Structural Vulnerabilities from Asset Management
AIC response to the FSB's Consultative Document

The Association of Investment Companies (AIC) is the trade association that represents investment companies. Investment companies are closed-ended collective funds, structured as companies and governed by an independent board, with their shares admitted to trading on public stock markets, usually on the main market of the London Stock Exchange (LSE). The sector has almost £150 billion of assets under management invested in a broad range of assets including listed equity, unquoted shares of small and medium sized enterprises (SMEs), property, infrastructure and debt (including business to business loans).

Asset management – current climate

As the FSB sets out, the asset management sector has seen significant growth over the past decade, with $76 trillion assets under management (AUM) at the end of 2014, of which $31 trillion assets are in open-ended mutual funds.

The global growth of asset management comes at a time when governments are increasingly looking to asset management to deliver greater investment in the 'real' economy and to mobilise retail savings to invest in SMEs and other areas of the economy that are short of investment. The European Union, for example, has launched the Capital Markets Union (CMU) that is intended to boost jobs and growth across Europe. It seeks to do this by providing businesses with alternative, more diverse sources of funding. Its proposals include strengthening venture capital markets and social investments to make it easier for investors to fund SMEs. It will also be establishing a European strategy on sustainable finance to support investment in green technologies and to use the financial system to promote sustainable growth.

Investors are also seeking alternative sources of income in the current low interest rate environment. This is increasing interest in illiquid assets such as property and infrastructure. It is creating strong incentives for asset managers to deliver new products to satisfy this demand, which is also often accompanied by a desire for liquidity in the product being held.

Policymakers should be cautious about relying on open-ended funds to respond to these demands. These structures incorporate features that restrict their ability to deliver these objectives successfully. While the FSB notes that open-ended funds have generally been resilient, there are clear risks created by the open-ended structure.

Open-ended funds

The most significant structural risk posed by open-ended funds holding illiquid assets is a potential liquidity mismatch between the underlying assets and the redemption policy of the fund. This is most likely to arise in times of market stress.

In the UK, for example, a number of open-ended property funds were 'suspended' during the financial crisis, which meant that their investors were unable to exit the fund. More recently in the UK, following the vote to leave the EU, around 98% of the £23.5 billion assets in UK-only open-ended property funds were subject to some form of action by the asset manager to

protect the fund from liquidity issues. At the time of writing, well over half of the total assets invested in the sector are subject to a suspension, so investors are unable to leave the funds. A significant number of funds were revalued, reducing returns for any investors who were able to exit. Other investors saw changes to the basis on which their investments were priced. This is despite relatively benign markets and the absence of the sort of financial crisis that was seen around 2007– 2009. These actions helped to protect the integrity of the funds but it is debatable whether or not they were in the interests of shareholders, particularly those wanting to exercise their rights to exit the fund.

This experience raises fundamental questions as to whether open-ended funds are a suitable vehicle for investing in assets such as property, infrastructure and alternative energy where the underlying assets may be difficult to value and sell in order to raise cash to meet realisations. Governments and regulators have already taken steps to address some of the risks of open-ended structures. The FSB proposes considering additional measures to ensure liquidity. These include putting in place limits on their investment in illiquid assets or requiring funds to invest in mainly liquid assets. The FSB also suggests that IOSCO should consider whether "*certain asset classes and investment strategies may not be suitable for the open-ended fund structure*".

These are important steps to consider, but they will not necessarily prevent liquidity risks which are an inherent feature of the open-ended structure. Once an open-ended fund has liquidity problems, it faces the choice of suspending redemptions, imposing exit penalties or trying to sell off assets in a falling market thus exacerbating problems. For a fund holding illiquid assets it may simply be impossible to sell the underlying portfolio so a suspension will be necessary.

Holding high levels of cash is unsatisfactory as it prevents full asset allocation. The investor is not actually buying the asset class the fund purports to offer. For example, only 86% of the assets of the open-ended 'Property Direct - UK' sector (with assets of £23.5 billion) is invested in direct property. The comparable closed-ended investment company sector is 97% invested in direct property. This creates significant risks that investors will not capture the benefits when this asset class performs. It will increase the cash weighting of the investor's portfolio and distort their ability to secure the correct balance of risk and return.

The FSB's proposals reduce the potential for funds to effectively deliver policymakers' objectives to deliver greater investment in infrastructure, unquoted companies or other illiquid asset classes. Where open-ended funds are the predominant fund structure, restrictions on illiquid investments will restrict the ability of the asset management sector to provide support to the wider economy.

Closed-ended funds

Closed-ended funds offer an alternative fund structure that does not present the liquidity risks created by open-ended funds. It is a structure that should be more widely used, particularly for investing in classes of assets that are unsuitable for an open-ended structure.

In a closed-ended fund, the investor buys a publicly traded share in a company which is established to make investments in a diverse portfolio of assets. The investor has no right to the underlying investments. Investment companies are, therefore, able to deliver a liquidity transformation which enables them to invest in illiquid investments such as property and

infrastructure, while providing straight-forward liquidity for the investor. It also makes them ideally suited for investing in SMEs where it may take years for an investor to be in a position to sell their investment to make a return.

Like investment companies, exchange-traded funds (ETFs), are traded on secondary markets and the AUM in ETFs has grown significantly. However their reliance on an authorised participant to deal with the ETF means that under stressed conditions they may not provide the same level of liquidity as an investment company.

Like any other investment that trades on a market, an investment company share is subject to market sentiment and the price can go up or down. This may lead to a gap between the net asset value (NAV) of the assets held in the company's portfolio and the share price. A share can trade at a discount or a surplus to the NAV. Historically, the majority of investment company shares have traded at a discount to the NAV. This does not, however, reduce the liquidity of the shares.

Conclusion

A closed-ended structure allows investment in illiquid assets without raising the regulatory concerns identified by the FSB. The AIC therefore **recommends** that an additional policy recommendation be adopted to inform regulatory approaches to the design phase of funds investing in illiquid assets. Specifically, a recommendation should be included before current 'Recommendation 3' stating that "authorities should have requirements or guidance stating that at the time of the design of a fund intended to hold illiquid assets, developers should consider why a closed-ended fund is not preferred over an open-ended one".

This should include taking into account options to provide investors with liquidity in their holdings without offering redemption (for example by instead trading the share or units on a public market). The fund developer should consider whether redemption is a suitable option given regulatory issues that might arise for investors, and the integrity of the fund, in both normal and stressed market conditions.

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