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Global Investment Manager Analysis | October 15, 2020

GIMA Update

GIMA News: Private Market Valuation Considerations During Volatile Markets

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In light of recent market volatility, Global Investment Manager Analysis (GIMA) believes it is prudent to enhance awareness of the valuation characteristics of illiquid investments and the potential impact these attributes have on private investment funds, non-traded real estate and interval funds, which invest across a range of private assets.

Generally speaking, private investments are valued with a lag compared to investments in public markets in both rising and falling markets. Typically, managers who value private assets do so in a number of ways, with the approach dependent on the fund structure (i.e., open-end vs. closed-end) and asset class, as further outlined below.

With the unprecedented market volatility over the last several weeks, GIMA's conversations with investment managers who focus on private investments have suggested it is too early to tell the magnitude of potential valuation changes in their portfolios, particularly in areas like private real estate and private equity. However, as we have seen in prior market downturns, such as 2001-02 and 2008-09, many illiquid assets are typically marked down with a lag to that of the public markets when there is a sustained move downward in asset prices and valuations.

In the case of closed-end illiquid funds, such as private equity, private credit and private real estate, managers typically fair value their assets on a quarterly basis, oftentimes performing the fair valuation internally. Frequently, with closed-end illiquid funds, a third-party valuation will not be performed until the year-end audit. Private market valuations are generally characterized as an unrealized value in the portfolio until the asset is sold, at which point the investment would be deemed realized. Closed-end illiquid funds are typically finite life, capital commitment vehicles with the manager's carried interest allocation based only on realized gains and management fees based on the investor's capital commitment or amount of invested capital. Therefore, there is less sensitivity to valuation issues compared to an open-ended fund, which allows for capital transactions based upon market values.

In recent years, with the democratization of alternatives becoming more mainstream, there has been a growing menu of available open-ended funds that invest in illiquid assets such as real estate and private debt. Open-ended means shares of the funds are continuously offered with subscriptions and redemptions occurring on a routine basis, often monthly or quarterly, but in some cases accepting daily subscriptions.

Non-traded real estate strategies and institutional core real estate funds invest in hard assets, such as multi-family apartments, office, retail or industrial buildings, which are all illiquid in nature. Certain credit interval funds invest in both liquid and illiquid credit, including tradeable high yield and levered loans as well as non-tradeable areas like direct lending and bank loans.

In each of the open-ended alternatives noted above, a manager will typically utilize third-parties to value the underlying assets. These third-parties include brokers, valuation agents, and/or real estate appraisers. Sound practice is for independent oversight of valuation to occur at a frequency consistent with investor transaction frequency (e.g., monthly subscription products have monthly independent valuations).

However, this is not practical for daily subscription products, which instead rely on internal procedures handled by the manager.

In the case of open-ended alternatives, investors should consider the lag effect that comes with valuing private investments, particularly during times of heightened volatility as valuations will change with a lag to the public markets. The valuation lag may result in a positive or negative effect depending on the direction of the market and whether the investor transaction is a subscription or a redemption to the underlying fund. While it is too soon to tell the extent to which private asset values may be impacted, in a recessionary environment the valuation risk is more elevated.

Accordingly, Financial Advisors and clients should be cognizant of the lag in mark-to-market valuations in closed-end and open-end alternatives when making their strategy and manager selection decisions during the current uncertain environment.

Should you have any questions, please contact GIMA's Head of Operational Due Diligence, Grant Badura, 212-296-1279, grant.badura@morganstanley.com or Senior Operational Due Diligence Analyst Keith Fortmiller, 212-296-1839, keith.fortmiller@morganstanley.com

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- Loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;
- Lack of liquidity in that there may be no secondary market for a particular fund;
- Volatility of returns;
- Restrictions on transferring interests in a fund;
- Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than other investment vehicles; and
- Risks associated with the operations, personnel, and processes of the manager.

In addition, the primary risks of investing in private credit include:

- Illiquidity risk – investments in private lending are typically highly illiquid and may require capital to be committed for an extended period of time, i.e. several years;
- Credit / default risk – non-payment of interest and/or or principal payments;
- Interest rate risk – changes in market interest rates are reflected as a change in the spread which loans in a portfolio pay over the base rate (US Treasuries), which in turn impacts the perceived value of the loans in the portfolio and thus the value of the portfolio itself;
- Prepayment risk – loans which are originated with relatively high interest rates may be paid off early if more attractive financing rates can be found
- Credit rating analysis risk – many borrowers have not issued other debt which has been rated by a recognized rating organization (e.g. Moody's, S&P, Fitch), as such the determination of the credit worthiness of such borrowers is dependent on the analysis performed by a portfolios' managers or advisors.

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RSI1602762448952 10/2020