

ON OUR WAY TOWARDS GLOBAL STANDARDS

A Primer on Marking-to-Market

By BPI ASSET MANAGEMENT

1st of 3 Series

With the onset of E-revolution, the Philippine Financial Markets are faced with greater challenge of global competition. In order to be at par with global counterparts, financial products must be re-engineered. The Monetary Board's recent approval of the Unit Invest Trust Fund (UITF) circular aligns the local pooled fund operations with internationally accepted standards.

In these series, we aim to impart the basics of pooled fund investment within the framework of UITF, the salient features of UITF under the pertinent circular, and its impact on investors.

Concept of Pooled Fund. Pooled Funds are collective investments of numerous investors, pooled together with the aim of achieving a specific investment objective. Pooled Funds include common trust funds and mutual funds. These Funds provide investors with a simple and efficient way of investing their money in a wide selection of financial instruments and securities denominated in Philippine Pesos or US Dollars. By investing in Pooled Funds, retail investors can have a diversified portfolio managed by professional fund managers. They can also enjoy the higher yields from the larger placement power of the Fund, and the lowest commissions and fees possible.

Unitizing Investment in Pooled Fund. Let us say that a fund manager is managing the money of various investors and invests said money in various securities/instruments. To account for the contribution of each investor, the Fund Manager can divide the Fund into UNITS and issues each participant a Unit Participation Certificate to evidence individual participation. The value of all the Fund's investments less fees, taxes and other qualified expenses is called the net asset value (NAV) of the Fund. The value of each unit of participation is called the net asset value per unit (NAVPU). Thus, to determine the value of one's investment at a certain point, the NAVPU is simply multiplied by the number of units one owns in the Fund.

Valuation of Pooled Fund Investments. Traditionally, Pooled Funds are valued based on the accrual method where interest earned by the Fund is simply added to the principal. To illustrate, let us consider a P10,000 investment yielding 6% p.a. After 60 days, under the traditional valuation method, an investor would have earned P10,100.00.

Ms. Lender, I really need P10K today. I will pay you back after 60 days at 6% Interest.



Ms. Borrower, I can lend you P10K now and expect to receive P10,100.00 after 60 days.. It's a deal!

**Maturity Value (MV) = Principal (P) + Interest (I),
Where $I = P * \text{Rate (R)} * \text{Time (T)}$**

The illustration above shows a transaction where a client gets the interest at the END of the period or term. Another way of looking at interest is by collecting it in advance, that is, interest will be deducted from the net proceeds. In this case, using the details above, the client will invest only P9,900.00 today to receive P10,000 after 60 days. This uses the PRESENT VALUE concept.

Gee, Ms. Lender, thanks. But instead of paying you P10,100.00 60 days from now, I will just accept P9,900.99 today so you can have P10,000 after 60 days.



That's ok with me Ms. Borrower, I will lend you P9,900.99 today and I expect to receive P10K after 60 days.

Present Value (PV) = $MV / [1 + (R * T)]$

Another way of valuing investment is via marking-to-market (M2M). M2M is an internationally accepted investment valuation method wherein investments are valued based on the current market price. The entire M2M concept depends on three (3) major components: first is the availability of a “secondary market” or the presence of buyers/lenders willing to buy a certain paper or instrument. Second, is, of course the “negotiability” or “marketability” of the instrument sought to be transferred, that is. The ownership of the instrument may be transferred from one person to another without any technical hitches. And third, is the “liquidity” – as provided by the secondary market.

Mr. Trader, I need help. I underestimated my cash requirement and I have lent all my money to Ms. Borrower. I heard you know of people who will be willing to take on my receivables.

Gee, I lent to Ms. Borrower at 6% only, that means I have to shoulder the 2% differential. I'll take it anyway, I just need cash now and can't go back to her anymore.

Ok, I will introduce you to people who might be interested to give you cash in exchange for your receivable from Ms. Borrower. But I am warning you, they will give you cash based on 8% market value of the 60 day loan. I believe you lent at offmarket.

Since M2M uses market rate in valuing investments, volatility in interest rates can affect the value of your investment. During times of increasing interest rates, the present value of your investment is lower. On the other hand, during times of decreasing interest rates, the present value of your investment is higher.

Mr. Trader mentioned to me your requirement. I can buy your receivables at 8% market value of the 60 day loan. I can give you P9,867.77 now and expect to receive P10K after 60 days.

Gosh, I advanced P9,900.99 for that, but anyway thanks Mr. Secondary Market, yes, I will take that cash now. You can get the P10K from Ms. Debtor, after 60 days.

Scenario: Higher Interest Rate

Ms. Creditor, I am willing to buy your receivables at 4% market price. I will give you P9,933.44 now and collect P10K after 60 days.

Wow, I just advanced P9,900.99 and I will now get P9,933.44. That's P32.45 gain for me.

Scenario: Lower Interest Rate

The effect in the illustration above can be mere entries in a client's book if there is no actual exchange. It is important to note that the volatility is only short term. If you keep an investment up to maturity date despite marking-to-market same during its entire life, you will end up with the ORIGINAL INTEREST RATE stated at the face of the instrument or investments held by the Pooled Fund.

You might ask, “if my investment will end up the same at maturity date, why mark-to-market? With the Pooled Funds “open-end” status, or where anyone participant can contribute or redeem his shares any day, M2M provides equitable treatment to investors coming in and out of the Fund. M2M provides both investor and fund manager a distinct indication of the real market value of the Fund any day, and fair price for buying and selling.

In the 2nd part of these series, we shall define a UITF and explain the recently approved UITF Circular

[2nd of 3 series](#) – Unit Investment Trust Funds Defined

In the first part of these series, you have hopefully appreciated the importance of marking-to-market investments. It is the way to go if we want to make our investment climate at par with international best practices.

Recently, the Bangko Sentral ng Pilipinas (BSP) approved the Unit Investment Trust Fund (UITFs) Circular. This was done to align the local pooled funds managed by trust entities with global standards, and ensure the china wall/distinction between bank deposits and trust products. With this, the BSP hopes to professionalize the asset management and trust industry by enhancing its credibility to the retail investors. It is anticipated that the effect would spill over to improving our capital market.

UITFs defined. UITFs, as defined in the Circular, are “open-ended pooled trust funds denominated in pesos or any acceptable currency, administered by a trust entity and made available by participation”. The open-ended nature of a UITF allows participation or redemption as often as stated in the Fund’s plan rules.

CTF and UITF differentiated. A UITF is synonymous to CTF. What then differentiates the two? The most glaring difference between the two is the valuation methodology. CTF is valued based on the traditional way of accruing or adding interest on investments to the principal. UITF is valued based on the market value of each investments in the Fund.

Under the UITF regime, allowable investments include the following: (a) bank deposits, (b) securities issued by or guaranteed by the Philippine government, or the BSP, (c) tradable securities issued by the government of a foreign country, or any supranational entity, (d) exchange-listed securities, (e) prime grade loans and/or non-risk loans, (f) any other marketable securities and/or liquid investment outlets/categories as the BSP may allow.

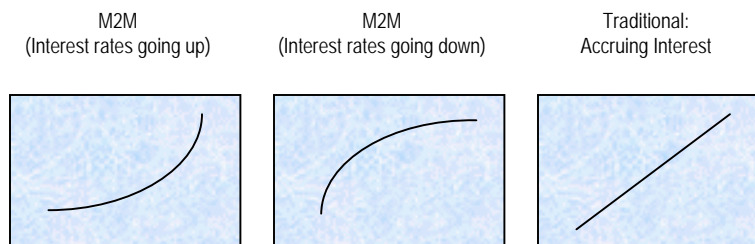
To ensure the competence and integrity of all UITF marketing personnel, the UITF circular also mandates that these marketing/sales personnel undergo a standardized training program.

In the last leg of these series we shall discuss the impact of the UITF circular on CTF investors.

[Last of 3 series](#) – Impact of UITF to Investors

In the previous article, it was stressed that marking-to-market investments in common trust funds (CTF) would uplift the standards of the asset management and trust industry, making it at par with global counterparts. As a CTF investor, you might ask “how would this impact on my investment?” or “would investing in a marked-to-market fund just subject my investments to interest rate volatilities?”

Since your investment is valued based on prevailing market rates, you are exposed to interest rate volatilities. When interest rates go up, the present value of your investment is lower. When interest rates go down, the present value of your investment is higher. The charts below illustrates the inverse relationship of interest rates and present value of investments. However, at maturity, despite marking-to-market, you will end up with the same interest rate.



With the knowledge that increasing interest rates will make the present value of one's investment lower, should an investor panic and automatically withdraw his UITF investment when this happens? The answer is DEFINITELY NOT. Due to the pooled fund nature of the Fund, it is composed of not only 1 or 2 investments but is definitely more, depending on the size of the Fund. The type of investment, term and maturity of each investment varies. Thus, increases in interest rates may not necessarily affect the Fund's value.

Why will a client need to invest in marked-to-market funds if there are other investments valued traditionally? Marking-to market is the most equitable norm of valuation. The NAVPU of the Fund reflects the market value of each of the Fund's investments, providing each investor an actual value of his investments at any point. As such, all investors get in and out of the Fund at the market value of the Fund. In addition, the M2M valuation concept provides more investment initiative/strategy formulation on the part of the Fund Manager. Hence, the investors are assured of closer, more thorough and active fund management. The Fund can, therefore, take advantage of available trading opportunities, being provided with additional window for asset growth or income realization. As such, it is noteworthy that, generally, international marked-to-market funds show better performance than accrual funds in the long-term.

As a sophisticated investor wanting to take advantage of market opportunities, the UITF regime should be a welcome development.