aic The Association of Investment Companies

Square peg in a round hole

Tackling the dangers of holding illiquid assets in open-ended funds

January 2020

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Hundreds of thousands of retail investors have been let down by the funds industry following the suspension, and eventual closure, of Woodford Equity Income Fund (WEIF). Consumers have been trapped in this fund for more than six months and, even now, remain uncertain over the total amount they will get back and when. This situation was the result of an avoidable problem.

In December 2019 a number of open-ended funds in the property sector suspended. This was blamed, in part, on *"Brexit-related political uncertainty"*.[1] This justification was offered despite the UK's departure from the EU being a likely outcome of the referendum in 2016 – the last time property funds were forced to suspend.

These failures have justifiably damaged consumer confidence in the funds sector. They have occurred when market conditions have been relatively benign (if not positive). They have arisen because of foreseeable failures of product design and inadequate regulation.

Bad as this is, this is not the full extent of the problem. If flaws in the design of investment funds are not corrected then many others could experience similar problems in the future to the extent that they undermine the broader economy. Preventing financial services being a cause of systemic risk is a core regulatory duty. Despite this, there has been a lack of urgency in the response of regulators and other policymakers.

The potential for further, and more widespread, problems arise because of the way open-ended funds are currently structured. Investors get their money back by calling on the assets of the fund. This is fine when those assets can be sold on demand. But many assets are hard to sell quickly; that is to say, they are illiquid. Nonetheless, in all market conditions, funds must find cash to facilitate investor redemptions. Most funds offer daily redemption, even though this promise does not match the time taken to sell the underlying holdings.

It is this mismatch that threatens financial stability and consumers. Daily redemption and hard to sell assets just do not fit together. It is like trying to jam a square peg into a round hole. The likelihood is that forcing the issue will cause something to crack, potentially with destructive consequences.

Funds facing unsustainable demands for redemptions must sell assets. This can result in poor performance and encourage more redemptions. The worst case is a vicious cycle of redemptions leading to further fund collapses and plummeting asset values.

Daily redemption and hard to sell assets just do not fit together. It is like trying to jam a square peg into a round hole.

Some argue that these risks are so great that funds offering redemption should not be allowed to hold illiquid assets. Thankfully, a less drastic option is available. Funds should be required to offer ‘reliable redemption’ terms to reduce mismatches between the redemption offer and the time taken to sell underlying assets. A central feature of this approach is likely to be notice periods when investors ask for their money back. This will relieve pressures that could fracture fund structures and cause cracks in financial stability.

The problems of liquidity mismatches have been identified. What is needed now is for policymakers to heed the warnings and act. If they do not do so it will be a fundamental failure of regulation.

With memories of the 2008 banking crisis still fresh, urgent steps should be taken to protect the financial system. Surely it is better to prevent problems building up than trying to tackle them once they break into the open?

Ian Sayers
Chief Executive
The Association of Investment Companies

1. Summary

The problem: consumer and systemic harm

Open-ended funds holding hard to sell assets while also offering frequent redemption are vulnerable to failure. Serious problems can arise when they cannot raise sufficient cash to meet their redemption promises. This encourages greater redemption requests, potentially leading to fire sales of assets and suspensions. This dynamic can lead to fund collapses.

Problems in one fund can have spill-over effects for others. A cycle of fire sales has the potential to depress asset prices in the market. This could destabilise the broader economy.

Of course, these failings also harm investors holding affected funds. The value of their investment can suffer, sometimes dramatically. They can be trapped in funds that they had expected to be able to leave at a time of their choosing.

The worst consequences of fund failures fall on retail investors, who are least able to weather losses or react quickly to the deteriorating position of the fund.

Businesses also suffer when open-ended funds get into trouble. Funds may seek to sell their shares in smaller growing companies, potentially undermining investor confidence and the enterprise's future capital-raising prospects.

This is a serious and growing problem. As these funds grow their share of the market, systemic and consumer risks are also increasing.

The need to act is not sufficiently recognised. Some stakeholders consider that fund suspensions, a consequence of failings in the redemption process, are not a serious concern. They suggest that suspensions are something that must be accepted as part of the operation of this market. This is a dangerous perspective. If accepted it will lead to even worse consequences for consumers and the economy when problems caused by suspensions break into the open.

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The solution: reliable redemption

Instead of allowing these problems to build up, policymakers should take urgent steps to prevent them.

Some have suggested banning open-ended funds from holding hard to sell assets. However, it should be possible to address these dangers without taking such drastic steps.

The objective should be to match the liquidity of the underlying assets (the time taken to sell holdings without a fire sale) with the redemption terms of the fund (the promise made to investors as to when they can get their money back).

This can be achieved by requiring open-ended funds to offer 'reliable redemption'. This means:

- **The basis on which an investor can leave the fund (in timescale, volume or price) should not change, irrespective of the level of redemptions;**
- **Redemption processes must not rely on assets being sold cheaply to raise cash to meet redemption requests; and**
- **Redemption arrangements must operate in both normal and foreseeable stressed market conditions.**

Also, enhanced governance standards should require the senior management of firms to be accountable for ensuring that reliable redemption is achieved by the products they offer.

Reliable redemption is proportionate. It will reduce systemic and consumer risks arising from open-ended funds holding hard to sell assets. Notice periods, likely to be key to achieving reliable redemption, are not unreasonable, particularly for investment products that are designed to be held for the long-term.

It will also help create a more balanced funds market able to meet the needs of investors and support economic growth.

Reliable redemption is proportionate. It will reduce systemic and consumer risks arising from open-ended funds holding hard to sell assets.

2. Problem in the making

Traditionally, funds have invested in quoted shares and debt. These both remain an important investment class, but other assets are increasingly being considered. These include unquoted shares and debt, property, venture capital and infrastructure – so-called alternative assets.

Many investors make long-term investments via a fund. Funds pool capital from many sources and spread it across a range of holdings. This provides the desired exposure and spreads risk (just in case one or more of the holdings does not perform as intended).

Open-ended funds dominate the UK market. When investors purchase an open-ended fund, they are allocated newly created shares. The money received is used by the fund manager to buy additional assets. When investors want their money back, they redeem their shares for cash. Sometimes this cash is available because other investors are buying into the fund. However, when more investors are leaving than joining, this cash must be taken from the fund's assets. Either the fund will have enough cash 'in the bank' to make the payment or the fund manager will sell some holdings to raise the money. This process is more difficult to manage where the underlying assets held are illiquid.

Twocoms / Shutterstock.com

Illiquid assets do not have a quick sale mechanism. They must be valued and marketed. Once a buyer is found, this party must do its own legal and other due diligence. Often negotiations last many months. Only when this transaction process is complete will the cash be available for redemptions.

Open-ended funds commonly offer daily redemption. This does not leave enough time for the fund operator to sell illiquid assets to raise cash to pay investors. This situation creates a liquidity mismatch. Even if redemption periods are extended by a few weeks or months, there is likely to be a liquidity mismatch and no guarantee that redemption demands can be met.

Offering funds with liquidity mismatches creates threats to the economy, the financial system and consumers, who could suffer major losses.

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"this is a big deal… something that could become systemic… these funds are built on a lie, which is that you can have daily liquidity for assets that fundamentally aren't liquid"

Mark Carney
Governor, Bank of England
June 2019[2]

3. Threats to financial stability

Globally over US$30 trillion[3] is held in open-ended funds with illiquid assets that offer frequent redemption. This amount has more than tripled since 2006.[4] Changing investment preferences will see these amounts increase. If this is not done in a responsible way, it could create harm which dwarfs any anticipated benefits.

Unstable fund structures

The potential for self-perpetuating redemption requests makes funds offering frequent redemption while they hold illiquid assets fundamentally unstable.

This risk arises when investors have lost confidence in a fund's performance or its asset class, which cause redemption levels to rise. When investors believe a fund's prospects are poor, they often ask for their money back.

Where a fund has a liquidity mismatch, investors have strong incentives to ask for their money back before others make the same decision. This 'first mover' effect exists because acting quickly lets them:

Protect the value of their investment: Delaying redemption risks a worse financial outcome. A fund having to sell assets is a forced seller, meaning it will not receive the best price. Assets are priced to facilitate a fast sale as the fund needs the cash and cannot wait to get the best outcome. More assets coming onto the market increases supply, which can further depress values.

Investors remaining within a fund suffer again if they wait to redeem because the holdings sold are likely to be the most attractive. After all, these will be the easiest to sell. So, the best assets are sold off on the cheap and the overall quality of the portfolio falls.

The challenges of valuing illiquid assets also tend to increase redemption requests as uncertainty creates incentives to sell out of a fund. This has been confirmed by the Bank of England, which observed that first mover incentives "*may also be compounded if investors anticipate that fund share prices may be 'stale', i.e. not yet factoring in the latest information with further adjustment to come once assets are sold, possibly at a large discount*".[5]

Seeking redemption early protects investors from these risks.

Secure their exit: If a fund's cash reserves are under pressure and asset sales take time, there is a risk that its operator may abandon daily redemption.

A fund may be suspended for months to give the manager time to sell assets. Redeeming before daily redemption is abandoned removes the risk that the investor cannot get their money back. In the worst case, a suspension could be the prelude to a fund's collapse.

Unfortunately, the threat of suspension creates yet another incentive to seek early redemption. Once again, demand for redemptions is increased, putting more pressure on the integrity of the fund itself.

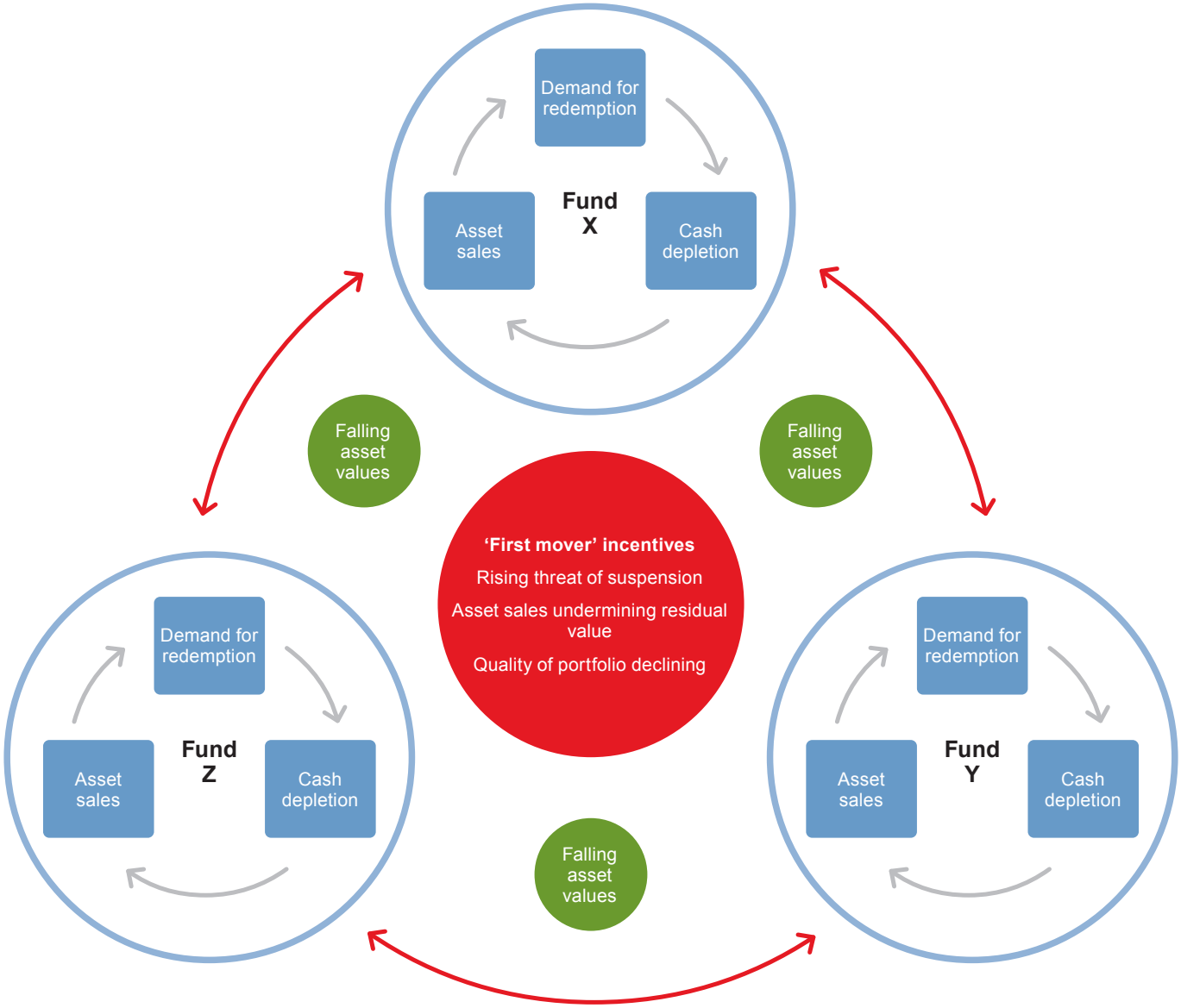
The dangers of not getting out early from a fund that is under pressure were starkly illustrated by the unfortunate experience of Woodford Equity Income Fund. Investors who redeemed before it was forced to suspend were in a far better position than those who waited. Once the fund was suspended, investors were trapped and could do nothing to protect their position. At the time of writing, investors are still waiting to find out how much money they will get back and when they will receive their final payment.

The threat of suspension creates yet another incentive to seek early redemption.

Risk of contagion

The negative consequences of one fund experiencing the worst effects of a liquidity mismatch can spill over into the broader market and harm the economic system.

Fig 1: Contagion risk summarised



Fire sales tend to lower asset prices in the market. This causes investors in other funds to lose confidence, leading to higher redemptions and further asset sales. Each fund with liquidity mismatches has the potential to affect others with the same structural deficiency. Again, these problems can be self-perpetuating.

The Bank of England estimates that over half of all open-ended funds have a liquidity mismatch.[6] Problems have already materialised where funds hold property and other assets (see 'Recent examples of liquidity issues' on page 13). The risks are greatest where the underlying holdings are least liquid.

Research[7] by the European Securities and Markets Authority (ESMA) simulated the impact of a possible 'redemption shock'. This is where an open-ended fund receives redemption requests of between 5% and 10% of its net asset value (NAV) in one week. ESMA described this as a *"large but plausible"*[8] event. It looked at 6,000 UCITS bond funds and found that 40% were vulnerable to redemption shocks. They may be forced into asset sales which, in turn, could depress asset values in the market.[9]

These systemic risks are increasing and not limited to any one part of the open-ended funds sector. As alternative assets become more significant holdings, contagion risks could emerge in any sector with liquidity mismatches. Any and all of these could be the catalyst for a negative economic shock.

Each fund with liquidity mismatches has the potential to affect others with the same structural deficiency.

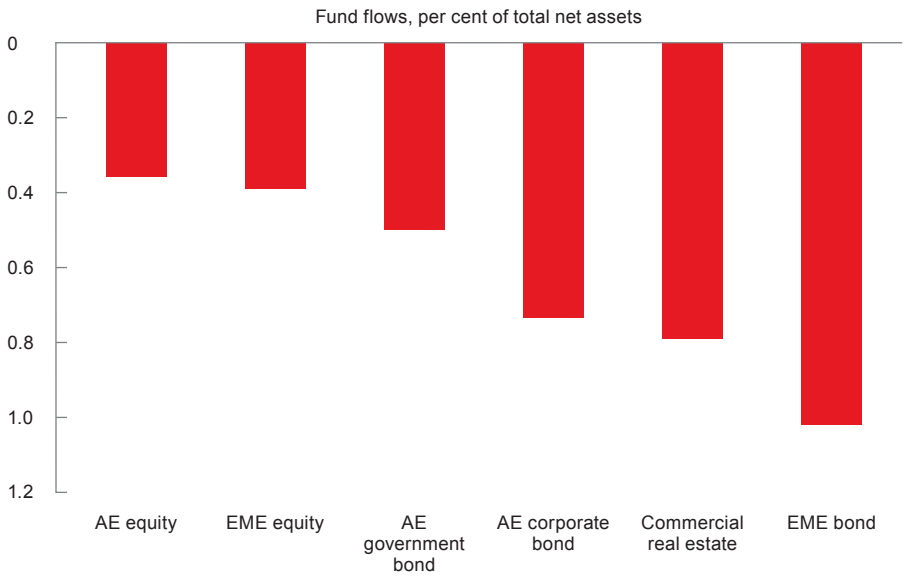
"It is quite frankly crazy to put these illiquid assets… into an open-ended fund. You are potentially asking to be a forced seller in stressed markets, which is very bad news for investors."

Rebecca O'Keeffe
Head of Investment, Interactive Investor
December 2019[10]

Harder to sell assets present the greatest threat

The less liquid the assets are, the greater the incentives to seek redemption when a fund gets into trouble.

Fig 2: Fund redemption following a fall in asset value[11]



Redemptions as percentage of total assets following 5% loss incurred over the previous month. AE – advanced economies. EME – emerging market economies.

Sources: Morningstar and Bank of England calculations

While all open-ended funds see redemption requests rise when asset values fall, the effect is most pronounced for assets that are most difficult to sell. The finding for commercial real estate is perhaps unsurprising given recent experience in the property sector. The finding for bonds in a variety of sectors is concerning given the growing popularity of funds holding these assets.

Recent examples of liquidity issues

In the global corporate bond markets, funds faced significant outflows at the end of 2018.

In December 2018, investors in open-ended leveraged loan funds redeemed US$37 billion of around US$200 billion invested in these funds.

UK Commercial Real Estate (CRE) funds faced high levels of redemption before and after the Brexit referendum result in June 2016. Six funds suspended redemptions and nine adjusted the prices that investors could receive to account for asset price movements or uncertainty. UK CRE funds also saw significant redemptions in late 2018 and early 2019, partly related to uncertainty about Brexit.

On 4 December 2019 M&G Property Portfolio fund, with assets of some £2.5 billion, was suspended. This was prompted by high levels of redemption. Later that week, Prudential also suspended trading in a number of its property funds. Following these events the property funds sector continued to see significant levels of outflows, creating fears of more suspensions to come.

The suspension of Woodford Equity Income Fund on 3 June 2019, while not systemic in nature, illustrated liquidity mismatches in a UCITS fund, a structure governed by strict EU rules on what assets can be held. Following a substantial redemption request from a single institutional investor, which came after many months of sustained outflows, it was forced to suspend. Emergency action could not resolve the problems besetting the fund and WEIF is now to be wound-up.

The Bank of England concluded that while "*these episodes did not have consequences for financial stability, they illustrate that liquidity mismatch in funds is a vulnerability that goes beyond any single market or fund type. This vulnerability could create financial instability under severe stress and is likely to become more important if more funds expand into less liquid assets*".[12]

Liquidity mismatch in funds is a vulnerability that goes beyond any single market or fund type.

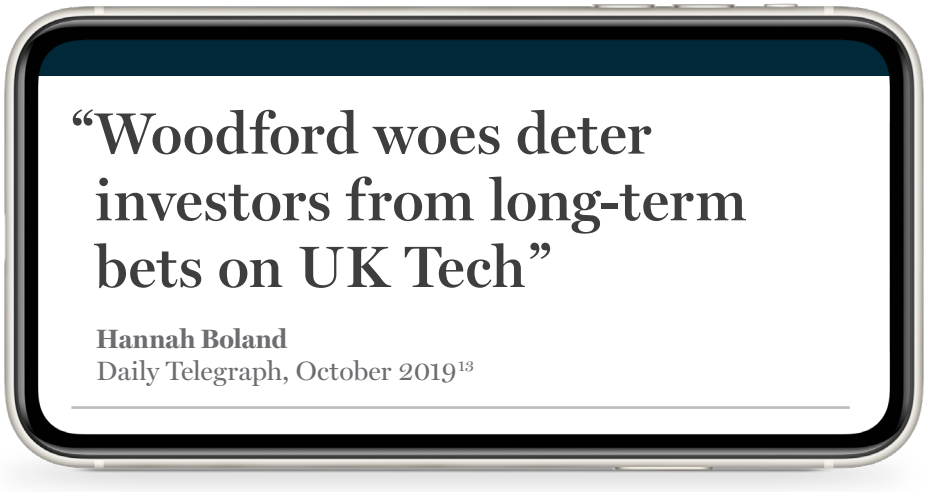
Business in jeopardy

Policymakers want funds to support smaller, growing, entrepreneurial business. If done responsibly, within the correct structure, investment by funds could increase the productive capacity of the economy, create jobs and support innovation. Done badly, using open-ended funds with liquidity mismatches, this investment could be devastating for these businesses in the long term.

Funds in trouble may be unable to uphold commitments they have made to provide follow-on capital. This could leave smaller, investment-hungry businesses in a highly uncertain position and searching for other investors to fill the gap. Instead of having investors they can rely on throughout the business cycle, they may have commitments abandoned just when they need funds the most.

Small businesses will be in even more jeopardy where funds are forced sellers of their shares. Fire sales send unhelpful signals to the market, potentially downgrading a company's value and damaging perceptions of its commercial prospects.

What may have seemed at the time as a welcome long-term investment, can transform into a source of serious harm for an otherwise promising business.



"Over half of investment funds have a structural mismatch between the frequency with which they offer redemptions and the time it would take them to liquidate their assets. Under stress they may need to fire sell assets, magnifying market adjustments and triggering further redemptions – a vicious feedback loop that can ultimately disrupt market functioning."

Mark Carney
Governor, Bank of England
June 2019[14]

4. Protecting consumers

Disclosure is not enough

Clear disclosure can help with some aspects of investment decisions but cannot protect investors from product flaws. Hardly any retail investors will read technical 'small print' relating to suspensions. Those who do are unlikely to grasp the implications. Instead, they will focus on the headline promise for daily redemption. Many will not understand that this option can be withdrawn.

Protecting the economy is, at its heart, a consumer protection measure. If liquidity mismatches undermine financial stability, then consumers' finances can be devastated.

The next priority must be ensuring individual funds operate as promised. This does not mean eliminating investment risk. Investment is inherently risky. Some investments will not perform as the fund operator wishes. This risk can be mitigated by diversification, but no asset manager can see the future. This means that, sometimes, investments may not be as successful as investors want.

What regulators can, and should, address is flawed product standards. This should stop unstable funds being offered to consumers and ensure that they are not led to expect redemption terms that cannot be delivered.

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Where there is a liquidity mismatch, and things start to go wrong, investors may place most reliance on promises that cannot be kept. Expecting them to have read caveats in the small print is not good enough.

Disclosure does nothing to prevent liquidity mismatches arising in the first place. Instead it facilitates processes that enable funds holding illiquid assets to become a source of systemic risk.

Effective disclosure is important but does not, in itself, deliver adequate product standards or protect the economy.

Effective disclosure is important but does not, in itself, deliver adequate product standards or protect the economy.

"It is essential that investors can rely on their fund manager to have in place appropriate arrangements to manage both the liquidity of assets and redemptions in their funds."

Steven Maijoor
Chair, European Securities and Markets Authority
November 2019[15]

A false narrative: the benefits of suspension

Some industry insiders have sought to make the positive case for suspension. These arguments are dangerously flawed.

Suspension can be appropriate if things have gone badly wrong for reasons that could not have been anticipated. In some cases, it can help repair problems caused by liquidity mismatches. If a fund cannot reopen, then suspension can be part of a process of orderly liquidation. For these reasons, suspension should be available when unforeseeable circumstances have compromised the integrity of a fund. However, some suggest that it can help protect consumers in other circumstances.

The view is that, in times of stress and falling asset prices, investors (particularly retail buyers) too often overreact. They seek redemption when this may not be in their best interests. They may not receive the best price and crystallise losses. The claim is that suspension stops investors making poor decisions. It means that, when asset values recover, those kept in the fund can benefit from its recovery.

These arguments are self-serving. If suspensions were indeed beneficial, they would be used voluntarily. They are not, because they are inherently undesirable.

Fund suspension in normal or forseeable market conditions is a fundamental breach of trust for investors and its consequences fall heavily on the consumer.

The reputational threat it poses explains why fund operators go to such lengths to avoid it. Funds holding illiquid assets, such as property, hold high levels of cash instead of the target asset class to reduce the likelihood of suspension. The poor performance penalty from cash holdings is preferred over the possibility of a liquidity crunch. Operators keep open the option to fire sell assets, again undermining investment performance, rather than not honouring the headline offer of daily redemption.

Apologists for suspension cannot be certain that remaining in a suspended fund is in investors' best interests. Consumers may urgently need the cash for an expense that takes priority over maintaining their investment exposure. Suspension takes away an investor's ability to choose how to manage their financial position.

Fund suspension in normal or forseeable market conditions is a fundamental breach of trust for investors and its consequences fall heavily on the consumer.

Investors have no certainty that a suspended fund will recover. Indeed, while the fund is suspended there is the danger that its financial position will further deteriorate as assets are sold off quickly to raise cash. Adding insult to injury, during this process, investors continue to see fees paid out of the assets of the fund.

On top of all these problems, allowing suspension in anything but unforeseeable situations, destabilises funds. Any expectation of suspension creates conditions where high, self-perpetuating levels of redemption are not only possible, they are likely.

Suspension may be helpful for fund providers but is never a desirable option. The problems of suspension fall disproportionately on the investor rather than the product provider. It is a sign that things have gone badly wrong for consumers. The availability of suspension is better viewed like requirements for public buildings to have fire extinguishers. These are important tools that offer protection in the worst case. But the fact that they are available does not reduce the importance of doing everything possible to stop a fire breaking out in the first place.

The problems of suspension fall disproportionately on the investor rather than the product provider.

"A number of fund managers were of the view that 'fund suspension' needs to be regarded as part of the normal, day-to-day tools of managing a fund rather than something bordering on the catastrophic. The stigma of suspending a fund needs to be removed."

Report prepared for The Association of Real Estate Funds
April 2017[16]

5. Regulatory requirements

International regulators have identified standards to prevent liquidity mismatches in funds:

Redemption terms must be achievable throughout the lifecycle of the product: The International Organization of Securities Commissions (IOSCO), the key global authority in this area, has been unequivocal. The redemption policy must work "*throughout the entire lifecycle of the product (design, pre-launch, launch and subsequent operations)*".[17] This includes when funds are experiencing high levels of redemption.

Redemption terms must operate in both normal and reasonably foreseeable stressed market conditions: IOSCO states, *"The investment strategy and objectives should be designed to give strong assurance that redemptions can be met in both normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions".*[18] Funds are at greatest risk from liquidity mismatches when confidence is weak and redemption levels high. If redemptions cannot be managed in these situations then their policies are, self-evidently, unable to contain economic risk and protect consumers.

Redemption policies should work throughout the business cycle as well as during more extreme but foreseeable situations. Foreseeable circumstances might arise from, for example, the UK's exit from the European Union, structural issues in the Eurozone, the possible unwinding of quantitative easing, growing global trade tensions and the impact of climate change. Policies unable to manage the impact of such events are inadequate.

Too often, fund operators focus on delivering redemption only in 'normal' market conditions. Open-ended property funds continue to offer daily redemption despite recent experience of liquidity mismatches and recognition by industry experts[19] that daily dealing is not realistic for this asset class.

Even where it is accepted that daily redemption may not be appropriate, industry stakeholders too often underestimate the liquidity challenge. Recent commentary on liquidity suggests that *"low liquidity"* assets, including property, "*may take up to three months to sell*".[20] This may be plausible for a small proportion of real estate assets but not for all. The Bank of England reports that commercial real estate takes, on average, 298 days to sell.[21] As 10 months is the average, it is likely that many properties will take much longer to sell. This indicates that the redemption period might have to be a year or more for many property funds if they are to operate in all foreseeable market conditions.

Industry stakeholders too often underestimate the liquidity challenge.

Suspensions must be, unequivocally, a final resort: Ensuring suspension is a last resort, available for use only in exceptional circumstances, is a regulatory principle identified by IOSCO.[22] Nonetheless, a recent report exploring how open-ended funds could be structured to hold illiquid assets suggested that suspension would be allowed in "*periods where redemptions are higher or liquidity lower than in normal conditions*".[23]

The willingness of some industry stakeholders to portray suspension as an intended feature of fund design was reinforced by a recommendation that funds be allowed to suspend redemptions while still allowing investors to put money into the fund.[24] This is a significant step towards normalising the use of suspension. Regulation must ensure that this is not allowed.

Unfortunately, the response to date from regulators does not meet IOSCO's standards. The FCA is introducing specific rules for funds holding illiquid assets.[25] Despite the IOSCO recommendations, it has stated, "*We do not consider the frequency with which funds investing in illiquid assets are suspended to be a measure of success*".[26] The FCA has noted that open-ended funds holding illiquid assets "*have a significantly higher probability of suspending than other funds*".[27]

The FCA seems to have accepted that suspension can be used in foreseeable situations, such as when the UK voted to leave the EU, or if investors holding a significant proportion of a fund's shares redeem them. This approach will allow the open-ended fund sector to become a source of preventable consumer and systemic risk.

Despite the IOSCO recommendations, the FCA has stated, *"We do not consider the frequency with which funds investing in illiquid assets are suspended to be a measure of success".*

Maintain the integrity of the sales process: Asset sales can be accelerated if they are sold at a knock-down price. However, redemption requirements that rely on fire sales undermine investor returns and destabilise funds. Again, this is an issue identified by IOSCO, which has stated: "*One of the broader goals of such liquidity management tools is also to maintain an orderly market and valuation process*".[28]

This objective has not been recognised by all stakeholders. The FCA considers fire sales to be acceptable provided that this possibility is disclosed.[29]

Operate irrespective of the investor profile: Large redemption requests, for example, from large institutions, must not be allowed to disrupt the redemption offer. Redemption requests are not, in themselves, unforeseeable events. They should never provide the justification for a fund suspension or other changes to redemption terms.

"OEFs [Open Ended Funds] should not be managed in such a way that the investment strategy relies on any additional ex-post measures such as suspensions. These measures are not a substitute for sound liquidity risk management from the outset, so that the dealing frequency of units meets the anticipated liquidity needs of the fund under normal and foreseeable stressed market conditions."

IOSCO
International Organization of Securities Commissions
July 2019[30]

6. The solution: reliable redemption

The solution to threats of liquidity mismatches is to require funds to offer 'reliable redemption'. This means:

The basis on which an investor can leave the fund (in timescale, volume or price) should not change, irrespective of the level of redemptions: This will reduce incentives that increase redemption requests when a fund is under stress. Achieving this will mean significant changes in the redemption terms of funds holding illiquid assets as it is inconsistent with daily redemption. This approach will mean that, instead of giving investors an expectation of liquidity which is undeliverable in certain circumstances, fund operators will have to make an offer that can be achieved (except in unforeseeable circumstances) even when the investment environment is poor.

This will probably mean that the headline redemption offer will include longer notice periods. After all, if it takes, say, a year to sell the underlying assets, this is likely to be the basis for setting a reliable redemption policy. This does not mean that fund operators would be prevented from improving on the redemption offer where circumstances allow. However, investors should not be led to expect that a swifter exit will always be available.

Redemption processes must not rely on assets being sold cheaply to raise cash to meet redemption requests. Fire sales create incentives to request redemption. They are a key driver of consumer harm and source of systemic risk. No reliance should be put on fire sales as a means to manage redemption.

Fund operators will have to make an offer that can be achieved even when the investment environment is poor.

Redemption arrangements must operate in normal and foreseeable stressed market conditions: Unless this is achieved, the fund's policy will be insufficient to protect consumers and prevent the fund becoming a source of systemic risk.

Delivering this means that the overall liquidity profile of a fund shall be maintained in all foreseeable market conditions. If this is not achieved, the fund may have to breach the other principles.

Achieving this outcome will mean providers clearly distinguishing those liquidity management tools, such as suspension, that would only be used in unforeseeable circumstances.

These are proportionate and achievable requirements. They will deliver the required outcome without setting inflexible redemption rules or unnecessarily restricting the development of products able to deliver for consumers and in the broader economic interest.

Why not just ban illiquid holdings?

Some jurisdictions simply prevent open-ended funds from holding illiquid assets.[31]

In Brazil, real estate funds and private equity funds must be closed-ended (see page 34 for an explanation of the closed-ended structure). In India, real estate must be held in a closed-ended fund and the units must be listed on a recognised stock exchange. The Central Bank of Ireland requires certain loan-originating funds to be closed-ended. In Italy, a fund that invests more than 20% of its assets in loans, real estate or securities not traded on regulated markets must be closed-ended. Open-ended funds in Portugal are prevented from investing in certain assets, including shares in real estate companies that are not traded on a regulated market. Other jurisdictions have similar, targeted prohibitions.

However, there are some good reasons for hesitating before banning illiquid holdings in open-ended funds. It may be too blunt a policy response, which could inappropriately restrict the flow of capital to alternative assets. Other options can protect the economy and consumers without being so restrictive.

Also, identifying certain assets (such as direct property holdings) and applying a ban does not prevent the broader possibility of liquidity mismatches. Some asset classes cannot straightforwardly be categorised as liquid or illiquid. Their liquidity may change over time and in different circumstances. Listed shares are a good example.

Where a stock is traded on, say, an emerging market exchange with relatively thin trading, then listed securities may be a source of a potential liquidity mismatch. Mismatches could also arise for a fund with a substantial holding in a company with a small market capitalisation (even if, overall, the trading venue offers substantial liquidity).

In these situations, funds may need time to dispose of listed shares at a price that does not disadvantage investors. This may be incompatible with, for example, daily redemption, but a ban on holding small-cap shares is likely to be disproportionate.

An outright ban is not the preferred approach but it could be required if reliable redemption cannot be achieved.

There are some good reasons for hesitating before banning illiquid holdings in open-ended funds.

Which funds should offer reliable redemption?

All open-ended funds should be able to deliver reliable redemption:

Funds holding quoted shares and securities: It will be straightforward for most funds holding quoted shares and securities to achieve reliable redemption, even where they offer daily redemption. These funds can often rely on public markets with deep pools of liquidity and reliable market pricing. Product manufacturers should not need to construct a new process[32] for each fund they offer. That said, some additional certainty for all open-ended funds is worthwhile even where traded securities are held. This is because some listed markets, and stocks, are less liquid. Where this is the case, a reliable redemption policy, which eliminates the requirement for suspension except in unforeseeable market conditions, remains essential.

Application to retail and institutional investors: Retail investors are more at risk than institutions from unreliable redemption offers. They are less able to understand and monitor the position of a fund, including its prevailing cash holdings or to react swiftly to market developments. On the other hand, institutions have the expertise and resources to make informed investment decisions and react to changing circumstances.

That said, the systematic risks of liquidity mismatches arise irrespective of who the investors are. They cannot be eliminated by excluding retail investors from funds holding illiquid assets or by making funds either retail-only or institutional-only. Splitting funds in this way may make it easier for some providers to achieve reliable redemption. It may reduce the potential for a single large investor to put pressure on the redemption offer. Nonetheless, reliable redemption is not achieved simply by segregating investors.

"The regulator should ban open-ended funds from holding illiquid assets"

Jeff Prestridge
Mail on Sunday, December 2019[33]

Ensuring accountability

Even well-constructed rules can sometimes result in technical compliance that does not achieve the desired outcome – in this case, reliable redemption. To address this risk, governance obligations should ensure that senior management is properly accountable for the product design choices made by firms.

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The board, or other governing body, of the firm operating the open-ended fund, should publish a statement confirming that the fund will deliver reliable redemption. This statement should be made before the fund is launched and annually thereafter. It would confirm that reliable redemption can be achieved in foreseeable, including stressed, market conditions.

This would support a business culture that gives due weight to regulatory requirements. It would elevate the importance of product design decisions and secure better consumer outcomes.

Just as importantly, it would create a means for firms to be held accountable by regulators and investors if things go wrong.

Role of disclosure

Disclosure on its own is insufficient to protect investors as it does not tackle the problems created by allowing liquidity mismatches.

That said, clear disclosure is essential to help investors understand what they are buying. Today, daily redemption is the prevailing assumption. Reliable redemption will change this position and the implications of this must be clearly communicated to consumers.

Redemption terms must be highlighted in financial promotions. They should be included in factsheets and in a prominent position on websites and pre-sale disclosures, such as Key Information Documents.

Stress testing and reporting

Effectively modelling outcomes in different market conditions is a prerequisite for ensuring that redemption processes can operate reliably in foreseeable market conditions. Reporting these findings to regulators provides the basis for monitoring emerging risks and ensuring that providers meet the requirements of reliable redemption.

Enforcing reliable redemption

As with any regulatory requirement, authorities must ensure that the penalties for non-compliance are sufficient to make firms take their obligations seriously. One of the problems with the current approach is that, all too often, the most serious consequences of liquidity mismatches materialising fall most heavily on the consumer rather than the fund operator.

"Investors in the Woodford Fund have been locked out of accessing their cash. Yet it has been reported that Mr Woodford is taking in nearly £100,000 in management fees a day.

The suspension of trading has provided Mr Woodford with some breathing room to fix his fund; he should afford his investors the same space and waive the fund's fees while the fund is suspended."

Nicky Morgan MP
6 June 2019[34]

Another option?

The Bank of England's Financial Policy Committee (FPC) recently published proposals to inform the UK and international response to liquidity mismatches.

It has proposed three principles. First, requiring funds to assess liquidity based on how long it would take to dispose of assets without needing to sell them at a significantly lower price. Second, allowing managers to adjust the price of fund units to reflect the impact of allowing investors earlier redemption. Third, setting notice periods for redemptions based upon the time needed to sell assets without discounts beyond those captured in the price received by redeeming investors.

In some respects, this approach reflects reliable redemption. The exception is allowing price adjustments to allow swifter redemption. The likelihood is that using price adjustments to manage liquidity will be self-defeating, bad for consumers and impractical.

Redemption incentives will remain: Pricing adjustments try to apportion any costs of redemptions (or purchases) to the investor leaving (or joining) the fund.

The model discussed by the FPC is 'swing pricing'.[35] This involves increasing the price of units when more investors are joining the fund and reducing it when there are net outflows.

However, the FPC's observes, *"Swing pricing would vary with market conditions and the redemption pressure".*[36] This indicates that investors can receive worse prices as circumstances change. This retains incentives for early redemption.

The Bank of International Settlements has observed that, while swing pricing can help dampen outflows in normal market conditions, first mover incentives may remain during stressed markets.[37]

This suggests that pricing adjustments will not work as hoped. Their deficiencies may be most acute for illiquid assets because in stressed markets investors may *"suspect that the prices of relatively illiquid assets that are used to calculate the NAV* [used to calculate the amount of dilution]… *do not yet factor in the latest information (i.e. they are 'stale') and could prove to be significantly higher than the prices at which the fund manager can actually sell the assets… each individual investor may thus be tempted to withdraw from the fund, hoping to benefit from a first mover advantage".*[38]

The likelihood is that using price adjustments to manage liquidity will be self-defeating, bad for consumers and impractical.

Repricing will not prevent asset sales: Price adjustments will not eliminate the need for asset sales. Some investors, faced with market stress and poor fund performance, will redeem if they can. Industry research[39] has observed that modern, swift, execution processes have increased the risks of a *"run on the bank"* for open-ended funds. A few investors, such as discretionary fund managers, can drive significant sales, particularly where funds are used as building blocks for model portfolios.

The same research found that *"based on interviews… most intermediaries are currently prepared to sacrifice performance in order to maintain daily liquidity".*[40] If liquidity (whether daily or not) is the priority, then pricing adjustments seem unlikely to help resolve liquidity mismatches.

Problematic for retail investors: Pricing adjustments will be complex and difficult to understand. Retail investors will not understand the potential for prices to move against them. Once more, they will be worse off than institutions holding the same fund. The downsides of pricing adjustments will be felt most by those least able to understand and protect their position.

Unworkable in practice?: Pricing adjustments will involve complicated judgements in situations where timely, reliable information is difficult to secure. Overlaying these difficulties is the fact that, as industry research has put it, *"fee arrangements for open-ended property funds reward the fund manager for maximising Assets Under Management. The manager has a vested interest in maximising inflows and minimising outflows".*[41] This *"perceived conflict of interest"* raises further questions over using price adjustments to manage liquidity.

Revert to reliable redemption: Valuation adjustments will not work and create additional problems. Reliable redemption provides a fairer, more effective approach.

7. Creating a more balanced funds market

Achieving reliable redemption will help create a more balanced funds market. It will help create a market that is more competitive and better able to meet the needs of investors and support economic growth.

A large part of the funds sector will continue to invest in quoted securities. No doubt these funds will continue to offer consumers daily redemption.

Other funds may offer very different terms. Increasing the diversity of the open-ended funds sector will reflect the situation already seen in markets where regulators have taken steps to reduce the risk of liquidity mismatches.

For example, since 2013, German regulations have imposed a minimum initial holding period of 24 months for investors in property funds. They also require a notice period of 12 months for redemptions.[43] Fixing redemption terms in this way is not the approach envisaged by reliable redemption, but the German example illustrates how different approaches can co-exist successfully within the funds market, giving investors more choice as well as effective regulatory protection.

Achieving reliable redemption, where consumers are given a more realistic perspective on their access to liquidity, may also increase effective competition between different fund structures.

The AIC's main concern is to protect closed-ended investment companies and their shareholders from the consequences of liquidity mismanagement in open-ended funds.

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If financial stability is disrupted by the open-ended sector, investment companies holding illiquid assets will be directly affected by falling asset values and low market confidence. Their financial position, and share prices, will come under pressure. Allowing this threat to materialise is not an acceptable outcome.

That said, if open-ended funds holding illiquid assets do start to manage liquidity risks more effectively, then the relative attractions of investment companies may change. After all, the sector has an established position in providing collective investment into alternative assets. Some 40% of the sector already offers investors exposure to such asset classes, including growth and venture capital, property, infrastructure and private equity.

Closed-ended investment companies do not offer redemption. They offer a different way for consumers to buy into, and exit, their investment.

If financial stability is disrupted by the open-ended sector, investment companies holding illiquid assets will be directly affected by falling asset values and low market confidence. … Allowing this threat to materialise is not an acceptable outcome.

The investment company model

An investment company raises capital at launch. Its shares are then admitted to trading on a public market. This process involves the publication of a prospectus, which sets out the investment approach and intended asset allocation. This explains the risks and characteristics of the company (its governance, rights of investors etc.).

After launch, the number of shares in issue is fixed. This is the basis for the investment company being described as closed-ended. In contrast, an open-ended fund creates and cancels its shares daily, according to whether investors are buying into or exiting the fund.

An investment company can periodically issue new shares to raise more capital from the market. Unlike their open-ended counterparts, this is a decision taken by the company and its existing shareholders in response to specific circumstances. Perhaps, for example, the manager might identify new investment opportunities and the company may wish to raise additional capital to take advantage of them. Each issue of new shares is a specific event, rather than part of the ongoing operation of the fund.

There are also occasions when an investment company might reduce the number of its shares by buying them on the market and cancelling them. Again, this requires shareholder approval and the decision is taken on its merits.

Each issue of new shares is a specific event, rather than part of the ongoing operation of the fund.

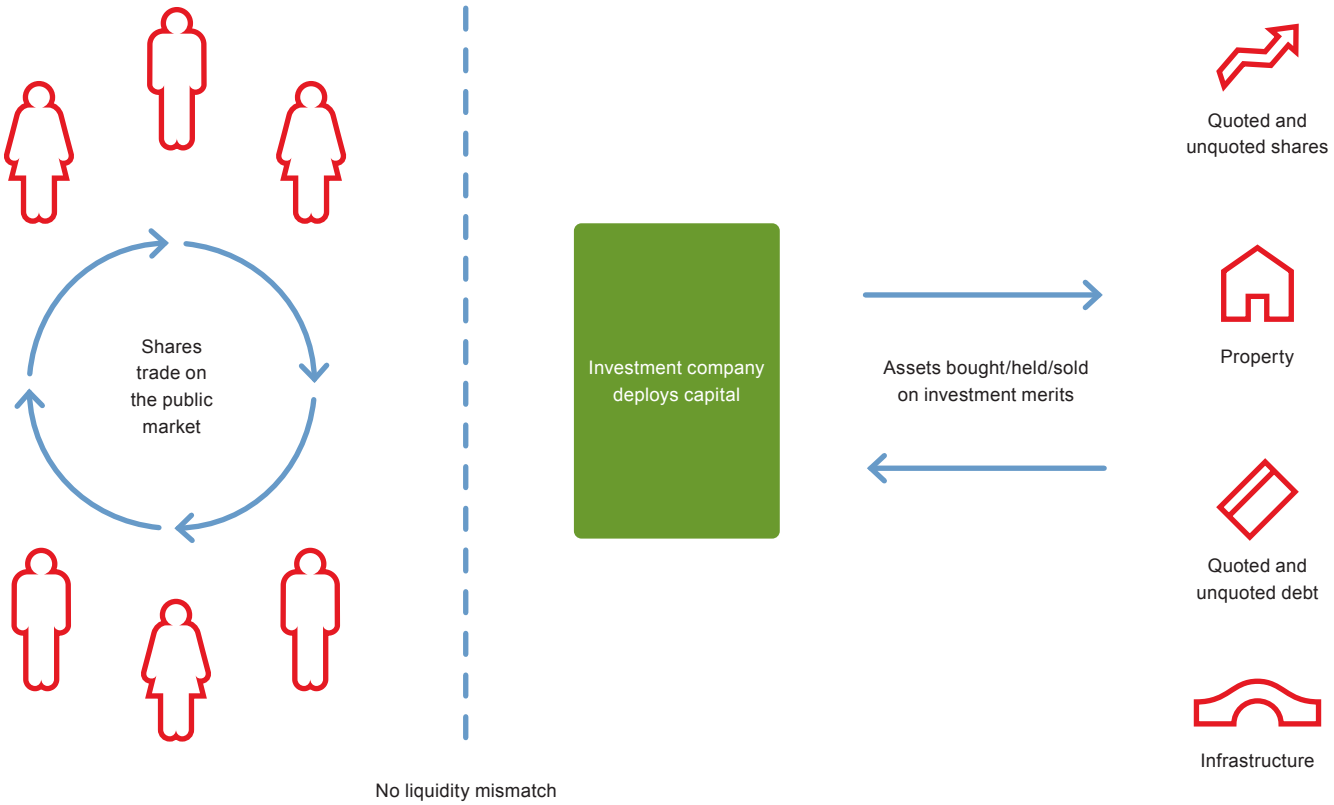
"Investment trusts do not need to sell assets when short-term investors turn bearish. They are a better and safer bet."

Lex. Financial Times
December 2019[44]

Investing funds raised

Once capital has been raised, the manager buys and sells holdings according to its view of the prospects for the assets and any need to (re)balance the portfolio. There is no need to sell assets to fund redemptions.

Fig 3: The ongoing operation of an investment company



As their shares are traded between investors on public markets, investment companies have no need to hold cash to manage redemptions. They can operate a full asset allocation. This contrasts with their open-ended counterparts holding hard to sell assets. For example, open-ended property funds are currently holding, on average, 20% in cash. This means the fund is not fully exposed to the target asset class. As a result, investors must sacrifice potential investment returns (an outcome often referred to as 'cash drag') as cash tends to underperform other assets over the long term. Also, investors pay fees on this cash balance, even though they are not getting exposure to the target asset class for this proportion of the fund's portfolio.

Open-ended funds receiving net inflows of investment on an unplanned basis also build up cash reserves. This occurs irrespective of whether the manager has identified suitable investment opportunities. Again, this can create a cash drag and reduce potential investment returns.

As investment companies do not have to respond to redemption demands they can be a more reliable long-term investor for businesses seeking capital. Their investment decision can be more closely focused on the situation of the business rather than whether or not cash is required to fund the needs of investors leaving the fund.

As their shares are traded between investors on public markets, investment companies have no need to hold cash to help them manage redemptions.

A more competitive market

Cash holdings is just one area where open-ended funds differ from investment companies. There are, of course, others. Investment company shares can trade at a different price from their underlying asset value. However, this is an expected feature of the investment proposition. Consumers can consider the implications of this and choose to invest accordingly.

If open-ended funds offer reliable redemption, this may cause investors to look differently at their options. Some will continue to prefer open-ended funds. Others may look again at investment companies.

The British Business Bank has recently considered options for pension schemes to increase their exposure to illiquid assets, in particular, venture and growth capital. Its review considered both open-ended funds and closed-ended investment companies. It concluded that investment companies are *"highly suitable"* for these investments.[45]

Regulation should enable the market to offer a range of fund types, able to provide access to illiquid assets, in reliable product structures. This will benefit investors, businesses seeking capital and policymakers trying to increase growth, job creation and productivity.

As investment companies do not have to respond to redemption demands they can be a more reliable long-term investor for businesses seeking capital.

"The implications of shares trading at a discount or premium to NAV is nuanced… As long as the total share price return broadly tracks NAV return, there is a minimal adverse impact for investors"

British Business Bank
September 2019[46]

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January 2020