



Mutual Fund Derivative Holdings

FUELING THE NEED FOR IMPROVED RISK MANAGEMENT

Mutual funds are no strangers to derivatives. In 1996, a Wharton study showed that among 675 equity mutual funds, roughly 20% were investing in derivatives.¹ Today, not only are more funds engaging in derivative trades, but the practice has caught on with non-equity fund managers. “Derivatives are popping up everywhere,” says a leading investment news source, “even in plain-vanilla bond funds.”² Indeed, the use of derivatives has grown across a broad cross section of funds, and industry experts expect the growth to continue.³

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As baby boomers enter the retirement market, their demand for yield has fund managers exploring new strategies. Derivatives represent one viable way to increase a fund's yield potential. As a result, in 2007 the industry saw an array of products that use derivatives, many of which were met with resounding demand among investors.⁴

Investors should know, however, that derivative strategies carry special risks. Derivatives are complex instruments that many do not understand. Because retirement-age investors typically invest to meet income production objectives, there is a concern that they might not understand the risks of investing in funds that employ derivative

strategies. As a result, shareholder advocates are pressing for greater clarity and disclosure about how such income is generated, and the associated risks.

Meanwhile, mutual fund boards, prompted by the rise in the use of

derivatives and the associated risks, have stepped up efforts to understand the risks, such as the impact on fund share valuation, accounting and taxation, legal and compliance, liquidity and shareholder reporting.⁵ Counterparty risk is another important consideration. These concerns have propelled thoughtful dialogue to determine where the most perilous risks lie, and where greater transparency may accordingly be warranted.

Despite the increased risk to investors, experts agree that the risks are manageable. "The use of derivatives invariably means increased operational risks due to the manual nature of the instruments," says Jill M. Helenbrook, Fund Services Derivatives Product Manager, JPMorgan Investor Services. "Properly managed, however, this shouldn't necessarily stop a fund from pursuing an investment strategy using derivatives; the key lies in properly meeting each potential risk head-on." ○



1. "How Are Derivatives Used? Evidence from the Mutual Fund Industry," by Jennifer Koski and Jeffrey Pontiff, *Journal of Finance*, vol. 54 (2), pp. 791-816, April 1999.

2. "Mutual Fund Derivatives Plays Heightened Risk," by David Hoffman, *Investment News*, April 23, 2007, <http://www.investmentnews.com>.

3. Ibid.

4. Ibid.

5. See "Assess the Risks: Key Strategies for Overseeing Derivatives," published by *BoardIQ*, February 21, 2008.

4 MUTUAL FUND DERIVATIVE HOLDINGS: KEY AREAS OF RISK

There are four focal points that industry experts recognize when addressing derivative-related risks: disclosure, fair valuation, code of ethics, and the role of the fund's board of directors and CCO in ongoing risk monitoring.

DISCLOSURE Assuming an effective investment risk management function that regularly evaluates and manages a fund's ongoing risk exposure vis-à-vis derivatives, disclosure is key.

"JPMorgan has developed a comprehensive set of integrated fund administration services to support fund directors and CCOs in providing daily audited accounting records, taxation, financial reporting, investment compliance, performance and risk data to assist with reporting and disclosure requirements, for a wide range of investment instruments, including exchange-traded and OTC derivatives," says Peter Donatio, Fund Administration Product, Executive Director, JPMorgan Investor Services. Such deep and broad integration affords greater reliability, serving as a safeguard in terms of verification and confirmation of information.

FAIR VALUATION One of the main issues is whether the values applied to the fund's derivative positions when calculating NAV reflect the instruments' market value. "Fair valuation is a particularly sensitive area for U.S. mutual funds due to fair-value pricing and same-day valuation requirements," says Helenbrook. "Fortunately, JPMorgan Investor Services offers a full suite of capabilities both in-house and through vendor networks to provide valuation of these instruments."

Factors to consider in applying

the "reasonableness standard" to valuation include current market conditions and expectations. Valuation of the fund's derivative positions should adhere to the board's procedures, obviously. But beyond this, "advisors should ensure that the value used each day for each derivative position held by the fund will reflect what the fund could reasonably realize on that position in a closing transaction at the time daily NAVs are determined," says Helenbrook.

CODE OF ETHICS Has the fund advisor articulated a clear, concise code of ethics by which it operates in regard to derivatives, from research to valuation? Having a definitive code of ethics and related policies can help prevent advisors from making inappropriate decisions.

Given the existing legal structure governing U.S. mutual funds, the task of protecting shareholders and ensuring fund advisors and administrators are capable of executing their duties falls on the fund's board of directors.

"JPMorgan's Investor Services has a long history of administering funds subject to the Investment Company Act of 1940, as well as adhering to the more stringent regulations and best practices governing mutual funds," says Donatio.

THE FUND BOARD DIRECTOR AND CCO'S ROLE IN MONITORING RISK

"Indeed, the use of derivatives increases the complexity of the



fund board director and CCO's job," admits Donatio. "Their responsibility—which encompasses ensuring that fund evaluation, performance and risk are within board-approved guidelines—is a difficult one." However, "JPMorgan Investor Services has expertise in these areas and offers products that can assist directors and CCOs in performing their duties," he adds.

Finally, compliance oversight can further guard against derivatives risk. "JPMorgan has worked with leading fund managers to continually innovate its investment compliance reporting application to support the growing use of derivatives within mutual funds to meet SEC 1940 Act guidelines," says Rajesh Kumar, Executive Director, Compliance Reporting Product, JPMorgan Investor Services. Recent innovations include providing market-leading compliance reporting services to assist funds with client-definable derivative cover calculations, asset segregation reporting and consolidation of exposure from securities lending activities, says Kumar. "This all amounts to helping our clients more accurately and efficiently monitor risk and ensure investment compliance with fund prospectus and regulatory requirements, and ultimately, rendering the risks inherent in derivative instruments manageable."