events, and prior to the sub-prime crisis occurring, industry initiatives were already taking place that would shape how the investor would need to demonstrate their diligence around use of alternative assets. In 2006, the American Institute of Certified Public Accountants (AICPA) published their practice aid document titled “Alternative Investment Audit Considerations.” Shortly thereafter, The Financial Accounting Standards Board (FASB) issued FAS 157 (later to become ASC 820) codifying the concept of fair value and bringing considerable implications for the valuation of alternative assets. The application of both of these established the foundation for how investors would need to demonstrate diligence, and would be further defined by regulatory changes worldwide.

Panel discusses challenges in alternative assets investing

At a recent Northern Trust insurance summit, the increasing challenges in alternative assets investing were the subject of discussion amongst a panel of industry professionals. A resounding theme was that diligence and fiduciary responsibility resides with the investor whether or not the program management is fully outsourced or even when outside service providers assist investors in managing the program. Despite the increased demands, the panel agreed that the increased diligence and regulatory changes are a positive evolutionary force.

A top stressor for investors is manager provided valuations, which as mentioned, are often appraisals developed by managers. The panelists agreed with the spirit of fair valuation for alternative assets but also acknowledged the importance of the investor fully understanding the manager’s valuation method and valuation policy. Additionally, they expressed the importance of participating in manager valuation policy development and, where possible, as a valuation committee member.

As global accounting standards sometimes seem to be inching nearer to an independent valuation requirement, the panel did not see value in forcing either the manager or investor to seek independent valuations. Interestingly, these seasoned alternative asset investors echoed the sentiment of most managers, especially private equity general partners, that independent valuations do not provide value and add time and cost to an already expensive and slow valuation process. There was an assertion that general partners generally do a reasonable and transparent job in developing valuations. It was further asserted that independent appraisers do not possess the same familiarity with the private company investments or properties, calling into questions the accuracy of independent valuations. The value of spending an inordinate amount of time on interim valuations for items such as private equity partnerships and real estate was questioned, as the interim valuations only are estimates that typically err on the side of conservatism, with the true value only being known when a fund investment is exited.

Related to the concept of valuation transparency, the participants did agree that access to information from managers has increased significantly in the last decade, including private equity partnership holdings information, transaction details, and valuation policy information. That said, most agreed that "normalizing" items such as classifications, cash flow details, and valuation information, remains a challenge. As an example, it was noted that situations do exist where a company held by two partnerships can be valued or classified differently with both being plausible, but not necessarily being certified as correct, in the eyes of prevailing audit guidance. Quality, quantity, and access to information has improved, but standardized data and reporting formats remain high on the wish list of every investor and service provider.

Greater standardization of reporting formats was acknowledged as being of value and the panelists expressed optimism regarding data standardization. The efforts of various data standardization initiatives were acknowledged, but it was noted that much greater industry traction needs to be established, especially greater buy-in from the asset management community.

Moving beyond the quantitative aspects of alternative assets administration, panelists cited environmental and social governance (ESG) as very challenging for alternative asset owners. Opacity and access to data is a smaller issue to the larger issue of the investor's ability to act on a holding in a fund vehicle such as a hedge fund or private equity partnership. Despite this very real issue, our panel felt it is very important to consider alternative assets in their ESG efforts not as a headline risk management issue, but as a matter of good corporate governance and citizenship.

The choice to outsource

Considering the effort required in assembling and normalizing data, investors do have various options for, and often seek, outside assistance. The key driver for outsourcing is usually the investor's actual or desired staff size, with some still having the appetite to fully insource accounting, performance, risk, and administrative tasks. When asked about the most likely opportunity for outsourcing, our panel saw value in assistance with accounting, but cited performance analysis as a very important aspect that is often difficult to optimally perform as an in-house task.

The highly specialized nature of alternative assets performance analysis and late arriving valuations were cited as creating significant challenges for investors. It was also noted that comparative analysis of alternative assets defies the traditional notions of benchmarking and most find it difficult to first establish, and then articulate, success with the same level of certainty found with public markets assets.

As the alternative assets allocations increase with the promise of strong returns, their materiality to the total portfolio drives the need for increased diligence from the investor. The very nature of alternative assets, coupled with external influences, such as accounting and oversight evolution, also influences the need for an increasing level of administrative control. Diligence is very much an ongoing exercise that continues long after the decision to invest and selection of investment has been completed. While aspects of managing and servicing of the alternative assets portfolio can be outsourced, fiduciary responsibility cannot. Therefore, it is important for the investor to have a strong framework regarding the managing and monitoring of alternative asset allocations.

"Panel participants viewed performance analysis as the service they are most likely to outsource due to the specialized nature of alternative assets."