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CAPITAL

More Write-downs and Forced Sales are Likely

The brutal hits taken by Australian equities (-10.9%) and hybrids (-6.9%) this week were obvious to anyone who picked up a newspaper. What might have been missed is that supposedly safe haven assets, government bonds and gold, also took losses this week. The underlying story of the week was some investors aggressively converting assets to cash, selling whatever they could not necessarily what they wanted to. American corporations were acting similarly, drawing down their lines of credit to make sure they have plenty of liquidity for whatever lies ahead.

When sifting through the wreckage of the week, it appears we had a partial repeat of the LTCM meltdown. The massive intraday moves led to rumours of forced sellers, who were in some cases trying to sell into markets where there was no bid. Even in the very deep and typically highly liquid on-the-run US treasury market there are stories of the selling from leveraged investors (both unwinding leveraged bets on treasuries and selling to cover losses elsewhere) overwhelming what would have otherwise been heavy demand. The spread between more liquid/on-the-run and less liquid/off-the-run treasuries exploded higher just like it did when LTCM melted down.

Fingers are being pointed at risk parity and short volatility strategies, but many hedge funds could have suffered badly from some of their typical strategies such as commodities, merger arbitrage and high yield debt. There's a long list of investors and strategies that could have been hit with or were approaching margin calls. When there is panic cash is king, and investors sell what they can, not what they want to. However, if this is the start of another financial crisis (perhaps a 50/50 call at this point) there will be a lot more forced selling ahead and it will move well beyond the more liquid asset classes of equities and government bonds.

We can look to recent problems in other countries and the Australian experience in the financial crisis as guide. In Europe and the UK, there has been a spate of property funds gating and closing down as a result of redemption runs. This classic liquidity mismatch, short term investment commitments used to purchase illiquid assets, generates a fresh batch of victims every downturn. We saw the same pattern in the financial crisis in Australia with property funds, credit/yield funds and mortgage funds locking investors in for years on end.

The process of writing down assets and managing liquidity in open-ended funds can be far less orderly than an ordinary investor might assume. For exchange trade securities, such as equities or hybrids there's no avoiding the write-downs as end of day pricing dictates the valuations. Funds heavy on these securities will show losses first.

For standard investment grade bonds, the valuations are likely to be updated daily or at least monthly so losses should show through quickly. Note that investment grade bond funds may show gains as the drop in interest rates in the last two months could outweigh the losses on credit spreads.

When we shift to non-vanilla bonds and securitisation, valuations can take months to be updated. As these securities trade irregularly and may not have easily comparable securities to value off it is tricky to know where to price them. What is clear though is that if the prices haven't moved as a result of the losses in the last three weeks, they are stale and almost certainly well above where they would trade today. Investors who enter and leave funds with stale valuations are being done a substantial disservice, with a first mover advantage to those who pre-empt asset write-downs and redeem. Within this group of securities there are a range of valuation techniques and timings, with some fund managers handling the complexity much better than others.

The last major group is unlisted asset classes like infrastructure, real estate, private debt and private equity. These are often revalued quarterly or six monthly, creating the potential for large gaps between where listed and unlisted assets are valued. It's a catch 22 for open-ended fund managers in these asset classes, if you mark the assets down in line with the listed comparables (e.g. using ASX listed property trusts to value an unlisted fund that directly owns shopping centres) the volatility and losses of the fund would shock some investors and lead them to redeem, potentially forcing a lockdown of the fund.

However, by failing to frequently update valuations, the manager allows some investors to front run others. This isn't just an issue for "for profit" fund managers, "not for profit" superannuation funds can have problems as well. If the private asset classes are only revalued at the end of each quarter or half year, what would stop an investor from redeeming from (higher valued) private asset classes late in the period and switching to (lower valued) listed equivalents after seeing the public assets take substantial losses?

Another concern that can arise in these difficult times is the buy/sell spread charged to investors joining or redeeming from a fund. In normal times, a 0.10%-0.20% round trip cost for less liquid assets might be a fair reflection of the costs to the fund of dealing with investors entering and exiting. However, in times like we are currently in, a round trip spread exceeding 5% might be appropriate. Few funds would ever apply such an impost even if it is the fairest treatment for all investors.

The combination of potential over-valuation of assets and an under-pricing of the buy/sell spread can accentuate the run-on-a-fund risk. As redemptions start to flow in the fund manager is left with a no-win decision; sell liquid assets and protect the short-term returns but risk being left with unsaleable securities, sell illiquid assets and report substantial losses, or close the fund to redemptions. This decision must be made each day, a decision made more complex by asset prices and redemption flows being highly unpredictable.

Where this all leads to is the possibility that open-ended funds may have losses and redemption runs ahead of them. If this occurs, a wave of forced sales of illiquid assets lies ahead. The big lesson from the last crisis was that the few left standing with cash ready to deploy captured enormous gains at the expense of those who failed to plan for such an event.

Written by Jonathan Rochford for Narrow Road Capital on 14 March 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure