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Asset Management ADVocate

Navigating Mutual Funds in Rough Markets—Valuation

In our previous post, we reviewed how the financial markets' reaction to the COVID-19 pandemic requires mutual funds to review, and possibly reclassify, the liquidity of their investments. As liquidity and valuation are often two sides of the same coin, factors that may lead to reclassifying a security's liquidity may also raise questions concerning how to value the security for purposes of calculating a mutual fund's net asset value ("NAV"). This post discusses when this may be the case.

More Valuation Basics

An earlier post examined *when* mutual funds must calculate their NAV; this post concerns *how* funds should calculate their NAVs. Rule 2a-4 under the Investment Company Act of 1940 encapsulates these requirements. In particular, it requires:

- "portfolio securities with respect to which market quotations are readily available [to] be valued at current market value;" while
- "other securities and assets [must] be valued at fair value as determined in good faith by the [fund's] board of directors."

It is important to note that current market value is only used so long as "market quotations are readily available." In Accounting Series Release No. 118 ("ASR 118"), the SEC observed that:

> If sales have been infrequent or there is a thin market in the security, further consideration should be given to whether 'market quotations are readily available.' If it is decided that they are not readily available, the alternative method of valuation … 'fair value as determined in good faith …'—should be used."

Liquidity and Market Value

In conformity with ASR 118, most mutual funds disclose that fair value, rather than market value, may be used when a security is thinly or infrequently traded. Funds can use the data for reviewing a security's liquidity classification to identify circumstances in which the security has become thinly or infrequently traded. When a reduction in market depth prompts the reclassification of a security held by a fund from Moderately Liquid to Less Liquid, for example, a fund might also consider whether the reduced trading still provides a reliable indication of the security's market value. We do not mean to imply a direct correspondence between a change in a security's liquidity classification and a shift from using market to fair value. A security's value should not "reflect size as a characteristic of the entity's holding even if the market's daily trading volume is not sufficient to absorb the entire quantity … without changing the market price." (*See* Question G30 of this linked FAQ.) We suggest only that, when a significant reduction in market depth prompts a reclassification of liquidity, it may be prudent to reassess the fund's reliance on market quotations as well. We would recommend documenting any reassessment and its conclusion, even if that is to continue relying on market quotations.

Liquidity and Fair Value

ASR 118 acknowledges that there is "[n]o single standard for determining" a security's fair value. One common method, which the SEC has acknowledged as appropriate in some circumstances, is to obtain an evaluation of the security's fair value from an independent pricing service. Most funds regularly use feeds of these evaluations to price portfolio holdings not traded on exchanges or in other markets that disseminate a closing price, particularly debt securities and over-the-counter derivatives. In anticipation of Y2K, the Division of Investment Management reminded funds that:

> when fair value pricing portfolio securities in an emergency or other unusual situation, [the fund's board] should evaluate the nature and duration of the event and the forces influencing the operation of the financial markets. The board also should evaluate factors relating to the event that precipitated the problem, whether the event is likely to recur, whether the effects of the event are isolated or whether they affect entire markets, countries, or regions."

Most mutual funds employ a Valuation Committee to make these evaluations, and these committees already should have considered the nature and duration of COVID-19 and the forces influencing the operation of the financial markets. In particular, Valuation Committees should ask their pricing services how they are accounting for these factors. A change in a security's liquidity classification may warrant further inquiry into a pricing service's method of evaluating the security's fair value. As the security may rarely trade under normal market conditions, the pricing service's evaluation will depend on offerings and trading of comparable securities and "market color" provided by dealers and other market participants. If a fund changes a liquidity classification due to a decline in trading activity for comparable securities, this may indicate that the pricing service also lacks current information required by its valuation methodology. In this circumstance, it may be prudent to confirm that the pricing service continues to have access to sufficient market information to support its evaluations. Finally, if the Valuation Committee determines to stop using the pricing service's evaluation, it should confirm that adequate resources are committed to the alternative method of valuation, such as broker quotes. In this situation, the fund should document the efforts taken to identify dealers willing to provide quotations and the process for obtaining and, if appropriate, challenging quotations each day the fund calculates its NAV.

Conclusion

When a fund experiences large net redemptions, it is important to assure that the remaining as well as the redeeming shareholders are treated fairly. This requires careful attention to how the fund's NAV is calculated, and its sources of liquidity are managed.

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