On June 3rd, one of the UK's most high-profile Fund Managers, Neil Woodford, was forced to suspend redemptions from his flagship Equity Income fund after a prolonged period of dire performance. The move triggered an avalanche of criticism and concern from investors in the fund and highlighted the vulnerabilities associated with the (commonly used) fund structure that Mr Woodford had adopted.

In this month's overview we examine what leads to some fund managers having to 'gate' (suspend dealing in) their funds. We assess the impact of such a move on the underlying investor and we also consider what can be done to avoid such funds and the associated consequences.

The catalyst for the suspension of Woodford Equity Income was a request by Kent County Council to withdraw the £250m that they had invested in the fund after a sustained period of dreadful investment performance, but trouble was brewing way before this redemption request. Up until that point, the fund was slowly leaking assets and had suffered net monthly redemptions for the last 23 months. Yet these only amounted to approximately 1% of the Net Asset Value (NAV) of the fund each week. Along with the usual monthly outflows, the Kent County Council redemption amounted to around 8.2% of the value of the fund. As Woodford had invested a portion of the fund into assets that it was impossible to sell in the short-term, the fund's authorised corporate director (ACD), Link Fund Solutions, implemented the suspension to provide time for them to raise the necessary funds to meet the redemptions without unduly impacting the remaining shareholders.

"The unlisted proportion of the fund was biting on them as the total fund size shrank." Charles Randell Chairman of FCA - June 2019

The Woodford suspension has shaken the investment world more than with any previous fund, partly because he was seen by the thousands of retail investors who had backed him as the safest of pairs of hands in a very 'liquid' sector (see below for an explanation of liquid). Investors are right to be alarmed when they can't sell their investments on demand because of 'a run' on the fund triggered by very poor performance.

However, the Woodford Equity Income fund is not the only large fund to be suspended in recent years although it is certainly the highest profile. Woodford is in good company - dealing in some of the largest open-ended commercial property funds run by the likes of Aviva, M&G and Standard Life was suspended immediately after the Brexit referendum and indeed last summer GAM suspended its Unconstrained and Absolute Return Bond funds, announcing the closure of the latter when redemption requests overwhelmed the fund.

Firstly - What is Liquidity?

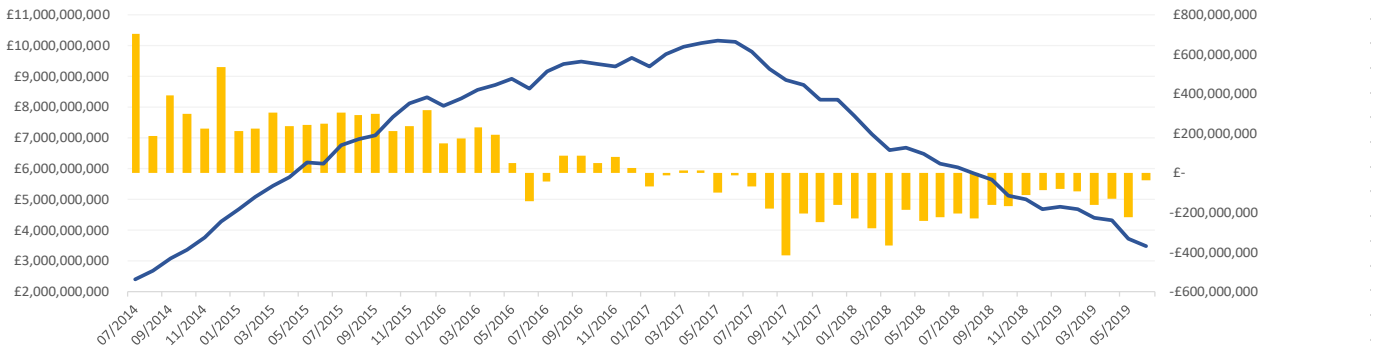
Liquidity is a measure of how easy or how hard it is to buy or sell

(trade) an investment. The more liquid an asset, the easier it is to trade. A liquid is free-flowing, flexible and responsive to the shape of its surroundings. It is therefore no mistake that the word 'liquidity' is used by the investment world as a measure of how fluid and responsive an investment is to supply and demand. Liquidity is not just a measure of whether or not you can trade an investment, but crucially also the quantity of that investment that you can trade. Typically, the greater the percentage value of the overall value of an investment that you are looking to trade, the more difficult it will be to do so. If you want to sell 1% of the shares in a company, it is usually much easier to do so than selling 70% of the shares in the same company. Liquidity is therefore a measure of both the volume tradeable and the supply/demand of an investment at any given time. A liquid investment is easy to trade whereas an illiquid investment is not.

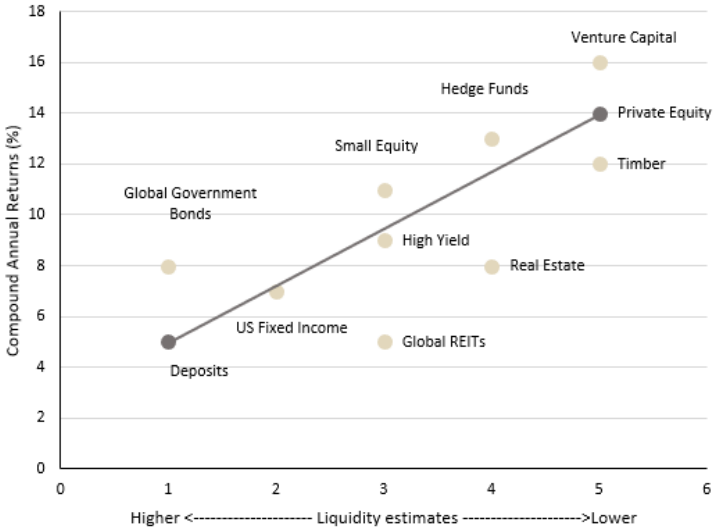
Types of investment and their associated liquidity

As a rule of thumb, the more defensive an investment is, the more liquid it tends to be. One of the characteristics of a low risk investment is that it should be easy to trade, giving investors the comfort that they can access their capital if needed. Cash on deposit should be the lowest risk asset class and will allow access at a moment's notice. At the other end of the spectrum, venture capital and private equity investments are much longer-term and it can often take a decade or more for an investment to generate the predicted returns.

The rise and fall of a star. Neil Woodford's Equity Income fund assets fall from £10bn to £3.6bn (blue line) and suffers 26 consecutive months of redemptions



Capital is therefore typically 'tied-up' for many years with no access. However, it is important to note that with these types of investment, you actually want the money to be tied up, for reasons that we will explain later. In the middle sits everything from property to US equities to high yield bonds.



Liquidity and confidence go hand-in-hand

It is all very well looking back at historic levels of liquidity for various asset classes but this can't prepare you for one-off shocks to a particular fund or indeed to a whole financial system. During times of market stress, panic selling often leads to massive volumes of shares being desperately sold into the market, with some investors prepared to accept any price just to get out. Such an event is termed a "liquidity shock", where investments once deemed liquid become suddenly incredibly illiquid.

Perhaps the best example of a broad general market liquidity shock was experienced immediately post the Brexit referendum in 2016, when investors who feared a massive downturn in the UK commercial property market scrambled for the exit in some of the industry's biggest property funds. Almost overnight, managers of nine of the fifteen largest commercial property funds dropped the selling price of each unit by between 4% and 15%, eventually suspending them for a number of weeks/months – and for good reason. Consider what these funds own – a portfolio of properties – bricks and mortar. These properties are held in a fund that investors can theoretically encash their units using a price that is available once a day. Funds of this type are said to have 'daily liquidity'. This means that the fund manager is reliant upon having a cash "buffer" in the fund, enough cash from rentals and new money coming in from investors to pay anyone who wants their money out. They don't want to be forced to sell a property to fund redemption requests.

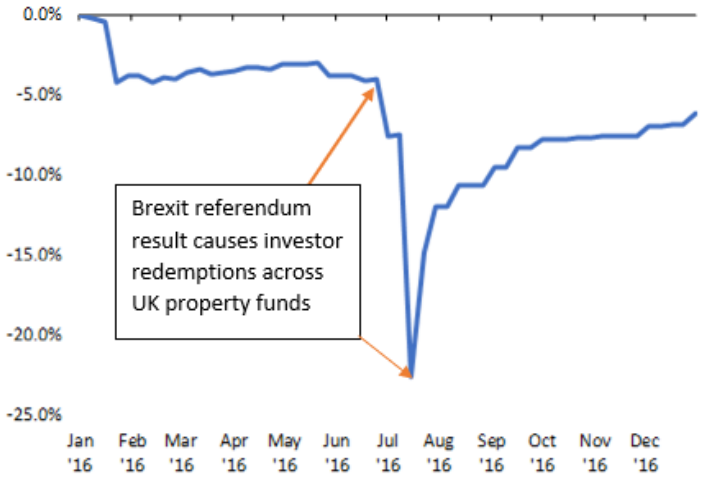
When Brexit was announced, several funds experienced a massive increase in the level of redemptions, the largest being around 8% of the fund. During the four days from Monday 4th July to Thursday 7th July, six 'daily liquidity' funds were suspended by their managers. These funds were collectively worth about £14.6 billion in assets under management. The managers were forced to sell properties to raise enough cash to pay out to redeeming investors.

So what is the problem with this?

There are several problems. Firstly, if you are a forced seller of something, it is likely that a buyer will know this and demand a lower price. The seller is therefore forced to accept a discounted price.

Secondly, not everybody wants to redeem from the fund. However, because each underlying property is owned by all of the unit holders of the fund, each unit holder shares the pain of the discounted price for the property that had to be sold. This means those that stay in the fund are disadvantaged by those that want to leave.

The fundamental problem with these property funds is that the liquidity offered by the structure of the fund (daily) does not match the liquidity offered by the investments that the fund buys (commercial bricks and mortar).



The open-ended Aberdeen UK Property fund suffers steep decline due to redemptions

What do fund managers do in this situation?

The fund's administrator may decide to reduce the price of the units so that those selling will end up doing so at a price that should not disadvantage those that remain in the fund. However, this only goes so far because if the selling pressure is strong enough and if the assets cannot be sold quickly enough, cash will run out and then the only way to stop the rot is to suspend dealing in the fund until there is enough cash from asset sales to satisfy all of the redemptions. This is exactly the spot of bother that those invested in Woodford find themselves in now.

Self-fulfilling prophecy

Like a run on a bank, a fund that has been suspended due to mismanagement or panic selling caused by bad performance will almost always end up being wound up. When it reopens, with much greater liquidity again, the remaining holders will typically redeem. We fully expect this to happen to Woodford.

However, the property funds survived because they were all a victim of investors' fears about Brexit generally rather than concerns about the management of the funds. When the dust settled investors realised that they had panicked irrationally, and bargain hunters even started to buy at discounted rates. We believe that this will not happen with Woodford.

Wider implications

A sudden change in liquidity conditions is not just limited to managed funds. Global government bonds should offer a high level of liquidity as they are backed by a government's coffers, but what happens when investors doubt the ability of a government to repay their debts? History is littered with examples of defaulting governments, most recently Argentina, Venezuela and of course Greece. Greek government bonds used to trade over €10bn a month with good liquidity. When the Eurozone sovereign debt crisis hit, almost overnight liquidity dropped to below €250m a month, with some bonds becoming untradeable. This shows that liquidity is greatly influenced by momentum and confidence. In theory, therefore, even the lowest risk investment is at risk of a liquidity shock, just like even the strongest bank in the world can still suffer a 'run on the bank' if enough customers want their money out.

Regarding investment funds specifically, Mark Carney (Governor of the Bank of England), highlighted his concerns about the structural implications of liquidity shocks in a speech recently:

"More than $30trn of global assets are held in investment funds that promise daily liquidity to investors despite investing in potentially illiquid underlying assets such as debt"

Also, following a six-year study (2008-14) on the evolution of liquidity in the UK corporate bond market, the FCA produced a paper detailing their findings. Whilst they concluded that, "there is no evidence that liquidity outcomes have deteriorated in the market" they did admit that "our own analysis shows that liquidity is subject to considerable deterioration if the market is under severe stress".

Other commentators have subsequently reported their concerns over structural liquidity in the market and those concerns have only been exacerbated by the recent fund suspensions.

Is there a better solution? We think so.

Longer notice periods - We mentioned in the above property problem that the fundamental issue was that the liquidity offered by the fund does not match the liquidity of the investments in the fund. So, what if instead the property funds mentioned above built in a redemption notice period when creating the fund of 12 months rather than daily, meaning that investors could only receive their redemption proceeds a year after requesting them? This would be much better because the manager would have an entire year to sell property in an orderly fashion when requests to sell came in. Up until now investors would not accept such a condition, preferring the illusion of daily liquidity and the reality of no liquidity instead of a more sensible approach of matching the liquidity of the fund to that of the investments within it. However, with all the controversy surrounding the Woodford fund and the pressure on the FCA to take action, perhaps some common sense will lead to wholesale change.

Closed ended funds – the problem with Woodford, GAM and the commercial property funds is that they are all 'open-ended' funds. This means that if investors want to sell, they sell their units back to the fund and the units are then 'cancelled' in return for the investor receiving cash. A much better structure for investments that are relatively illiquid is a 'closed-ended' fund. These funds raise money from investors at outset, but it is locked-up, sometimes indefinitely. However, if an investor wants to sell, there is a market for them and they can sell their shares in the fund to another investor that wants to buy, via the stock market. This means that the fund itself is not affected by redemptions because the selling investor simply sells the shares to the buying investor, not involving the fund manager whatsoever.

In the case of commercial property, private equity, some debt and some hedge funds, we believe that a closed-ended fund is the most appropriate vehicle for investors in these assets.

"Investment company managers do not have to worry about inflows of hot money and outflows when times are tough, and buyers are hard to find but can concentrate solely on the long-term performance of the portfolio." *Annabel Brodie, Director, Association of Investment Companies 2016*

Regulatory pressure – this is inevitable in light of the Woodford debacle. We believe that funds will be forced to comply with more rigorous liquidity tests of their underlying investments and that they will be limited to the amount of illiquid investments that they can hold. There is even talk of the UK regulator ditching the existing Europewide funds structure and creating a new funds framework specifically for UK investors.

Our approach

A core pillar of our investment process has always been an assessment of liquidity. We do buy open-ended funds, but we monitor asset flows of our chosen funds on a regular basis, placing as much emphasis on regular inflows as well as outflows to determine if there will be any potential changes to the current positioning or liquidity profile of the fund.

However, recent events have simply re-confirmed our view that the most appropriate structure for longer-term illiquid investments such as property, unlisted and private equity investments is a closed-ended fund such as an Investment Trust. Using this type of fund means that we will avoid the issues of a big liquidity shock in sectors that have so badly affected users of open-ended funds.

The recent news about Woodford is a much-needed wake-up call for the fund industry as a whole. The news prompted us to take a belt and braces approach, asking all our buy-list funds to reconfirm the liquidity profile of their underlying investments and we were not surprised to discover that our chosen funds have very little exposure to illiquid investments. We are as confident as we can be that that they could not suffer the same fate as investors in Woodford. We hope that the regulator takes a pragmatic but firm approach to ensure that retail investors are protected from such issues in the future, but history teaches us that this incident won't be the last. Now more than ever, deep analysis is required before investing, even in funds and with managers that are assumed to be a dead cert, as Neil Woodford has found out to his cost.