

SEEING INSIDE THE BLACK BOX

DON MULLER OF NORTHERN TRUST TALKS TO *HFMWEEK* ABOUT THE IMPORTANCE OF INDEPENDENT VALUATION SERVICES IN THE FACE OF A GROWING DEMAND FOR TRANSPARENCY ACROSS THE HEDGE FUND INDUSTRY



Don Muller

is the global head of middle office services at Northern Trust Hedge Fund Services. Prior to this, Don served as the head of product control and over-the-counter structured products for Omnium. He has more than 10 years of experience in the client service, operations and valuation space.

Comprehensive and independent valuation services have become increasingly important in recent years as hedge fund managers seek to better engage with market data and investors drive the demand for heightened transparency. *HFMWeek* talks to Don Muller of Northern Trust about how a good relationship between administrator and manager can be crucial in delivering efficient valuation services.

HFMWeek (HFM): What trends are impacting the way that an administrator provides valuation services to hedge funds?

Don Muller (DM): Firstly, we are seeing a trend towards the independent sourcing of valuations, which has been the case for some time. As an extension of this, we are also seeing growing demand for transparency into the underlying market data and calculations that support valuations. In addition, many of our clients are trading higher volumes of more vanilla products, leading to increased expectations around speed and accuracy for trade capture, valuations, and profit and loss (P&L). Clients require this transparency for different reasons. Some managers want transparency as a means to test valuations, using it on an ad hoc basis, while others require transparency on market data for each valuation. In general, clients are looking to engage with the data to a greater degree and want to understand how their portfolio is being valued each day.

We view this trend as an opportunity – it allows us to create stronger relationships with our clients. More significantly, though, it aligns with our philosophy: if you achieve best practice on a daily basis, the month-end simply becomes another trading day. There will always be some extra activity at the end of the month, but full engagement each day contributes to the type of relationship we strive to have with each of our clients.

HFM: What do you mean by trade capture and how important a role does it play in an administrator’s valuation capability?

DM: Ultimately, trade capture and trade management is about how we obtain and represent a trade within our sys-

tems. While the industry tends to focus on reconciliations and valuation data output, we view accurate trade capture – the comprehensive representation of trade attributes in the books and records – as the foundation of any administrator’s valuation capabilities. In other words, accurate valuations start upstream of an administrator’s valuation team. Trade capture is where details of each trade are exchanged, recorded and validated to the client’s trading counterparties. This all contributes to building a ‘golden copy’ of books and records, which in turn feeds more accurate valuations, P&L and financial reporting.

Regardless of an administrator’s valuation capabilities, the accuracy of those valuations will suffer if they are performed from sub-standard trade records or inaccurate trade details. We strive to capture comprehensive economic detail of every individual trade. That may sound obvious, but it’s not always the approach that is chosen within the industry. We believe that if we can get an accurate and complete representation of trade activity, this creates the foundation for us to deliver the type of valuation service we want for our clients.

“
IF YOU ACHIEVE BEST PRACTICE ON A DAILY BASIS, THE MONTH-END SIMPLY BECOMES ANOTHER TRADING DAY
”

HFM: Transparency continues to be a trend impacting all areas of the hedge fund industry. What does it mean in the context of valuations?

DM: Clients want to understand and become comfortable with the valuation methodology being used. By reconciling to their administrator and gaining transparency to the market data used in valuations, managers are able to easily isolate any differences in modelling methodology, making valuations less of a ‘black box’.

As an example, Northern Trust Hedge Fund Services provides clients with access to their valuation results through a portfolio monitor tool that enables them to take advantage of all our attribution functionality. They can then delve into varying levels of aggregation across the portfolio and also drill down to an individual security level. The tool sits on a client’s desktop, which empowers them to truly engage with the data, supporting the trend of gaining transparency within the book.

HFM: Are there any challenges between the administrator and the manager when it comes to the exchange of data and how do you overcome these?

As featured in *HFMWeek*. Email: Don_Muller@ntrs.com

DM: It is important to capture every economic detail of every individual trade so that we have the level of granularity required for strong valuations. As a result, accurate mapping and data normalisation are critical but can be one of the principal challenges in the exchange of this data. We therefore put a lot of effort up front into our implementation process to enable us to capture robust and granular trade details. We also want to make the process efficient for the client, so we work with them to default values to market standards and to auto-populate trade details derived from counterparty agreements. This helps reduce the burden on them to provide us with the necessary trade details. Through trade affirmation and reconciliation to prime brokers and custodians, we strive to identify and correct any trade errors, while at the same time seeking to address the root cause of the break, so we do not see the issue repeatedly.

HFM: Has the increasing focus on transparency changed the relationship between managers and administrators?

DM: Yes. In our role as administrator we are increasingly being seen as an extension of the manager's team which means that confidentiality and trust are of the utmost importance. When you have that relationship, we believe it is important that both administrator and client be open with one another.

We strive to give clients as much transparency to their books as possible. It's their portfolio and there is nothing we want to hold back on our side. Through our online tools, we provide clients with insight into independent valuation methods, which allows them to compare the independent valuation with their own assumptions and models. We want them to have access to all of their data and we try to do so in a way that doesn't require them to request access to information on an ad hoc basis. Our goal is to empower the client to conduct these types of queries and drill downs on their own, within their own desktop.

HFM: How is the growing importance of independent valuation sources manifesting itself in the way valuation services are being offered?

DM: The importance of independence has seen valuation shift from a monthly service to a daily offering. Clients that are most actively involved with the review and approval of their daily P&L have a smoother month-end process. Because they are focused on keeping a clean book of trade activity throughout the month, the month-end simply becomes just another day. Added to that, the service has become far more comprehensive. Today, we provide our clients with transparency around all of the key drivers of the valuation: the valuation methodology, when it was valued, and by whom. We are providing clients with direct access to

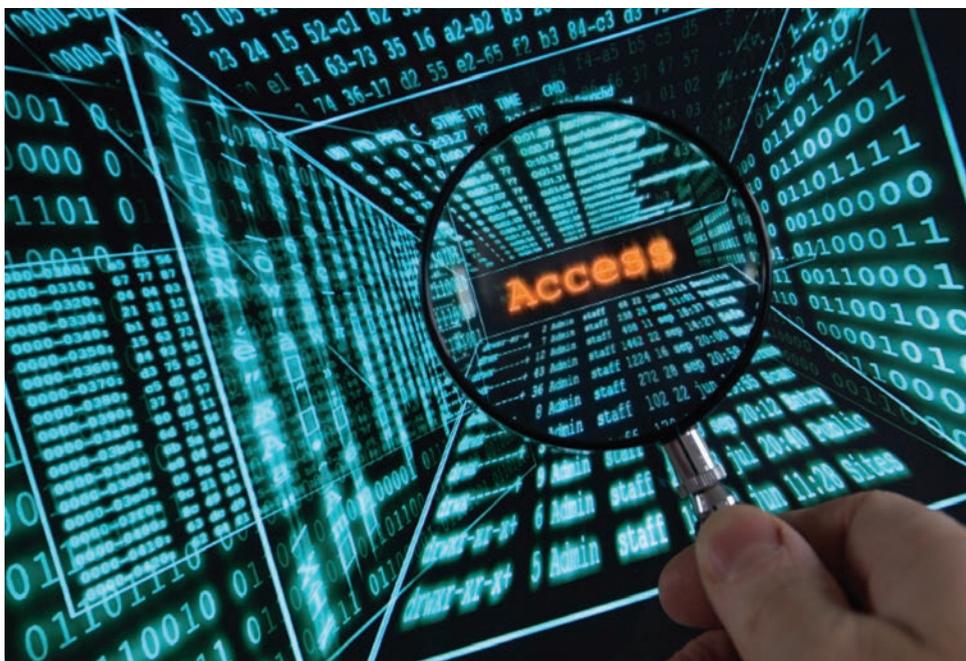
this type of data on their desktop, essentially giving them transparency at their fingertips.

HFM: How does the Northern Trust offering differentiate itself from those of its competitors?

DM: We feel we differentiate ourselves in a couple of ways: firstly, through our people. We have a dedicated team for valuation and P&L distribution to our clients. This enables us to take a highly targeted approach focusing domain expertise on each step of the process. Upstream, we have teams dedicated to activities such as trade affirmation and event processing. Downstream, where fund accounting takes place, there is a group that concentrates on that function alone.

Secondly, we also have what we feel is a best-in-class technology platform. This gives our clients the flexibility to access the same tools on their desktop that our teams are using on the administration. This supports a high degree of transparency into what we're doing each day, and it also improves communication with the client – since both the client and our staff are using the same tools and viewing the same data. These interactive tools give clients transparency into how the portfolio is valued on a daily basis in accordance with their valuation policy. Key triggers such as stale pricing and large percentage movements are not just seen through reporting, but immediately through the technology on the client's desktop as well. Data is available to view for current day and historically, and is available to easily interact with at an aggregate or individual security level.

Everything we do – from trade capture all the way through – is focused on that end state, where clients are engaging and working with their data. We don't want to start the process at month-end. We want this to be an everyday, ongoing dialogue – which makes us an extension of their team. ■



As featured in HFMWeek. Email: Don_Muller@ntrs.com