Taking the measure of credit instruments

Hot topics for asset managers who invest in the credit markets

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KPMG's Credit Instruments in Asset Management event, held May 2018 in New York, explored hot topics in credit investing, with KPMG leaders and industry experts sharing insights on the opportunities and challenges facing funds investing in this evolving asset class. We highlight key trends in the following to help asset managers succeed in credit investing.

Strong investor demand is driving new business

It is a good time to be a credit asset manager. Institutional investor interest in debt securities is rising, and the credit market continues its record of strong performance. In 2017, the private debt industry's assets under management reached an all-time high of $638 billion, and the trend has continued into 2018. Returns exceeded 18 percent.[1]

In recent years, many institutional investors have realized that traditional hedge fund strategies sometimes result in more beta than stakeholders are comfortable with. As a result, illiquid strategies—including investments in credit securities—are on the rise.

According to one asset manager, credit markets today are loaded with great opportunities. Investors are looking for something different, but see that it's hard to find alpha without a skilled manager with experience in the credit asset class.

Often used as a diversification play, credit instruments are also viewed as a kind of middle ground—a safer bet than riskier asset classes but with the opportunity to outperform equity markets over the long term.

[1] Private debt market grows to record size (AltFi, Feb. 7, 2018)

Consistency, transparency and structure are critical in valuation

It is art, not science.

Pricing illiquid securities is not a new challenge, given the lack of data in the asset class and the judgement required to value an investment. But with investors becoming both more sophisticated and informed, asset managers are getting more questions about how they value their credit positions. Likewise, auditors are beginning to look at transactions earlier, focusing on the details of credit investment valuation methodologies behind them.

In the eyes of both clients and auditors, consistency and transparency in the valuation process is of utmost importance. Showing consistency is one way to overcome the lack of clarity and exactness in the pricing of illiquid investments.

"The precision level of valuing credit investments is not what auditors accustomed to valuing stocks are used to," said Thomas DeVita, COO and CFO of MKP Capital Management. "Make your process simple so clients and auditors can follow the math and be consistent in how you apply your methodology."

A robust valuation policy will call for multiple pricing data points, collected both independently, in-house, and through external brokers for comparison.

"As a leading practice, asset managers should use several sources for valuing credit positions, including dealer marks and internal analysis," said Brian Bouchard, a partner in KPMG's Economic & Valuation Services practice. "If you only get a couple of quotes, and there is a large discrepancy between them, that's when issues tend to arise."

Many asset managers have implemented valuation committees tasked with putting more structure behind valuation to ensure the process is unswerving and unimpeachable, that it stands up to peer review, and that the people in the front office actually doing the valuation work fully to understand and follow the formal policy. The valuation committee typically includes representatives from the fund's portfolio management, finance, risk, and operations teams.

"Think of your valuation policy as a living document that should be reevaluated and updated regularly," said Bouchard.

Also crucial in valuation: Report and document everything. It will serve as corroborating evidence when defending an exit price.

"If you didn't document it, you didn't do it," said Bouchard.

Increase in demand for illiquids comes with a demand for infrastructure. A good infrastructure clearly defines governance, methodology, quality control procedures (such as back testing), valuation sources and inputs, and reporting and documentation.

Funds turn to tech and outsourcing to cope with operational complexity

Investors are not only clamoring for more credit investments but also increasingly seeking custom strategies from their asset managers. At the same time, competition is heating up; there are now more than 335 private debt funds in the market.[2] Meanwhile, the volume of data funds deal with to make pricing decisions and report back to investors and regulators continues to explode.

More demand means funds need to scale up. More competition means they need to become more efficient. And, they need to get better at harnessing, accessing, leveraging and reporting data—a huge exercise.

The result of these converging trends is immense operational challenges for asset managers. To cope, many funds are investing in their technology and infrastructure, with the goal of reducing system redundancies, streamlining core processes, creating a single source of data, and increasing speed, reliability, and accuracy in areas such as trade execution, valuation, accounting, and reporting.

Some asset management firms are using technology in the back office to keep up with operational complexity of the business. One firm spent upwards of $80 million on technology in the five years postcrisis to "make the back work."

Funds are also looking to outsource more work to fund administrators, including reporting, wiring, confirmation, valuation, and certain client services, such as subscriptions/redemptions. Fund administration outsourcing can help speed up and automate processes that previously took up an enormous amount of time and resources internally.

"We're rethinking how we operate and organize our data internally, including what we should stop doing and let others help us do," said DeVita. "We manage multiple complex strategies and have moved to use our data to improve an outsourced model that handles the complexity and also allows for scale. The fund administrators and other outsource providers continue to move the needle in connectivity, flexibility, process, and technology. There's an up-front investment required, but we think it will pay off in the long run."

[2] Private debt market grows to record size (AltFi, Feb. 7, 2018)

Regulation of credit funds may evolve with new SEC priorities

Jay Clayton was sworn in as Chairman of the Securities and Exchange Commission (SEC) on May 4, 2017, marking a new era of leadership at the SEC—and new focus areas for both rulemaking and enforcement. There have also been other changes at the commissioner level that may further shift policymaking, voting, and settlement trends.

From a rulemaking standpoint, the SEC recently streamlined the Agency Rule List—the rulemaking the commission wants to propose or adopt in the next year—from 60 to 25 rules,[3] with a number of potential rulemakings coming off the Agency Rule List and a number of deregulatory rules added. The Division of Investment Management is expected to quickly begin to move through the remaining rules on the list—and the SEC's long-term list too—as the staff's bandwidth opens up with the recent easing of certain congressionally mandated financial regulations, including oversight of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

For private funds, potential rule changes to watch include a new advertising rule focused on testimonials, refinements of the custody rule to make it less cumbersome, a reproposal of the derivatives rule, a plainer vanilla Exchange Traded Fund (ETF) rule, and revisions to the accredited investor standard to make status less dependent on wealth and income. In addition, the SEC has formed a new committee to specifically look into the fixed income markets.

"The SEC used to tend to recycle topics on its regulatory docket, making the Agency Rule List a relatively weak indicator of what's to come," said Matt Giordano, KPMG Audit partner. "But recently, the list has become a much more specific, accurate, and useful tracker of impending rule changes, worth watching by all investors."

From an enforcement standpoint, many credit fund leaders believed enforcement would go down under then Chairman Clayton's tenure, given his stated emphasis on protecting retail investors and regulating capital formation.[4] But exams have actually picked up, with the Office of Compliance Inspections and Examinations (OCIE) currently on a record breaking exam pace in the registered investment adviser (RIA) space, which was about 15 percent for 2017. OCIE is hoping for a 20 percent exam rate in 2018.[5]

The core focus of enforcement actions has been on retail investors, not private fund investors. But don't be fooled. "If you have any pension plans or government agencies investing in your private funds, they are considered retail investors," said Jamie Lynn Walter, partner in the Investment Funds Group of Kirkland & Ellis LLP.

Credit fund exams largely tend to focus on conflicts of interest, particularly targeting advisers who allow certain clients to invest in both the debt and equity of a fund.

"Examiners want to know if you invested a client's money in the debt of a fund to bolster a separate equity investment, because you knew it would be a loser down the road," said Walter. "They also want to know how you will handle the inherent conflicts that will arise in the case of a restructuring."

In disclosures to investors, just saying there will be affiliated investors in both equity and debt will not cut it. Asset managers should increase the specificity of the disclosure of potential conflicts—even naming all of the clients who have fallen into that category in the past and present.

Examiners also closely watch funds' processes for securities that are hard to price, with private debt instruments topping the list. They want to understand the independent valuation process, the relationships between the fund and the broker who provide the quotes, how funds validate quotes for debt instruments that may not have a mark, and much more.

"The SEC recognizes that it is extremely difficult to pinpoint valuation of private debt and bring a case on a specific valuation, but if they find it didn't follow its valuation policy to a tee or suddenly changed its policy without disclosing a reason, it can lead to problems," said Walter.

[3] Agency Rule List (Securities and Exchange Commission, Spring 2018)

[4] Clayton Shifts SEC Focus To Retail Investors In First Year (Law360, May 4, 2018)

[5] SEC advisor exam rates see sharp uptick (www.financial-planning.com, March 8, 2018)

Conclusion

The credit market opportunities and participants continue to expand in breadth and depth across the hedge fund, private equity, and real estate segments. However, the increasing demand for credit instruments does come with a price—stress on the fund's infrastructure. While technology is a key mitigating factor to help facilitate the continued growth, it is clearly important for the C suite to maintain a pulse on leading market practices and regulatory trends and to periodically reassess their fund's governance structure and operations for continuous improvement opportunities.

How KPMG's Alternative Investments practice can help

The alternative investments space continues to grow—and grow more complex. Fund managers find themselves confronted with increased risk management and regulatory pressures, inefficient technology and operational processes, enhanced global competition and cross-border transactions, and more diversified and demanding clients and stakeholders.

The pressure to deliver in this challenging environment means that it is more important than ever to work with the right business adviser who:

— Understands the dynamic nature of the marketplace and its enormous growth potential

— Possesses the experienced professionals, industry insight, and global footprint to anticipate new challenges

— Boasts the innovative technology and resources that enable fund managers to thrive.

KPMG is a market-leading professional services provider to funds of every size and at every stage of the growth life cycle. Our focus is on providing fund managers with the clarity, confidence, and insight to succeed. Whether you are starting, building, or expanding your fund or firm, we can help with formation and capital accumulation; acquisitions of investments; reporting on performance and plan delivery; restructuring, refinancing, and divesting; and realization and exit.

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