Liquidity Liberation for Mutual Funds

Let's choose discretion and elegance over valor and quantitative models in the battle to discover optimal liquidity risk management.

By Joe Pimbley

A trending anxiety in the financial world is the alleged decline of secondary market bond liquidity. The evolution of banking regulation -- in a manner that discourages the banks' bond dealing activity – is a plausible explanation for **the falling liquidity**. (http://www.businessinsider.com/goldman-sachs-on-bond-market-liquidity-2015-11)

All else equal, fewer dealers implies lower liquidity. But regulators and commentators have also raised **the alarming prospect** (http://libertystreeteconomics.newyorkfed.org/2015/10/redemption-risk-of-bond-mutual-funds-and-dealer-positioning.html#.VsyAM30rK9J) that shareholders in bond mutual funds may stage runs on the funds that current bond market liquidity cannot support.

Run on Third Avenue Crushes a Flagship Fund

The failure of the *Third Avenue Focused Credit Fund* (http://www.bloomberg.com/news/articles/2015-12-10/third-avenue-plans-to-liquidate-focused-credit-fund-after-losses) (TAFCF) this past December hits this theme squarely. Investors expect that a mutual fund such as TAFCF will make immediate redemption payments upon demand. Indeed, the *Investment Company Act of 1940* (the "*'40 Act*") stipulates that a mutual fund may not "**delay payments of redemption proceeds for more than seven days**." (http://www.icifactbook.org/fb_appa.html)

The TAFCF owned illiquid, distressed debt. The fund's executive spokesman blamed TAFCF's failure on a combination of "the general reduction of liquidity in the fixed income markets" *and* investor redemptions These factors, he elaborated, effectively forced Third Avenue to choose between "fire sales" that would destroy value or "blocking [further] redemptions." Third Avenue opted to block redemptions and terminate the TAFCF.

Regulators Seek Improved Liquidity Risk Management

Regulators and regulatory guidelines understand the threat. The *'40 Act* itself states that 85% of a fund's assets must be liquid – *i.e.*, each such liquid asset "can be sold … in the ordinary course of business within seven days at approximately the price at which the mutual fund has valued it." Unfortunately, life and liquidity are not so simple. Both *actual* and *perceived* liquidity vary with time and stress.

Prior to the TAFCF failure, the SEC **proposed improved liquidity risk management for mutual funds**

(https://www.sec.gov/news/pressrelease/2015-201.html) in **September 2015**. (https://www.sec.gov/rules/proposed/2015/33-9922.pdf) The core ideas are to specify with more precision the expected liquidity of fund assets and to permit some amount of "swing pricing" to push liquidity losses, if any, to the selling shareholders.

An Elegant, Simpler Solution Recognizes Uncertainty of Future Liquidity

There's no need to dive into details of "liquidity risk management" concepts to recognize a simple point. It is not possible to achieve *complete* certainty of seven-day redemption for *any* pool of assets, unless all holdings are cash or debt obligations maturing within seven days.

With this understanding, why not simply eliminate the requirement for immediate liquidity? There is no clear need for investors to have, or to insist on, such a promise. Instead, the mutual fund would simply make "best efforts" to return cash to redeeming shareholders through prudent steps.

More broadly, risk management requires common sense. As Alan Wheat, a past CEO of CSFB, described in a 1999 conference discussion in Paris, CSFB's board of directors rebuked the firm's executives in the wake of the Russian debt crisis of 1998. The board criticized the absence of "peasant logic" in the bank's over-reliance on clever pricing and risk models.

In the current mutual fund world, it defies "peasant logic" to require that the *liabilities* of a balance sheet should have essentially daily maturity while the *assets* of the same balance sheet have long tenors and uncertain market liquidity. There are no adequate models or stress cases to prove that redemption will always be immediate in the real world.

Fund Managers Cannot Guarantee Returns *or* Liquidity

It is highly likely that the intentions of the *'40 Act* authors and the regulators have been to protect mutual fund shareholders with this immediate liquidity expectation. While protecting small investors is a noble thought, it is clear that markets and regulators do not shield investors from risk of *loss*. A key, time-honored principle is that investors must bear the risk of loss.

In a deep and important sense, risk of *liquidity* and risk of *loss* are similar and often intertwined. A fund manager cannot assure the shareholders that there will be no loss without specifically limiting the fund to (risk-free) assets that will bear no loss.

What's more, there is no other "risk management" that will eliminate the possibility of loss. Shareholders understand this point and deliberately *choose* to bear the risk of loss in the hope of earning a return greater than the risk-free rate.

We argue that the ideal state with respect to liquidity is similar. There can be no guarantee to shareholders of immediate liquidity without limiting the eligible assets to this same liquidity standard. Shareholders can and should *choose* the level of liquidity risk by review of available mutual fund investments and their differing investment goals.

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