THE INVESTMENT ASSOCIATION

INVESTMENT MATTERS

LIQUIDITY IN FUND MANAGEMENT

A GUIDE FROM THE IA

WHAT IS LIQUIDITY?

'Liquidity' is the term used to describe how easy it is to buy and sell the investments such as shares, bonds or property that a fund holds. Some assets (such as listed shares in very large companies) can usually be bought and sold almost instantly; others (such as property) can only be sold once a buyer has been found and a price has been negotiated, meaning that the process can take longer.

Depending what a fund is invested in, this might occasionally affect how quickly investors can sell their holdings in the fund itself.

Liquidity can also change depending on market conditions. Some assets – for example, listed shares of small companies – could be very liquid when there are plenty of buyers and sellers, and become more illiquid when market conditions change.

One of the roles of an investment manager is to manage these issues and, if necessary, to communicate them to investors. One of the benefits of investing through a fund is that investors can have access to a mixture of assets with different levels of liquidity, while the fund as a whole provides the overall level of liquidity that investors need.

WHAT DOES THIS MEAN FOR INVESTORS?

Units in most funds available to individual investors in the retail market can be bought and sold on a daily basis. Investors usually value the assurance that the funds that they invest are liquid enough that they can expect to be able to take their money out of it at short notice.

This means that funds need to make sure that they keep a sufficient amount of highly liquid assets to ensure that they can redeem investors' holdings and pay out the value when asked.

It's important to remember that funds should be seen as long-term investments, and people investing into funds should be thinking about the next five to ten years, not their immediate financial needs. This means that consumers should rarely need instant access to the money in their funds: funds cannot be treated like an ATM or like cash in a bank savings account.

The IA represents the investment management industry, supporting savers, investors and businesses in the UK, EU and beyond. Our 250 members manage £7.7 trillion, £1.7 trillion of which is on behalf of European clients – providing the UK with an important economic contribution in the form of export earnings, tax paid, and jobs created.

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THE RULES

The most fundamental rule followed by fund managers is that they act solely in the interests of investors.

There are then two main rules governing the way that funds manage their liquidity:

- Funds must not invest in a combination of individual assets which could compromise the liquidity of the fund as a whole.
- No more than 10% of the assets held in UCITS – the most common type of fund offered to retail investors – can be in assets not traded on a liquid market. For the other main type of funds offered to retail investors, NURS, the limit is 20%. In practice, funds very rarely approach these limits.

In addition, a fund's offering documents, such as the prospectus and Key Investor Information Document or Key Information Document (the main marketing document that investors rely on) must make clear the investment strategy that investors should expect from a fund, and how this will be achieved. This would include a strategy that means that the fund invests substantially in illiquid assets and the effect that this could have on investors wishing to access their investment at short notice.

LIQUIDITY 'BUCKETS'

The management and monitoring of liquidity is a very important part of the role of the fund manager, and this will be overseen by their board and Authorised Corporate Director (ACD). One way of doing this is to organise assets into 'liquidity buckets', which show how liquid all the assets that they hold are, and therefore how liquid the fund as a whole is. These will be regularly reviewed to make sure that they are accurate. Each fund manager will run the process slightly differently but as a guide, liquidity buckets may look like this:

Liquidity is a subjective measure, especially for less traded stocks (for instance listed small companies and lower grade corporate bonds) and liquidity can vary significantly depending on market conditions.

Many funds invest in a mixture of assets with different levels of liquidity. This means that they can pay out investors' withdrawal requests, or redemptions when required, but also that investors can benefit from the **liquidity premium**. 'Liquidity premium' is the term used to describe the additional value that investors can receive from holding long-term, illiquid assets (such as infrastructure) which are hard to sell, but which have the potential to grow over the longer term. One of the aims of liquidity management is to avoid a situation in which a large number of investors wish to redeem their holdings forcing fund managers to sell illiquid assets at a discount to ensure a rapid sale.

MANAGING LIQUIDITY

Firms use several tools to make sure that their liquidity matches their customers' needs:

- **Liquidity Analysis**. Fund managers carry out liquidity analysis at least monthly or quarterly to ensure that the assets they hold still match their investors' requirements. When market conditions require it, the frequency of analysis will increase.
- **Regular Conversations**. Fund managers are in regular touch with some large investors to understand when they may want to redeem their holdings. This means that plans can be made in advance to ensure that sufficient liquidity is available. The investor might, for example, agree to a phased withdrawal and, in some cases, a large investor might take the underlying assets rather than cash (known as an "in specie" redemption).

  As these conversations cannot usually be held with smaller individual investors, funds ensure that they always have enough liquid assets available to meet the likely levels of investor redemptions. Fund managers will monitor redemptions in their funds as a basis to estimate likely future redemptions.
- **Stress Testing**. Fund managers regularly stress test their funds' holdings to check whether there would be sufficient liquidity in a range of scenarios, such as unexpectedly high withdrawals or major political events. Holdings can be adjusted to ensure that funds would continue to operate in these scenarios. Some fund managers also perform reverse stress testing, which involves working out how much redemptions the fund could cope with at one particular point in time until it would not be able to meet redemptions.
- **Deferred Redemption**. Occasionally, in particular scenarios covered by FCA rules, funds which offer 'daily dealing' (that is, the ability to request to redeem holdings on a daily basis) can defer this for one extra day to allow sufficient cash to be made available.
- **Limited Redemption**. Some funds, such as property funds, are by their nature less liquid than others. These funds might only be redeemable only at fixed points (up to every six months), so that sufficient cash can be made available in advance.
- **Fund Suspension**. On very rare occasions, funds can be suspended if unexpectedly high levels of withdrawals mean that it would not be possible for a fund to receive a fair value for its assets. This is to protect those who stay in the fund and to avoid a fire-sale of assets, which could cause two problems. First, it could mean that investors receive a lower price for their holdings than may be the case if the fund has time to sell the assets; or second, it could mean that a fund is forced to sell the most liquid assets, leaving the remaining holders with the less liquid holdings. That's not in the best interests of either those withdrawing their investment or those remaining in the fund, so funds can be 'suspended', meaning that no more investments or withdrawals are permitted until sufficient liquidity is restored.

  FCA regulation allows for funds to be suspended to protect savers, whether they want to exit the fund or stay in it. Suspension is not undertaken lightly but it can be the right thing to do in the best interests of all investors. The FCA has made clear that suspension is not an outcome they seek to avoid if it is in investors' best interests.

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