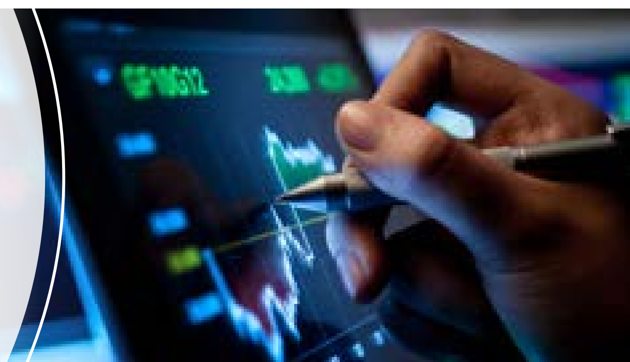

Digging deeper: Investment Trusts

2. Liquidity

Key takeaways:

- Be aware of the liquidity advantages of an investment trust relative to an open-ended investment company (OEIC)
- Understand the concept of 'gating' within an open-ended fund
- Be aware of new FCA regulations regarding liquidity

Category: Investment insights

Liquid v illiquid assets

Liquidity is the ease with which an investment can be bought and sold. Shares issued by large, well-known companies – e.g. those listed in the FTSE 100 Index – are considered highly liquid assets, because they can be easily bought and sold with low transaction costs. Shares in smaller companies (those listed on the Alternative Investment Market (AIM), for example) are less liquid. A good measure of liquidity is the average daily volume (ADV) of the company's shares that are traded on the stock exchange.

Outside shares, debt instruments such as investment-grade corporate bonds and developed-market government bonds are also considered to be liquid assets. Illiquid assets include (but aren't limited to) the following:

- 'Bricks and mortar' property
- Private equity
- Infrastructure

Why liquidity matters: investment trusts v OEICs

Investment trusts are closed-ended funds, meaning they are bought and sold on a stock exchange. By contrast, funds with open-ended structures – such as OEICs – have shares that are created and 'cancelled' by the fund manager in response to investor demand.

Investment trusts have an advantage over OEICs, because shares are inherently more liquid, being listed on the stock exchange. They do not need to sell their underlying assets to pay investors who want to sell their shares. By contrast, open-ended funds may close or "gate" if there are pressures on liquidity within the fund. A 'gate' on a fund is exactly how it sounds – it stops investors leaving the fund.

Key points

- Because investors receive cash for the shares they sell, the fund must have adequate liquidity to pay the investors selling shares.
- In an open-ended fund, it may have to temporarily close if there is inadequate liquidity (cash) to pay those investors selling shares.
- This situation is exacerbated when a fund manager cannot create liquidity quickly because the underlying assets (e.g. property) are difficult to sell.

Investment trusts are therefore worth considering if a client wishes to invest in illiquid assets.

Real-life examples of gating

During the global financial crisis, several UK 'bricks and mortar' property funds imposed gates, because the underlying assets were valued quarterly. Because the crisis originated in the sub-prime mortgage market and caused liquidity to dry up, illiquid property assets were particularly affected. Accurate valuations could not be taken and investors in the funds were not permitted to sell.

More recently, investors in Woodford Investment Management's Equity Income Fund were unable to redeem their holdings because they were heavily invested in illiquid assets. The fund was structured as an OEIC and investors should have had access to daily liquidity. As the fund performed poorly and redemption requests swelled, the manager was unable to sell the most illiquid assets. The fund collapsed and administrators were appointed to manage the fund's assets. This is an extreme example, traced back to management mistakes, but it serves to remind us of the importance of liquidity.

Funds are usually gated in the event of one or both of the following scenarios:

- A large number of investors opt to sell out of the fund, or
- A fund manager has failed to maintain adequate liquidity (cash).

A caveat

It's worth noting that investment trusts are subject to liquidity risks too, especially if the trust is small (remember, it trades as a share). A lack of liquidity, or an over-supply of shares in a trust, can lead to significant discounts (see factsheet 1. "Discounts and premiums" and 6. "Share buybacks".

FCA regulations

To protect investors, the FCA introduced new rules in September 2019. The regulator's stated aim is to "place additional obligations on the managers of funds investing in inherently illiquid assets to maintain plans to manage liquidity risk. The rules also aim to reduce the potential for some investors to gain at the expense of others and reduce the likelihood of runs on funds leading to a 'fire sale' of assets which disadvantage fund investors".

The idea of 'material uncertainty'

During the Covid-19 pandemic, independent valuers invoked a "material uncertainty" clause when valuing property funds, which meant that new investment and redemptions were suspended. Further new regulations (FCA Coll rules) that took effect on 30 September 2020 say that "non-UCITS retail schemes (NURSs) investing in inherently illiquid assets must suspend dealing where the independent valuer determines there is material uncertainty regarding the value of more than 20% of the fund's assets".

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