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Pimco ETF Case Pinpoints Pricing Pain Points

By Jackie Noblett September 26, 2014

The SEC's investigation into valuation procedures and performance reporting within Pimco's Total Return ETF highlights the industry's challenge to match solid data with pricing policies for hard-to-value securities, experts say.

The regulator is looking into how the Newport Beach, Calif.-based firm valued so-called "odd lot" mortgage-backed securities, and whether significant differences between the discounted price that Pimco paid for the securities and their fair valuation artificially boosted returns in the fund.

Pimco is said to have used outside pricing vendors to help determine a value, but it is unclear whether lead portfolio manager Bill Gross and Pimco's own traders provided input.

The exchange-traded fund clone of its Total Return mutual fund launched in March 2012 and holds nearly $3.6 billion in assets. The fund made waves with early performance that was 350 basis points higher in the first six months than its $221 billion twin.

It is the latest in a string of investigations and enforcement actions against fund boards and firms related to valuation policies and practices, and their impact on shareholders.

The circumstances of the case raise slightly different questions, however. Actions against UBS Global Asset Management and Morgan Keegan dealt with valuation actions taken in periods of market stress, but the Pimco case raises involves the valuation of esoteric securities in a relatively normal trading environment in 2012.

And while Pimco is well known for its skill in trading niche fixed-income and derivative instruments, an increasing appetite industrywide for illiquid securities, or ones with unique attributes, is making the job of finding the right data sources to value them more challenging, experts say.

"Really the issue is the same, regardless of whether you are using a pricing vendor or internal information, which is a lack of observable prices," says Matthew Berry, partner of **Bedrock Valuation Advisors**, a valuation consultancy.

Pimco categorizes mortgage-related securities as so-called Level 2 securities within the fair value hierarchy, according to a description of its practices in the Pimco Total Return ETF annual report. According to that system, Level 1 is holdings, such as equities that trade on U.S. exchanges, with the most easily observable prices, and Level 3 is those hardest to gage.

For its Level 2 holdings Pimco typically turns to pricing service providers that use broker-dealer quotes or estimates based on internal models.

"The pricing models for these securities usually consider tranche-level attributes, current market data, estimated cash flows and market-based yield spreads for each tranche, and incorporate deal collateral performance, as available," according to the ETF's annual report.

Pimco is hardly the only shop to use outside vendors for such data or help developing models to come up with a fair value of an illiquid security. But the algorithms or methodologies used to come to those particular values can vary significantly.

Understanding those differences is increasingly important following new guidance related to the use of pricing vendors included within the SEC's new money fund rule, says Paul Kraft, director of Deloitte's U.S. mutual fund practice. Before a firm can accept the valued price from a third party, it must understand the inputs and assumptions that form the basis of the price.

And in some cases, the assumptions made do not completely match the circumstances. "When you get into the odd-lot issue, it's even more difficult because most of the [pricing] vendors offer a one-size-fits-all type of approach, assuming it's not an odd lot," Berry says.

Some of the discrepancies between the prices Pimco traders paid for odd-lot mortgage securities and the much higher valuations given to those securities a short time later could be a result of a vendor looking at much larger pools of assets. Bigger pools are more appealing and therefore valuable to traders, to generate prices, according to media reports.

The differences could result in a fund reporting gains that are simply a result of different valuation metrics, not real swings in the market value of the holding.

It is not clear whether the purchase price or other Pimco trades were used in valuing the odd-lot securities.

Current guidance suggests that boards and fund advisors should use all the data points that can be reasonably identified.

In that light, the SEC might argue that the price a firm paid for a security is a data point that should be considered in applying the firm's stated valuation methodology, says Paul Huey-Burns, partner at **Shulman Rogers**.

"But it's one among a number of data points, not the sole data point," he adds.

Further, it is unclear what role Gross or anyone else on the investment committee had informing the valuation committee.

Having a portfolio manager involved in fund valuation decisions "is a bit of a mixed blessing," Berry of Bedrock Valuation Advisors says.

While the manager is often viewed as a biased party, he or she arguably has a high level of skill in valuing securities, he says. "The pricing vendor is not trading securities."

Most often investment staff provides input to the investment committee along with vendors and valuation consultants, but is not involved in the final decisions, Berry adds.

The exact inputs, algorithms and methodologies boards and fund advisors use to draft valuation policies are less important than how they are incorporated into the decision-making process, however, attorneys say.

"Pricing always involves the exercise of judgment. The law requires that judgment be reasonable," Huey-Burns says. "The SEC may disagree with the particular algorithm or particular methodology, but the only basis for enforcement action is if the methodology is unreasonable or is not applied consistently."