

WHITE PAPER No. 39

GREYCOURT

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## White Paper No. 39 – *Yes, Virginia, There Is a Grinch: The AICPA Practice Aid on Alternative Investments*<sup>1</sup>

Not long ago we were thinking to ourselves how fortunate investors were to live at a time when relatively new investment strategies enabled them to build lower-risk, higher-returning portfolios. By employing judicious exposures to “alternative” assets such as hedge funds and private equity partnerships, investors were reducing volatility and improving returns – especially on the downside.

But the next thing we knew, it was open season on alternatives, especially hedge funds, with such luminaries as Warren Buffet, David Swensen, and even Michael Steinhardt (*Michael Steinhardt?*) weighing in. And now, apparently from out of the blue as far as investors are concerned, the accounting profession has fired the biggest salvo yet: if institutional investors can’t satisfy their auditors on a wide variety of issues associated with alternative investments, they risk receiving a qualified opinion.<sup>2</sup> And since many institutional investors have debt outstanding containing covenants that require a clean audit opinion, the accountants are wielding a very large stick, indeed.

The purpose of this paper is to review the background behind the AICPA Practice Aid, to look at what the Aid actually says (and doesn’t say), to compare the Aid’s audit requirements to best investment practices, to examine some of the mischief that implementation of the Aid has caused (to audit teams as well as investors), and to speculate about how the auditors’ approach might be modified to improve both the quality of audits and the quality of investment portfolios.

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<sup>1</sup> *Alternative Investments – Audit Considerations: A Practice Aid for Auditors* (AICPA 2006), cited herein as the Practice Aid.

<sup>2</sup> In other words, if the auditor is unable sufficiently to audit the existence or value of the alternative investment portfolio, that limitation on the scope of the audit will, if material, require the auditor to qualify or disclaim its opinion.

## AU section 332 and the Practice Aid

In August 2005, the American Institute of Certified Public Accountants (AICPA) issued two Auditing Interpretations pertaining to auditing fair values.<sup>3</sup> The Interpretation at issue for most institutional investors is Auditing Interpretation - AU section 332, Interpretation No. 1, “Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist.” This Interpretation made it clear that simply receiving a confirmation from a third party (typically either the manager of the alternative asset or a third party administrator engaged by the manager) will not in and of itself constitute adequate audit evidence with respect to the existence of or valuation claimed by the investor in its financial statements. Unfortunately, what *would* be considered adequate evidence was not specified.

Following the uproar that greeted AU 332, the AICPA established a task force to look at the problem of auditing alternative investments. Given that the issue at hand was first and foremost an investment matter, one might have supposed that the task force would be chock full of investment professionals. However, as far as we can determine, the task force consisted only of CPAs.<sup>4</sup>

Based, nonetheless, on the report of the task force, AICPA issued a “Practice Aid” on July 18, 2006. Practice Aids occupy a curious position in the pantheon of auditing standards. They are “intended to provide auditors with information that may help them improve the effectiveness and efficiency of their audits,” but they “have no authoritative status:”

“If an auditor applies the auditing guidance included in [a Practice Aid], the auditor should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the subject audit, and appropriate.”<sup>5</sup>

Interpretation No. 1 of AU 332 and the Practice Aid apply for the first time to institutions undergoing audits for the fiscal year ended June 30, 2006, which includes most colleges and universities and many private foundations.<sup>6</sup> Partly because this is the first experience of institutions and audit teams with these issues, and partly because of the approach taken in the Interpretation and Practice Aid themselves, a serious degree of confusion has been injected into institutional audits and into the coherence of the investment process itself.

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<sup>3</sup> Auditing Interpretations are issued by the Audit Issues Task Force (AITF) and reviewed by the Auditing Standards Board (ASB), the senior technical body of the AICPA.

<sup>4</sup> The task force included two representatives from universities (Dallas and Chicago) and one from the hedge fund community (Paloma), but all were financial professionals (treasurers and CFOs), not investment professionals. Members of the Task Force are identified in the Practice Aid, p. iv.

<sup>5</sup> Practice Aid, p. iii.

<sup>6</sup> Also covered by the Practice Aid are hospitals, pension plans, and investment companies. *Ibid.*, p. 1.

We suggest that this confusion has arisen in part because of the following approaches embedded in the Interpretation and Practice Aid that are inconsistent with best practices in the investment world:

- ◆ *A seeming preoccupation with potential fraud in the alternatives area.* Certainly fraud exists, especially in the hedge fund sector, but it is no more prevalent there than in the corporate world. More important, the largest losses suffered by hedge fund investors have resulted from bad manager judgment (Long Term Capital Management, Amaranth), not fraud (Bayou, Beacon Hill).
- ◆ *An unsophisticated understanding of the complexity of valuation in the alternatives sector of the markets, resulting in an over-emphasis on valuation as the primary criterion for assessing the risks of alternative assets.* As discussed below, valuation of securities in the alternatives sectors is often subjective, and is less directly associated with risk of loss than other factors.
- ◆ *A requirement that nonprofit management understand all aspects of the complex world of hedge fund investing that they so represent to the audit team.* Most nonprofit executives are only loosely involved in the investment process, and especially in the alternative asset area, relying instead on board members and outside experts.
- ◆ *A very odd confusion about management's ability to rely on an outside advisor to carry out the requirements of the Practice Aid.* Given the complexity of alternative investing, it is essential that smaller institutions be permitted to delegate the heavy lifting in this area.
- ◆ *An apparent lack of understanding of the role of diversification in alternative asset investing, and of the role of funds of funds.* Diversification isn't a tool of risk management in alternatives – it is *the* tool. Yet, the Practice Aid ignores this crucial issue.
- ◆ *More broadly, a tendency on the part of some audit teams to misapply the guidance in the Practice Aid or to fail to heed the admonition to apply it only where "it is both relevant to the circumstances of the subject audit, and appropriate."* Local audit teams are given broad discretion to apply the Practice Aid, and since most audit teams understand alternative investing no better than the management teams, that discretion is all too often misused.

Each of these issues is discussed more fully below.

But why are the accountants butting in, anyway?

For those of our readers who are not CPAs, it may not seem immediately obvious what business the accounting profession has trying to tell institutional investors how to

structure, manage, and perform diligence on their investment portfolios, whether on the traditional or alternative side. In fact, however, the size and health of an institution's endowment may be crucial to the overall fiscal soundness of the institution, and creditors (including bondholders) may rely on the endowment when extending credit. If the value of the endowment is materially lower than what appears on the financial statements, then the institution may be making material misstatements of the value of its endowment to its creditors, insurers, and other stakeholders.

But whatever the motive for the accounting profession's involvement in the issue of alternative asset diligence, their attempt to establish standards for diligence in the alternatives area is to be applauded – *someone* certainly needs to do it, and at least the auditors have institutional investors' undivided attention. As everyone knows, far too many investors – institutional and otherwise – have rushed into the private equity and hedge fund sectors with little understanding of the role these assets play in their portfolios, with little understanding of the risks involved, and (especially) with little upfront and ongoing diligence. Even taken as it is, the procedures advocated in the Practice Aid represent a vast improvement over what most investors are doing now.

Our concerns have to do with the way institutional investors have responded to the Practice Aid and, more generally, to the accountants' bean-counting approach to a vast and elaborate sector of the market that cries out for a more subtle and sophisticated solution.

### Investors' Reactions to the Practice Aid

In our view, investor reactions to AU 332 and the associated Practice Aid have made themselves felt in two main ways.

#### Avoidance of alternative investments

The worst consequence of the Practice Aid and its application has been the broad shying away from alternative investments by institutional investors for reasons that have nothing to do with the value of these exposures in investment portfolios and everything to do with the fear of receiving a qualified opinion. In case after case, both in our own client base and elsewhere across the country, institutional executives, board members and, especially, investment committee members, greatly fear that their audit teams may somehow determine that the organization's diligence on its alternatives portfolio has been inadequate and that a qualified opinion may result. Since the consequences of receiving a qualified opinion are immediately disastrous, while the consequences of a suboptimal portfolio are long-term in nature, the choice for too many institutions is clear: steer clear of alternative investments. We think this is a dreadful consequence of AU 332 and the Practice Aid, and that steps need to be taken to avoid it.

Management's representations may be suspect

We certainly understand the need for audit teams to rely on representations from management regarding a variety of issues. But when the representations demanded are clearly beyond management's capacity to apprehend fully, and when the failure to make the representations will lead to a qualified opinion, who are we fooling? Certain sectors of the alternative investment world, especially hedge funds, are wretchedly difficult even for experienced investment professionals to understand. Investors place money in these strategies because they have confidence in the managers and because they know that investment talent will be more likely to produce attractive returns if it is focused on an inefficient sector of the market. To require a harried nonprofit management team to know more about investments than the investment professionals themselves is simply unrealistic. Management can certainly be forced to make detailed representations about alternative asset portfolios, but we suggest that many of these representations will be suspect. Surely, such dubious representations will not improve the quality of institutional audits, but will instead undermine the integrity of the process itself.

### Improving Audits – And Investment Portfolios

We are not accountants, and ordinarily we wouldn't think of trying to tell our accountant friends how to manage their business. But when accounting guidance begins to compromise the quality of investment portfolios, and therefore places smaller institutional investors at a competitive disadvantage versus larger investors, we find it hard to control our urge to be helpful. We will leave it to the CPAs to figure out how best to implement needed changes, but in our view the following issues associated with the Practice Aid may bear some further analysis.

#### The obsession with fraud

It might seem elementary that the crux of the audit of any investment portfolio is to establish that the investments actually exist. Clearly enough, if there is no, or insubstantial, evidence that an alternative manager actually owns the securities he claims to own, fraud is probably afoot. The trouble arises in the alternative world because of the inconsistency between the demands of the Practice Aid and the ordinary practices of the investment world. The Practice Aid asserts that "simply confirming investments in the aggregate does *not* constitute adequate audit evidence with respect to the existence" of securities held by an alternative investment manager, while "confirmation of the holdings

of the alternative investments on a security-by-security basis typically *would* constitute adequate audit evidence.” [Emphases supplied.]<sup>7</sup>

Some hedge fund managers offer complete transparency at the individual security level (typically those managers who are not vulnerable to being traded against), and presumably this would satisfy the “existence assertion.” But many other hedge fund managers simply will not provide this level of detail – and properly so. The Practice Aid recognizes this issue, but the solution advocated by the Aid amounts to massive overkill:

“[E]ven if the fund manager confirms all requested information, it may be necessary for the auditor to perform additional audit procedures. Such alternative or additional procedures may include:

- Observing management site visits or telephone calls to investee funds (or reviewing documentation of such calls or visits)
- Reviewing executed partnership, trust, limited liability corporation, or similar agreements
- Inspecting other documentation supporting the investor’s interest in the fund (for example, correspondence from the fund or trustee acknowledging transactions with the fund)
- Reviewing periodic statements from the fund or trustee reflecting investment activity and comparing activity with amounts recorded by the investor
- Vouching relevant cash receipts and disbursements”<sup>8</sup>

We can imagine circumstances where such extremes of diligence might be appropriate – if fraud is suspected *because of other than position-level non-transparency*, for example, or if the non-transparent positions are material in the aggregate to the investor’s financial statements. Otherwise, we suggest that the audit requirements be amended to correspond to normal best practices in the investment world.

Finally, we notice that the accounting profession itself never tires of pointing out that an audit is not designed to ferret out management wrongdoing. Indeed, a recent paper issued by the CEOs of the six largest accounting firms suggests that if investors are concerned about ferreting out fraud, they should be willing to pay for vastly more intensive (and expensive) “forensic” audits.<sup>9</sup> If trained, experienced auditors dedicated to the task of auditing can’t be relied upon to detect fraud in the corporate world (and we agree that they can’t), why should we expect busy nonprofit managements to be able to detect fraud in the hedge fund world? As with auditors, there are certain diligence steps that any hedge fund investor should take, but even the most astute investors will sometimes get burned

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<sup>7</sup> Ibid., p. 3.

<sup>8</sup> Ibid.

<sup>9</sup> *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks* (November 2006), available at [www.globalpublicpolicysymposium.com](http://www.globalpublicpolicysymposium.com).

by clever frauds. Normal diligence that is standard practice in the investment industry should be sufficient – especially since even the best efforts of non-investment professionals are unlikely to detect all instances of fraud in this murky sector of the marketplace.

#### Equating valuation with risk

Valuation of securities in the alternatives sectors is often subjective, and the complexities of judging valuations are usually well beyond the ken of almost all lay investors, including most institutional executives. And while incorrect or improper valuations of alternative assets can certainly lead to losses, most mis-valuations correct themselves fairly quickly and, short of fraud, are less directly associated with risk of loss than other factors. Thus, the emphasis on documenting valuation as the primary criterion for assessing the risks of alternative assets is inconsistent with investment industry practice. We don't mean to undersell the importance of knowing the value of what an institutional investor owns, of course, but we suggest that the emphasis on documenting valuation is misplaced for many reasons, of which we cheerfully offer a few:<sup>10</sup>

*The fact that a security has a “readily determinable fair value”<sup>11</sup> is anything but a safeguard against risk. We could write a book on this subject, but consider merely the following two recent and painful examples:*

- ◆ Enron, Tyco, WorldCom, and many other securities all had a “readily determinable fair value,” namely, their prices on the New York Stock Exchange minute by minute. Yet investors lost many billions of dollars on these securities, far more than anyone ever lost on a hedge fund investment.
- ◆ During the Tech Bubble of the 1990s, thousands of investors engaged long-only managers, including mutual funds, which loaded up on tech stocks at ridiculous, but readily determinable, prices. Some of these managers declined more than 80% in 2000 and 2001.

*Complexity creates value, it doesn't destroy it. As we noted above, investors like the hedge fund world precisely because its complexity permits talented, skillful and determined managers to add value to their portfolios. That this complexity also complicates the precise valuation of some individual positions is a small price to pay.*

*Like it or not, uncertain valuations are part of the discomfort that builds capital. If investors allowed accountants to design our portfolios, we would all own only the most*

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<sup>10</sup> We would also take note that in other contexts the accounting professional has taken a much more nuanced view of the valuation issue. See, for example, FASB Statement No. 157, *Fair Value Measurements*, effective for fiscal years beginning after November 15, 2007.

<sup>11</sup> Practice Aid, p. 1.



liquid, easily priced securities, and we would all be a lot poorer two decades hence. Yes, being uncertain about the precise value of some of the securities in our portfolios makes us somewhat uncomfortable, but comfort is inconsistent with building wealth.

*The example of “smoothing” investment returns.* As an example of how valuation concepts differ in the alternatives world from valuation in the long-only world, let’s consider the problem of smoothing of investment returns by hedge fund managers. As noted frequently above, many hedge funds are buying and selling (and selling short) securities that exist in murkier parts of the capital markets. Some of these securities are devilishly difficult to understand and price, and consequently they represent one of the sectors of the market that enable skillful investors to produce attractive risk-adjusted returns. But these securities aren’t like, say, GE and IBM, where millions of buyers and sellers are busily at work creating readily determinable fair values. Instead, the markets for these securities are so complicated and thinly traded that it is not at all unusual for a security to show dealer quotes that are 20% apart.<sup>12</sup> Best practice requires a hedge fund manager to eliminate outlier quotes, average the others, and thus arrive at the price at which he should carry the security on his books.

But there is many a slip between outliers and averages, and some of these slips are encouraged by irrational investor expectations. Investors, for example, prize hedge fund managers that produce consistently positive returns, month after month. Assets flow into funds that produce such track records, and away from funds that don’t. Imagine a hedge fund that has produced many months of consecutive positive returns, but now faces a difficult month that looks alarmingly flat. Exercising his best judgment about valuations of the securities in his portfolio, the manager discovers that the portfolio was down modestly – let’s say -0.1% – for the month. Ouch. Exercising his second best judgment about whether those four dealer quotes were really outliers, the manager recalculates his returns and discovers that – voila! – he was up 0.2% on the month.<sup>13</sup>

We’ve droned on about the smoothing issue not to emphasize the importance of smoothing itself – it’s a practice that is simultaneously unavoidable<sup>14</sup> and odious – but to make the point that valuation in the alternatives sector means something rather different than valuations in, say, the listed securities market. Over-emphasizing the uncertainty of

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<sup>12</sup> This is what Adil Abdulali calls “translucent” pricing. Adil Abdulali, *The Bias Ratio: Measuring the Shape of Fraud* (Protégé Partners, 2006), p. 2.

<sup>13</sup> It might seem to the layman that this “smoothing” of investment returns is relatively harmless – what’s the big difference, among friends, between a -0.1% month and a +0.2% month? In fact, though, such small valuation changes can significantly understate fund volatility and can significantly increase the serial correlations of fund returns. The best recent discussion of the “smoothing” issue appears in Abdulali, *ibid*.

<sup>14</sup> Managers dealing with extremely illiquid assets and stale pricing situations have no choice but to assign prices to securities in a manner that is mainly arbitrary, for example.

valuations simply means that an institutional investor would need to avoid alternatives altogether.

Requiring that nonprofit executives master hedge fund investing

We've beaten this dead horse enough. Suffice it to say that a requirement that harried nonprofit executives must fully understand the hedge fund strategies their investment portfolios are exposed to – and that they will so represent to the auditors – means, purely and simply, that nonprofit organizations (excluding Yale, et al.) cannot invest in hedge funds.

Here is the “understanding” requirement as articulated in the Practice Aid:

“Taking responsibility for the valuation of the alternative investments will necessitate that the management of the investor entity has a sufficient understanding of the nature of the underlying investments, the portfolio strategy of the alternative investments, and the method and significant assumptions used by the fund manager to value the underlying investments.

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An effective process for supporting fair value estimates of alternative investments includes the investor entity's management having an understanding of the underlying investments.”<sup>15</sup>

And here is the requirement that management issue specific written representations:

“The auditor is required to obtain written representations from management as part of an audit of financial statements in accordance with generally accepted auditing standards. In connection with this requirement, the auditor ordinarily would obtain appropriate written representations related to alternative investments. The auditor may consider obtaining representations regarding the following:

- Appropriateness of the measurement methods and consistency in the application of the methods
- Completeness and adequacy of the disclosures related to estimated fair value information
- Subsequent events requiring adjustment to the estimated fair value measurements and disclosures.

AU section 328 suggests a number of items to be included in the management

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<sup>15</sup> Practice Aid, p. 5.

representation letter valuation assertion related to fair value estimates. The auditor ordinarily considers the following:

- The reasonableness of significant assumptions
- Whether the assumptions appropriately reflect management’s intent and ability to carry out specific courses of action”<sup>16</sup>

We suppose it is possible that there is an auditing team out there somewhere who understands as much about alternative investments as the Practice Aid requires of management, but if so we haven’t met them.

#### Confusion about reliance on outside experts

It is obvious that smaller institutional investors – in other words, virtually all institutional investors – cannot possibly meet the standards set forth in the Practice Aid unless they are able to rely on the advice of an outside expert advisor, such as a consultant. The Practice Aid specifically recognizes that an institutional investor might seek the assistance of an advisor:

“With respect to valuations based on estimated fair values, when obtaining an understanding of internal control related to valuation, the auditor might consider the following:

- *Use of an investment adviser* to monitor the alternative investments, including the underlying investments, and/or to monitor markets or market indicators and their effect on the estimated fair values of the entity’s investment”<sup>17</sup> [Emphasis supplied]

Yet, schizophrenically, the Aid goes out of its way to insist that management cannot delegate its responsibilities at all:

“Management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity’s financial statements. With respect to valuations based on fair value, AU section 328.04 states:

*Management* is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, *management* needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements

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<sup>16</sup> Ibid., p. 13.

<sup>17</sup> Ibid., p. 9.

are in accordance with GAAP. [Emphases in the Practice Aid. The Aid is quoting from AU 328, “Auditing Fair Value Measurements and Disclosures.”]<sup>18</sup>

*This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity’s management.”* [Emphasis supplied]

It is absolutely essential that smaller institutional investors be able to rely on the advice they receive from outside investment advisors, as there is no other reliable source<sup>19</sup> of knowledge and experience on which an alternative asset portfolio can be built and maintained. Nor is reliance on an outside expert unusual in the audit setting. Consider that management is entitled to rely on legal experts with regard to the materiality of pending litigation, on petroleum engineers regarding the quantity of proven reserves, on actuaries regarding pension assumptions, and so on. As with those areas, specialized professional knowledge is required to navigate the world of alternative investing, and that knowledge is infinitely unlikely to be found among the management teams of smaller nonprofit institutions.

#### Diversification and funds of funds

Although the Practice Aid recognizes the existence of funds of funds,<sup>20</sup> nowhere in the Practice Aid is there even a reference to the cardinal rule of risk reduction in alternative asset investing: diversification. The complexity, illiquidity and lack of transparency that characterize so much of the alternative sector make it essential for investors to diversify their alternative asset portfolios. Diversification can be obtained by large investors by committing capital to numerous hedge funds engaged in different market sectors and strategies, and by smaller investors by committing capital to one or more funds of funds.

Consider the fates of two institutional investors, one of which invested in Amaranth Advisors directly and one of which invested in a fund of funds that, in turn, invested in Amaranth. The former would have lost 70% of its capital when Amaranth blew up, while the latter would have lost, at most, 3½%.<sup>21</sup>

Diversification can make up for a multitude of sins of omission on the diligence front, especially given the prevailing mismatch between risk and liquidity in the hedge fund and

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<sup>18</sup> Ibid., p. 4.

<sup>19</sup> Members of the investment committees of smaller institutions can be sources of important advice on alternative assets. But these part-time volunteers cannot be expected to substitute for the kind of diligence that is required for success in the alternatives space, nor should they be exposed to liability for their efforts on behalf of the institution.

<sup>20</sup> Practice Aid, p. 1.

<sup>21</sup> Assuming the fund of funds had a 5% exposure to Amaranth.

private equity worlds. The Practice Aid could move a long way toward best practices in alternatives investing by de-emphasizing some of the issues discussed above and placing much greater emphasis on diversification.

#### Misapplication of the Practice Aid

When a subject matter lies squarely within the core competence of an audit team, granting the team broad discretion in the application of the rules is appropriate and useful. But when the subject matter – alternative asset investing – lies far outside the skill set of most audit teams, granting those teams broad discretion can only lead to mischief, as inappropriate, overly expensive, inconsistent and arbitrary requirements are imposed on hapless institutional investors. One result of the misapplication of the Aid is that institutions with very similar alternatives portfolios can find themselves faced with wildly divergent requirements imposed by their auditors. It seems to us that when dealing with an area as complex as alternative investing, and especially an area so generally foreign to audit teams, what is needed is more certainty in the guidance and less discretion on the part of the auditors.

#### Summary

Our key concern about the Practice Aid is that it represents an accounting solution to an investment problem. Since too many of the requirements of the Practice Aid differ from best practices in the investment world, those requirements are likely to be resisted by everyone outside the accounting profession. In other words, investors and investment professionals will view the accounting requirements as little more than expensive make-work, designed mainly to help auditors avoid liability in the case of a blowup in the alternatives portfolio. Nonprofit executives, investment advisors, and alternative asset managers will all have a large incentive to go through the motions, but to avoid what they view as unnecessary time and expense. Worst of all, it will be the institutions that are currently following best investment practices that will be most disadvantaged by the Practice Aid – their diligence is already top-notch from an investment point of view, yet they will be forced to jump through additional hoops that have little to do with further risk reduction.

We think all of this is a shame. As we noted earlier, the Practice Aid represents a very important opportunity to encourage far better practices in alternative investing than are currently being followed by most institutional investors. And if consensus can be reached on what those practices are between the accountants and the investment professionals, the practices will likely spread to non-institutional investors as well.

And so, without trying to put words in the mouths of our accounting friends, here is how we think an investment-oriented audit of an alternative asset portfolio should proceed:

First, why were alternative assets included in the portfolio? What role are they expected to play? How was the level of exposure to alternatives arrived at? How often is the alternatives exposure reviewed?

Second, what risks were identified by the institution as being embedded in the alternatives portfolio, and how do these risks differ from the risk of more traditional investment assets? What steps have been taken to deal with these risks?

Third, how well diversified is the alternative asset portfolio? In the hedge fund portfolio, how many funds are included and how different are their investment strategies and market sectors? In the private equity portfolio, how many partnerships are included and how well diversified are they by strategy (early stage venture, late stage venture, small and middle market buyouts, large buyouts, mega-buyouts, mezzanine), industry (technology, industrial, etc.), manager, and vintage year? If funds of funds are being relied upon for diversification, these same questions should be asked of the funds of funds. What would be the impact on the financial health of the institution of a complete loss in the largest alternative asset investment?

Fourth, how were the alternatives managers identified? What up-front diligence was performed on each manager? What ongoing diligence is being performed? How are the diligence steps memorialized?

Fifth, what skills is the institution bringing to the challenges of investing in alternatives? Does the institution maintain an in-house investment staff? If not, did the institution engage an independent investment advisor? Does the institution's board have an investment committee and do the members of that committee have experience and skills in the alternatives sector?

We would bet our mean variance optimizer that any institutional investor that can provide solid answers to these questions owns an alternatives portfolio that should be of little concern to the auditors. In such a case, we would strongly encourage that the more onerous requirements of the Practice Aid be waived, and that these burdens be imposed instead on institutional investors whose answers to the questions leave a lot to be desired. That's where the dangers lie.

A final note about dealing with the Practice Aid

Since there is no likelihood that the accountants will modify their approach to auditing alternative investments any time soon, here are some steps institutional investors can take to make the process as non-disruptive as possible:

- ◆ Read the Practice Aid and Interpretation No. 1 and compare the guidance in those reports with what your institution is doing now.
- ◆ Look at some of the publications that offer explanations and glosses on the Practice Aid,<sup>22</sup> or which outline how existing diligence activities can be used to discharge the obligations set forth in the Aid.<sup>23</sup>
- ◆ Meet with the local audit team well before the audit process begins to discuss the Practice Aid and your institution's diligence process. Set this meeting up long enough in advance of the audit itself so that you will have time to shore up any glaring weaknesses in your institution's policies and procedures.
- ◆ If you have an outside investment advisor, involve that advisor in the auditor meetings.
- ◆ Resist duplication of effort and very narrow readings of the Practice Aid, especially regarding your institution's ability to delegate diligence steps to your investment advisor. Insist that the auditors weigh the cost of additional diligence steps against the likely benefit *to the institution*.
- ◆ No matter how maddening the process, try to keep in mind that at least someone in a position to be heard is trying to improve the (alas, abysmal) level of diligence that investors are now bringing to the process of investing in alternative asset classes.

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<sup>22</sup> E.g., *New Audit Guidelines for Alternative Investments* (Association of Governing Boards of Universities and Colleges, 2006); John Mattie and Jack McCarthy, *Meeting the Challenges of Alternative Investments* (PricewaterhouseCoopers, 2006); *Valuation: Policy and Practice* (Commonfund Capital, 2006).

<sup>23</sup> E.g., *Due Diligence Process* (Park Street Capital, 2006); *Letter to Investors* (Alternative Investments Group, 2006).