HORIZON
from
SKADI

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In this month's HORIZON:

- **Big returns, open access** – what are the issues with illiquid holdings in open-ended fund structures? Can investors really have it all their own way?
- **Mansion House Compact** – as the UK Asset Management industry announces plans for more private and unlisted investments, what are the risks?

It could have been a rapturous fanfare. Bill Ackman's Pershing Square USA's attempted IPO was daring. It was daring in size, aiming to raise US$25bn, but also in terms of vehicle. The IPO would have utilised an investment vehicle that can only be really described as Old Skool! A closed-end fund! Nowadays, the bulk of fund listings, such as Mutual Funds and their ever-popular cousins Exchange Traded Funds (ETFs) are open-ended.

Closed-end, Open-end, what's the difference?

With a closed-end fund, capital is raised, and the fund is launched. The capital raised is known as **permanent capital**. No new capital will be created through the life of the fund. It is the job of the Fund Manager to put the raised capital to work. Independent of the Fund Manager, investors wishing to increase their holding need to find someone else who owns the fund and buy from them. If they wish to divest, they need to find someone to buy from them. In practice this is typically facilitated by a market maker who offers liquidity in this, and a range of other, funds.

With an open-ended fund the pool of capital changes as investors buy and sell the fund. In a mutual fund the fund manager creates and destroys units as demand dictates. With ETFs the creation/redemption process is similar, but it is handled by authorised participants (we have written about this before – essentially designated market-makers) who offer liquidity to the market in the ETF and then create the basket of stocks, bonds, underlying and then hand this hedged package to the fund manager to create or redeem the fund.

The attraction of a closed-end fund for the Fund Manager, in this case Bill Ackman, is that they oversee a stable pool of capital, giving some certainty over their stream of **management fees**. For the investor though, there is the disadvantage that they cannot access the true performance of the underlying assets. The quoted price of the fund should track the Net Asset Value (NAV) of the fund, but will likely slip to a discount, and this could widen at times of market stress if there is persistent selling pressure[1]. Bill Ackman seems to have hoped that investors would be enticed by reduced management fees. Permanent capital would have made reduced fees

[1] Theoretically the quoted price could be at a premium to the NAV, at times, but in practice this is rare.

feasible. It seems though, that the risk of discount outweighed the incentive of reduced fees for potential investors, stymying demand.
Whilst the bulk of funds launched these days tend to be open-ended, it is definitely not the case that this is because closed-end = bad, open-ended = good, especially when it comes to illiquid assets. The permanent capital advantage of closed-end funds can be a boon when investing in illiquid assets that may take time to "mature", but this can (at times) be a hinderance in an open-ended vehicle. This illiquidity issue is most famously exemplified by the **Woodford** Fund, which was forced to suspend redemptions, and ultimately close.

The issue that really caused the problem for Woodford was the liquidity mismatch between his investment portfolio and the fact that its open-ended structure allowed for daily dealing. The UCITS fund structure he employed allowed for a certain portion of the fund to invest in illiquid securities (up to 10%), but the problem he faced was that the illiquid portion became a larger and larger portion of the overall portfolio as he was faced with redemptions. In fact, and this is a common problem with open-ended funds, there is a huge **first mover advantage** to redeeming ahead of other holders if there is a feeling that there might be issues with a portfolio.

[As an aside, it later transpired that the illiquid holdings at Woodford were much larger than known at the time as he had "listed" several of the unlisted holdings on the Guernsey Stock Exchange to optically keep the illiquid holdings below the 10% UCITS limit.]

Damian Taylor, co-host of the SKADI Podcast and ex-Hedge Fund manager explains...

*"You have to be very aware of "**mission creep**" within an investment objective. You saw it with Woodford, moving into unlisted investments as he looked to boost performance in a low-interest rate environment. Certainly, when we launched our hedge fund back in 2015, we (and our Directors) where very exact around the wording of our investment universe and objective. Our remit was to trade futures only (we were a CTA (Commodities Trading Advisor, a subset of the Hedge Fund universe) and it was specifically worded that we could only trade certain contracts on certain exchanges with specified counterparties. In fact, we could also only make certain investments with our cash balances (US Treasuries or cash deposits). Any deviation from a stated objective or playing fast-and-loose with investments or cash balances, should be a **red-flag**."*

We felt it important to revisit the Woodford saga and the issue with unlisted holdings within a portfolio given another announcement this month, that of the launch of the venture between Phoenix Group and Schroders that will aim for excess returns by investing a portion of pension money into private businesses and investments. We support this move, and the aspirations of the Mansion House Compact which gives rise to it, however we feel there are important lessons to be learned from the mistakes made at Woodford Investment Management.

For control staff at Asset Management firms, we feel the following areas should be considered:

- **Mandate/Strategy** mission creep. Ensure that funds are sticking to their stated mandated strategy, with special focus on how cash balances are managed. If there is a change to a mandate, are the correct procedures followed prior to the change being implemented (e.g. Director sign-off, shareholder agreement), and are all parties notified when a mandate has changed (such as shareholders, counterparties)?

- **Stress testing**. Controls to ensure appropriate stress testing versus prospectus stated and regulatory limits. A classic example would be the UCITS 5/10/40 rule (no single asset can represent more than 10% of the fund's assets; holdings of more than 5% cannot in aggregate exceed 40% of the fund's assets.). Even though a portfolio may currently be well within certain limits, what might a sudden dislocation in the listed markets do to these? Or a sudden increase in redemptions? As we saw in the Woodford case, multiple redemption requests saw liquid (listed) assets decline, pushing the unlisted component past regulatory limits.

- **Conflicts of interest**. In the case of multiple funds following the same strategy, what policies are in place to ensure that executions are allocated correctly, and not favouring one fund over another. The Bluecrest example is an excellent case in point – internal funds dealing ahead of externally managed money.

- **Counterparty risk**. Knowledge of where positions are held and how they are held. Are they centrally cleared, with a prime broker, or a custodian? If with a prime broker – are positions on swap, and, if so, is there a (dreaded word) re-hypothecation agreement (or more likely non-rehypothecation agreement) and is it checked that this is being enforced?

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Listen in on this month's podcast to hear Nic and Damian's thoughts the topics above.

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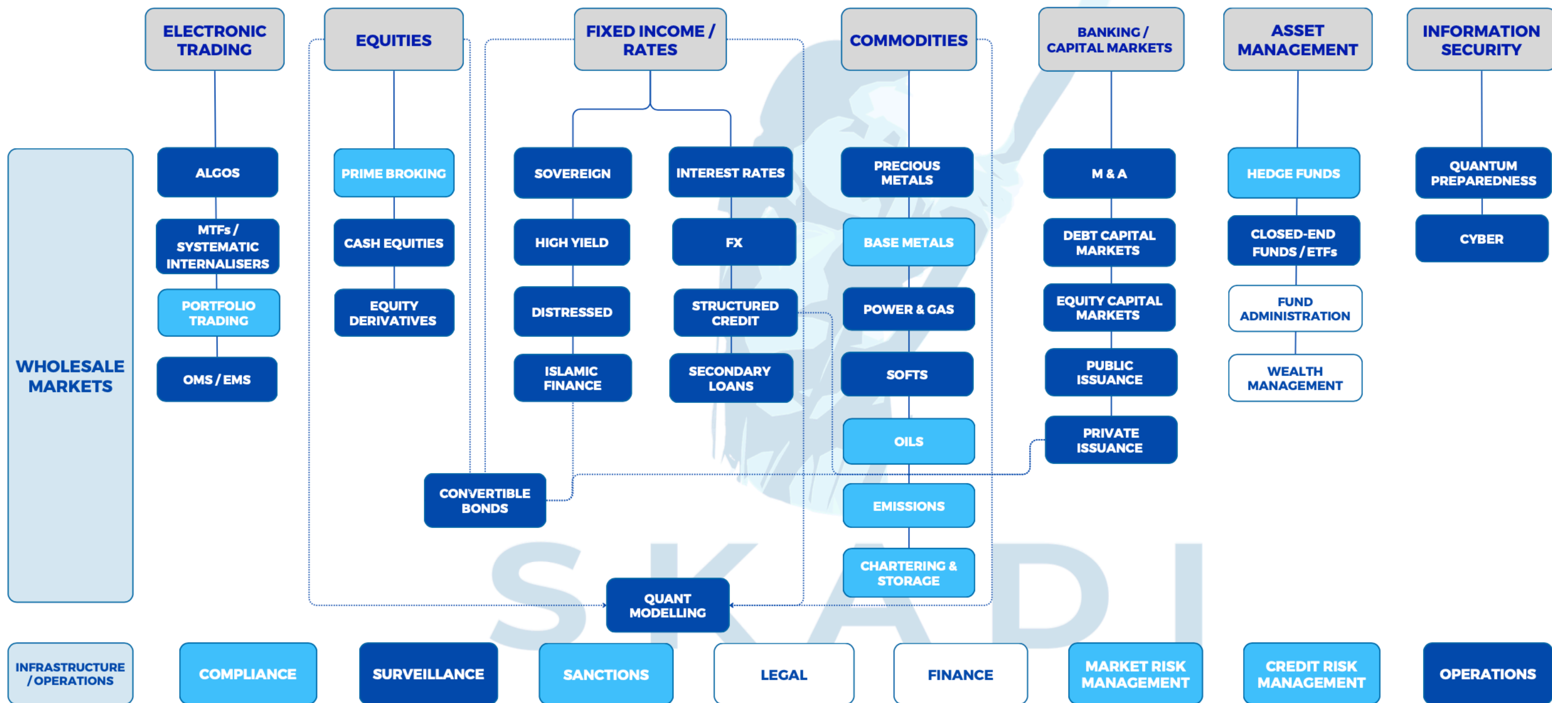
SKADI PRODUCT MAP

KEY: **SKADI MASTERY** | **SKADI DEEP EXPERTISE** | **WITHIN THE SKADI KNOWLEDGE NETWORK**



"Whether we've worked as traders or in operations everyone you'll speak to at SKADI has front-line knowledge and a deep understanding of financial products"

Previous **Horizon** editions can be found **here**

"William Taaffe and Nicolas Corry – SKADI Podcast Ep. 38 Cyber Crime and Security"

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