



"Ensuring Investor Protection"

SECURITIES AND EXCHANGE COMMISSION, GHANA

FREQUENTLY ASKED QUESTIONS (FAQS) ON MARK-TO MARKET METHOD OF VALUATION

1. What is the impact of macroeconomic indicators on the Securities Industry?

- ❖ The securities industry, usually referred to as the capital market, plays a significant role in the economy of Ghana as it offers avenues for capital raising and mobilizing savings and investments. Given that the securities industry operates within the economy, it is impacted by macroeconomic developments such as inflation, interest rates and currency depreciation. Ghana has been experiencing adverse macroeconomic developments in recent months with rising inflation, interest rates and depreciation of the cedi, which have created challenges for the securities industry. High interest rates lead to a decline in the market value of bonds and so investors may move to liquidate existing investments to take advantage of other higher yielding investments. The depreciation in the cedi also creates challenges for asset owners holding cedi investments.

2. What drives asset prices (equities & bonds)?

- ❖ The price of listed securities such as equities and bonds reflects the general sentiments of investors about the issuers of the securities as well as other considerations such as political and economic factors. Investors are typically influenced by the profitability, growth potential, prospect of dividends and capital gains, liquidity, and credit ratings

- of the issuers and either exert selling or buying pressure on the listed securities. Selling pressure tends to drive asset prices down while buying pressure pushes asset prices up.
- ❖ In the case of bonds, prevailing interest rates determine bond prices. The relationship is inverse, where a hike in interest rates leads to a decline in the market price of bonds and vice versa.
 - ❖ While there is no cut off period for when volatility would end with equity investments, volatility for bonds is limited to the tenor (duration) of the bond and will revert to 100% of the face value on maturity.

3. What is the concept of unrealized gain and loss?

- ❖ Capital gain is one of the important returns that investors look forward to and it represents the difference between the price at which a security is bought and the prevailing price of that security, provided that the prevailing price is higher. However, as there are two sides to every coin, there is also the possibility of capital loss where the prevailing price is lower than the original purchase price. It is important to remember that just as a stock price can go up and down, a bond price can also go up and down depending on how interest rates move against the face value of the bond.
- ❖ Price movements, determined by the activities of investors, can result in a capital gain or loss. Both capital gain and capital loss remain unrealized until the investor decides to sell the security. In other words, a capital gain or loss is ‘on paper’ and only becomes an ‘actual’ gain or loss when the investor decides to sell the investment. However, market prices can go up or down, it is possible for an unrealized gain or loss to be eliminated after the market corrects (and asset prices change).
- ❖ *Example:* John invests in a Fund when the price is GHC 2 per share. One year later, the fund price falls to GHC 1.5 per share. When John checks his statement, on paper he realizes he has lost 50 pesewas. However, that loss is only on paper if John does not go one step further to withdraw the funds. Now imagine that John leaves his money invested and one year later, the share price is now GHC 2.50. The loss that showed on John’s statement would now have become a gain and John’s actual loss would be GHC 0. So a paper loss only becomes a real loss when you choose to withdraw while the value of your investment has dipped.

- ❖ To avoid locking in your loss (otherwise known as crystallizing your loss), it is recommended that an investor do not withdraw their money just because the balance has dipped temporarily. Unless there is a pressing need for the funds, an investor facing an unrealized loss is usually advised to hold on to his/her investment until the market corrects.

4. What is the meaning of holding to maturity (HTM) and how does it reflect on a portfolio?

- ❖ When a security has a maturity date, as is the case with fixed income securities such as bonds, holding to maturity allows the investor to benefit from any contractual cashflows (i.e., interest payments) for that security until it matures. Upon maturity, the fund manager will then reinvest proceeds into another instrument. A fixed income portfolio strategy that “holds to maturity” would therefore reflect the face value of the bonds plus any accrued interest.

5. What is the meaning of mark-to-market (MTM) and how does it reflect on a portfolio?

- ❖ Mark-to-market is a valuation approach where the value of a security in a portfolio reflects its prevailing market price, and not the purchase price or face value. It therefore indicates how much you would receive if you sold the security on the market today. A portfolio that is marking-to-market could see its price go up and down (i.e., experience volatility) based on market conditions.

6. How do collective investment schemes provide for redemption requests?

- ❖ Collective investment schemes (otherwise known as mutual funds or unit trusts) are pools of funds that are managed on behalf of investors by a licensed professional fund manager. The manager used the money to buy stocks, bonds or other securities according to specific objectives that have been established for the scheme.
- ❖ One key advantage of investing in collective investment schemes is the easy entry and exit. With a small amount of money, an investor can participate in a collective investment scheme.
- ❖ Fund managers of the collective investment schemes are required to make sure funds are available (i.e., provide liquidity) when clients need to withdraw. To do this, fund managers make provisions in their asset allocation to hold part of the assets of the

scheme in cash or near cash instruments. However, where redemption requests far exceed the prudential provision made for liquidity in the scheme, the fund manager may have to sell some securities at a gain or loss to make up any shortfall. Depending on the market conditions, such a sale of securities may be lower or higher than the price at which the securities were bought.

- ❖ It is for this reason that, in our current high interest rate environment (as explained in question 2), selling bonds would mean selling same at a discount.

7. What are the implications of applying MTM for collective investment schemes?

- ❖ Collective investment schemes that are open-ended create and sell units/shares daily as investors enter and exit the scheme.
- ❖ The recent directive by the Securities and Exchange Commission (SEC) {Directive Number SEC/DIR/002/10/2022} for collective investment schemes to use the mark-to-market valuation method is designed to protect the interest of all investors who keep and continue to invest in the schemes and preserve the integrity of capital markets.
- ❖ Using the mark-to-market valuation method offers several benefits:
 - Investors would enter or exit the scheme at a fair and transparent price that reflects the current market value of the securities held in the portfolio of the scheme
 - The process by which securities are valued is fair and transparent
 - It ensures securities are booked at their current market price and portfolios reflect their current market values
 - It ensures the portfolio value of investors who remain with the schemes is preserved

8. What are the benefits of applying the MTM in a portfolio for the investor?

- ❖ **Gives investors a realistic and current picture of the value of the investment** and helps them to make better investment decisions (i.e., it guides the timing for depositing and exiting a fund). The mark-to-market valuation method does not change the value of investment or the value of the underlying securities compared to any other valuation method.

- ❖ **Allows investors to better appreciate the risks that underlie their investment.** This helps investors to select suitable securities to match their risk tolerance levels. The mark-to-market valuation method also helps investors to match appropriate levels of return for the levels of risk they assume.
- ❖ **Ensures investors who remain invested in their schemes over the long term and investors who exit the scheme are treated fairly and equally** particularly in a declining market environment where market prices of securities may fall below the face value. Where a fund values the portfolio using the Held-To-Maturity method (that is, using the face value), investors who exit the fund do so at elevated prices, which are higher than the current market values of the assets. What this means is that liquidating investors get a higher price than is currently on the market, and thus investors who stay with the scheme will bear the loss associated with paying out funds to those who are withdrawing at an elevated price.
- ❖ **Ensures liquidating investors exit the scheme at the prevailing market value of their underlying securities.** This preserves value for the investors who stay with the scheme. Investors who continue to stay with the scheme for the average maturity period of the underlying securities are likely to eventually recoup any capital loss in the underlying security on maturity.

9. What happens when you exit from a portfolio that uses MTM valuation method?

- ❖ When you exit a portfolio that is marking-to-market, you would be doing so at the price that reflects the current market value of the portfolio and not the face value. Given the current high interest rate regime, exits from fixed income portfolios that are marked to market would be at a discount/loss. Investors who hold bonds directly also face a comparable situation without the benefit of diversification.

10. What is the optimal response of investors in a volatile market?

- ❖ **Stay invested.** If you do not need your investment, especially in schemes that have invested in bonds, it is not necessary to put in a redemption request as the current exit price is likely to result in a loss at the time of withdrawal.

- ❖ **Consider alternative sources of cash.** It may be helpful to explore other means of meeting your short-term funding needs that may not see you losing a portion of your investment value due to the current market conditions.
- ❖ **Investing more of your savings.** Because the marked-to-market value of the portfolio is likely to be lower, you will get the advantage of gaining more units/shares. This reflects the fundamental investment mantra of “buy low and sell high.” Today is an appropriate time to invest in fixed income mutual funds that use the mark-to-market valuation method.

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