

Following the Property Funds Illiquidity Issues Post 23rd June - Will UK Smaller Company Funds be the next sector to leave UK investors stranded?

New Research – 11 October 2016

Background – The Brexit Property Fund

SCM Direct were one of the first to highlight the liquidity issues connected with UK property funds, post the Referendum vote on 23rd June¹. We alerted the FCA on the business day after Brexit² to the fact that major property funds with illiquid investments were being mispriced and needed to be re-priced and/or suspended.

Property funds had a fundamental liquidity mismatch where investors were being allowed to buy or sell the fund daily, whilst the underlying investments often took months to buy or sell.

When funds are suspended it can lead to the whole of an investor's portfolio being suspended – for example, in August Standard Life called a halt to any investors wanting to cash in its life insurance bonds following the property fund suspension saga.

Whilst the new FCA chief, Andrew Bailey, has called for the 'liquidity mismatches' in property funds to be addressed³, no action has been taken to date to either address the fundamental issues in property funds or more importantly other funds.

UK Financial Advisers Should Consider Liquidity Risk When Assessing Fund Risk

In respect of risk, some advisers can overly focus on how much a fund changes in price each day - volatility risk, rather than how long it might take to sell the actual investments in a dramatic market event - liquidity risk.

For example, the widely used FE Analytics Risk Score measures *"risk as a measure of volatility relative to the FTSE 100 index, which has a risk rating of 100. Instruments more volatile than the FTSE 100 have a score above 100 and vice versa giving a reliable indication of relative risk"*.

¹ <http://www.thetimes.co.uk/tto/money/investment/article4531079.ece>

² <https://alanmillerscm.wordpress.com/2016/07/08/brexit-hits-property-fund-compensation-could-hit-140-million/>

³ <http://www.investmentweek.co.uk/investment-week/news/2463855/new-fca-chief-bailey-calls-for-liquidity-mismatches-in-property-funds-to-be-addressed>

This measure in connection to property funds recorded the following low scores:

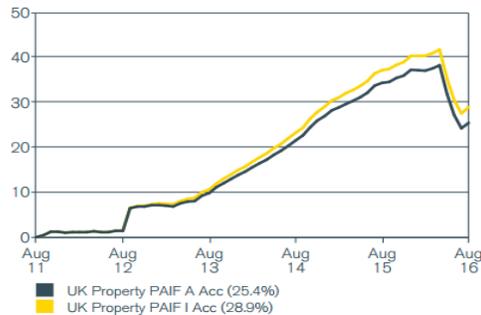
- 34 score for the Threadneedle UK Property fund
- 38 for the Henderson UK Property fund
- 41 for the Aviva Property Trust
- 42 for the Standard Life UK Real Estate.

Based on these low scores, some advisers may have thought that by including them within client portfolios they were reducing the clients' overall risk.

As the performance of many property funds showed, a price moving steadily upwards for a prolonged period does not necessarily mean that it cannot fall in price materially. Here is one example – the Henderson UK Property fund:

Performance

Percentage growth, 31 Aug 11 to 31 Aug 16.



Source: at 31 Aug 16. © 2016 Morningstar. All Rights Reserved, bid-bid, UK sterling, net income reinvested.

Please note: Prior to 31 May 2016, the past performance shown is that of the Henderson UK Property OEIC. Performance before 29 August 2014 represents the Henderson UK Property Unit Trust. Henderson Global Investors are dedicated to providing suitable and relevant information to all clients. With this in mind, the performance of the IMA Property sector will not be included for comparative purposes until further notice. This is because the IMA Property sector contains funds investing in global commercial property and property related equities, which makes comparisons between funds inappropriate and potentially misleading.

Source: Henderson

Cumulative performance	A Acc % change	I Acc % change
1 year	-6.6	-6.0
2 years	3.2	4.6
3 years	14.2	16.5
4 years	23.7	27.0
5 years	25.4	28.9

Source: at 31 Aug 16. © 2016 Morningstar. All Rights Reserved, bid-bid, UK sterling, net income reinvested.

Discrete year performance	A Acc % change	I Acc % change
30/06/2015 to 30/06/2016	-3.8	-3.1
30/06/2014 to 30/06/2015	10.9	11.6
28/06/2013 to 30/06/2014	10.4	11.1
29/06/2012 to 28/06/2013	6.8	7.5
30/06/2011 to 29/06/2012	0.9	0.9

Source: at 30 Jun 16. © 2016 Morningstar. All Rights Reserved, bid-bid, UK sterling, net income reinvested.

Discrete performance data may change due to final dividend information being received after quarter end.

SCM Direct's Research Findings - UK Smaller Companies Sector Is Facing the Same Liquidity Issues as Direct Property Funds

SCM Direct analysed the liquidity of the largest funds in the following Investment Association sectors:

- UK All Companies
- UK Equity Income
- UK Smaller Companies
- Global Emerging Markets
- European Companies Excluding UK
- European Companies Including UK
- European Smaller Companies sectors.

The research methodology selected funds investing in equities where there was available holdings and liquidity related data available via Bloomberg. In addition, funds with less than £100m invested were excluded.

This screening resulted in a research segment of 187 retail funds from all the sectors listed above, with assets invested amounting to £245 billion.

A fund with cash and liquid stocks can use these as a buffer to meet redemptions but, as the property fund debacle showed, this may only offer investors temporary protection. Once significant redemptions occur, and the liquid investments are extinguished, the fund may be forced to either accept serious markdowns to sell illiquid assets or suspend. Our research analysed the liquidity for each fund on the basis that they participated in 10% of the average daily volumes in the stocks over a six-month period.

We analysed the 187 funds to see how many days it would take to sell 10% or 20% of the fund. The data was collected from Bloomberg on the 19th and 20th September 2016.

Findings

1. BY FUND SECTOR

The average UK Smaller Companies fund has investments which would take more than a business day to sell if 10% or more of the fund was redeemed; raising serious questions about these funds offering investors daily liquidity.

73% of the UK Smaller Company funds had a liquidity mismatch between their underlying holdings and the daily liquidity offered to investors should 20% of their funds be redeemed.

SECTOR NAME	No. DAYS To sell <u>10%</u> of Fund	No. DAYS To sell <u>20%</u> of Fund
UK Smaller Companies	2 Days	5 Days
UK Equity Income	Less than 1 Day	1 Day
UK All Companies	Less than 1 Day	1 Day
European Companies Excluding UK	Less than 1 Day	Less than 1 Day
European Companies Including UK	Less than 1 Day	Less than 1 Day
European Smaller Companies	Less than 1 Day	1 Day
Emerging Market Equities	Less than 1 Day	1 Day

Source: SCM Direct, Bloomberg LP

2. BY FUND

The following funds, with £4.6 Bn in total invested, were found to take **two weeks (ten business days) or more to meet a 20% redemption**, based on the funds participating in 10% of the daily volumes in the stocks held:

FUND NAME	No. DAYS To sell 20% of Fund	Fund Size(m)	SECTOR
Liontrust UK Smaller Companies	29 Days	£468m	UK SMALLER COMP.
Schroder UK Dynamic Smaller Companies	27 Days	£434m	UK SMALLER COMP.
Schroder UK Smaller Companies	19 Days	£581m	UK SMALLER COMP.
Schroder Institutional UK Smaller Companies Inst	12 Days	£370m	UK SMALLER COMP.
CF Miton UK Smaller Companies	12 Days	£143m	UK SMALLER COMP.
Marlborough UK Micro Cap Growth	12 Days	£527m	UK SMALLER COMP.
Schroder UK Mid 250	11 Days	£1,139m	UK ALL COMP.
Aberdeen Global Emerging Markets Smaller Companies	10 Days	£934m	Global Emerging Markets

Source: SCM Direct, Bloomberg LP

But - what if there were higher than a 20% redemption?

The data within the Appendix shows how many days it would take to redeem differing percentages of each fund in the table above according to how much of the typical daily volume the fund managed to participate in. **The figures are astonishing.**

For example, if the **Marlborough UK Micro Cap fund** had to sell as much as 50% of the fund, and it managed participated in 10% of typical daily volumes as per above, it would take 53 business days. If it had to sell the entire fund on the same assumptions, it would take 22,706 business days i.e. 89 years. Even if the fund managed to participate in as much as 30% of daily volumes, it would still take 7,569 business days i.e. 30 years to liquidate the whole fund on this basis.

Of course, in such circumstances the manager of this or other similar funds might try and place large holdings with institutions through a broker rather than sell small amounts each day through the market. However, this might lead to pricing issues as the first holders 'out of the door' would receive the current market price for their stocks which could well be far higher than the eventual price received?

This might require such funds to suspend dealings to treat all investors fairly.

Conclusion

In light of SCM Direct's findings, it would appear prudent for the FCA to encourage advisers and fund groups to look beyond simply how much a share price moves up or down each day in terms of assessing fund risk. **To fulfil the Treating Customers Fairly (TCF) principle, investors should be advised that illiquid investments are higher risk.**

SCM Direct suggests that this research illustrates the imperative for the FCA to step in where fund's underlying liquidity does not match the dealing terms offered to investors. Either the investments need to change or the dealing terms need to change.

Questions to the Regulator:

- Why does the FCA not force fund groups to match the dealing in funds more closely with the underlying liquidity?
- Should the FCA not address this fundamental issue with UK smaller company funds where a typical fund has a fundamental liquidity mismatch between the liquidity of its holdings and its daily liquidity that it offers investors?
- If it takes say a week to sell 10% of a fund on a normal basis, should the fund not have weekly subscriptions and if it takes close to a month or more, should it not have monthly subscriptions?

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Appendix

Details of liquidity horizon of all individual funds named in the report:

Liontrust UK Smaller Companies Fund

Cancel: Screen not saved

1) View 2) Actions 3) Settings 4) Trade Simulat Portfolio & Risk Analytics

Characteristics

Main View Summary Cash Flows Liquidity Risk Key Rates

Port LIONTRUST U vs Default (SMX) by GICS Sectors in GBP As Of 09/16/16

Analytic Liquidity Horizon

Liquidity Summary						Breakdown			
% Part	% MV (Volume History: 6 M)					Security	% MV Sold	% MV Left	Cost Sold
	10	20	30	50	95				
5	9.20	58.10	108.78	273.92	1,693.98	13,659.2	20.00	80.00	197.80
10	4.60	29.05	54.39	136.96	846.99	6,829.62	4.75	95.25	0.00
15	3.07	19.37	36.26	91.31	564.66	4,553.08	6.93	93.07	78.50
20	2.30	14.53	27.20	68.48	423.50	3,414.81	7.82	92.18	183.12
25	1.84	11.62	21.76	54.78	338.80	2,731.85	10.26	89.74	278.66
30	1.53	9.68	18.13	45.65	282.33	2,276.54	11.59	88.41	257.51
							16.61	83.39	246.52
							18.16	81.84	228.84
							100.00	0.00	0.00

Transaction Cost Summary					
% Part	% MV (Volume History: 6 M)				
	10	20	30	50	95
5	21.62	162.36	292.22	589.10	1,165.50
10	40.64	197.80	329.83	628.12	1,205.59
15	72.93	233.42	366.09	665.28	1,243.57
20	106.52	268.28	401.50	701.45	1,280.45
25	139.77	302.66	436.36	737.00	1,316.62
30	172.77	336.70	470.83	772.09	1,352.28

(1) 85 Notices

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Source: SCM Direct, Bloomberg LP

Schroder UK Dynamic Smaller Companies

10 View 10 Actions 10 Settings Trade Simulat										Portfolio & Risk Analytics				
Characteristics														
Main View Summary Cash Flows Liquidity Risk Key Rates														
Port SCHRODER UK vs Default (SMX) by GICS Sectors in GBP As Of 09/16/16														
Analytic Liquidity Horizon														
Liquidity Summary						Breakdown			% Part			10	% MV	20
% MV (Volume History: 6 M)						Security			% MV Sold			% MV Left	Cost Sold	
% Part	10	20	30	50	95	100	Portfolio							
5	22.04	54.86	92.00	244.78	3,110.83	19,717.8	* Real Estate	1.56		98.44		0.00		
10	11.02	27.43	46.00	122.39	1,555.41	9,858.94	* Consumer Disc	11.79		88.21		206.55		
15	7.35	18.29	30.67	81.59	1,036.94	6,572.63	* Materials	12.91		87.09		303.14		
20	5.51	13.71	23.00	61.19	777.71	4,929.47	* Industrials	14.18		85.82		180.91		
25	4.41	10.97	18.40	48.96	622.17	3,943.58	* Energy	15.03		84.97		934.95		
30	3.67	9.14	15.33	40.80	518.47	3,286.31	* Information Te	15.67		84.33		212.14		
							* Financials	16.33		83.67		187.30		
							* Consumer Stap	32.18		67.82		208.79		
							* Health Care	43.92		56.08		139.18		
							* Cash	100.00		0.00		0.00		
Transaction Cost Summary						Unit			BPS					
% MV (Volume History: 6 M)														
% Part	10	20	30	50	95	100								
5	69.14	165.54	267.15	544.61	1,185.63	1,297.98								
10	94.35	202.14	304.80	583.40	1,225.60	1,338.00								
15	129.00	237.63	340.81	620.31	1,263.42	1,375.87								
20	162.99	272.33	375.96	656.23	1,300.12	1,412.61								
25	196.55	306.53	410.56	691.50	1,336.08	1,448.61								
30	229.81	340.37	444.76	726.32	1,371.53	1,484.09								
(1) 52 Notices														
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Source: SCM Direct, Bloomberg LP

Schroder UK Smaller Companies

10 View 10 Actions 10 Settings Trade Simulat										Portfolio & Risk Analytics				
Characteristics														
Main View Summary Cash Flows Liquidity Risk Key Rates														
Port SCHRODER UK vs Default (None) by GICS Sectors in GBP As Of 09/16/16														
Analytic Liquidity Horizon														
Liquidity Summary						Breakdown			% Part			10	% MV	20
% MV (Volume History: 6 M)						Security			% MV Sold			% MV Left	Cost Sold	
% Part	10	20	30	50	95	100	Portfolio							
5	12.68	37.27	63.15	141.55	1,181.32	3,988.46	* Energy	11.60		88.40		234.13		
10	6.34	18.64	31.57	70.77	590.66	1,994.23	* Information Te	11.93		88.07		148.29		
15	4.23	12.42	21.05	47.18	393.77	1,329.49	* Consumer Disc	14.37		85.63		178.15		
20	3.17	9.32	15.79	35.39	295.33	997.12	* Industrials	15.74		84.26		215.66		
25	2.54	7.45	12.63	28.31	236.26	797.69	* Health Care	17.45		82.55		143.36		
30	2.11	6.21	10.52	23.59	196.89	664.74	* Financials	17.71		82.29		155.74		
							* Consumer Stap	22.04		77.96		143.73		
							* Real Estate	25.01		74.99		163.29		
							* Materials	28.25		71.75		178.19		
							* Cash	100.00		0.00		0.00		
							* Telecommunica	100.00		0.00		0.00		
Transaction Cost Summary						Unit			BPS					
% MV (Volume History: 6 M)														
% Part	10	20	30	50	95	100								
5	45.85	135.14	219.65	412.72	1,056.70	1,159.90								
10	69.07	165.02	250.93	446.19	1,091.79	1,195.09								
15	97.63	195.18	281.65	477.75	1,124.61	1,227.99								
20	126.14	224.54	311.48	508.31	1,156.25	1,259.69								
25	154.24	253.38	340.75	538.22	1,187.12	1,290.61								
30	182.03	281.86	369.61	567.66	1,217.43	1,320.98								
(1) 93 Notices														
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Source: SCM Direct, Bloomberg LP

Schroder Institutional UK Smaller Companies Inst

Liquidity Summary							Breakdown			
% Part	10	20	30	50	95	100	% Part	10	% MV 20	
5	9.62	24.66	41.01	85.35	818.65	3,408.17	Portfolio	20.00	80.00	118.83
10	4.81	12.33	20.51	42.67	409.33	1,704.09	* Funds	9.17	90.83	0.00
15	3.21	8.22	13.67	28.45	272.88	1,136.06	* Financials	11.58	88.42	108.98
20	2.41	6.17	10.25	21.34	204.66	852.04	* Energy	13.01	86.99	190.32
25	1.92	4.93	8.20	17.07	163.73	681.63	* Information Te	14.41	85.59	105.64
30	1.60	4.11	6.84	14.22	136.44	568.03	* Industrials	15.63	84.37	154.69
							* Consumer Disc	17.26	82.74	111.40
							* Health Care	19.11	80.89	95.78
							* Consumer Stap	23.07	76.93	84.14
							* Real Estate	25.49	74.51	115.57
							* Materials	36.04	63.96	92.38
							* Cash	100.00	0.00	0.00

Transaction Cost Summary						
% Part	10	20	30	50	95	100
5	36.10	91.31	149.30	272.62	693.64	706.81
10	55.40	118.83	177.87	303.53	726.88	740.07
15	82.48	147.36	207.23	333.62	758.07	771.27
20	109.92	175.49	235.79	362.80	788.19	801.40
25	136.97	203.16	263.84	391.39	817.61	830.84
30	163.74	230.48	291.50	419.56	846.54	859.77

(1) 68 Notices

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Source: SCM Direct, Bloomberg LP

CF Miton UK Smaller Companies

Liquidity Summary							Breakdown			
% Part	10	20	30	50	95	100	% Part	10	% MV 20	
5	9.23	24.28	47.09	148.31	1,477.20	3,863.09	Portfolio	20.00	80.00	170.00
10	4.62	12.14	23.55	74.16	738.60	1,931.55	* Utilities	2.75	97.25	53.55
15	3.08	8.09	15.70	49.44	492.40	1,287.70	* Real Estate	11.57	88.43	0.00
20	2.31	6.07	11.77	37.08	369.30	965.77	* Information Te	12.93	87.07	102.56
25	1.85	4.86	9.42	29.66	295.44	772.62	* Financials	14.72	85.28	9.60
30	1.54	4.05	7.85	24.72	246.20	643.85	* Health Care	19.76	80.24	215.35
							* Industrials	20.72	79.28	173.51
							* Consumer Disc	22.76	77.24	163.60
							* Telecommunic	31.80	68.20	0.00
							* Materials	32.02	67.98	62.16
							* Consumer Stap	48.87	51.13	137.89
							* Energy	54.96	45.04	755.42

Transaction Cost Summary						
% Part	10	20	30	50	95	100
5	54.05	135.33	220.49	434.92	1,296.20	1,353.80
10	83.38	170.00	258.64	474.82	1,337.97	1,395.62
15	117.29	205.64	295.01	512.19	1,376.78	1,434.48
20	150.89	240.21	330.19	548.23	1,414.06	1,471.78
25	183.91	274.07	364.61	583.40	1,450.33	1,508.08
30	216.50	307.44	398.48	617.97	1,485.88	1,543.66

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Source: SCM Direct, Bloomberg LP

Marlborough UK Micro Cap Growth

Liquidity Summary							Breakdown			
% Part	10	20	30	50	95	100	Security	% MV Sold	% MV Left	Cost Sold
5	6.22	23.25	42.50	105.40	927.43	45,412.5	Portfolio	20.00	80.00	113.79
10	3.11	11.62	21.25	52.70	463.71	22,706.2	Real Estate	5.27	94.73	136.58
15	2.07	7.75	14.17	35.13	309.14	15,137.5	Utilities	5.26	94.74	101.16
20	1.55	5.81	10.63	26.35	231.86	11,353.1	Funds	8.90	91.10	0.00
25	1.24	4.65	8.50	21.08	185.49	9,082.5	Information Tech	11.82	88.18	129.36
30	1.04	3.87	7.08	17.57	154.57	7,568.75	Financials	12.43	87.57	145.10
							Industrials	12.51	87.49	116.30
							Consumer Disc	12.81	87.19	142.09
							Energy	18.78	81.22	299.97
							Telecommunica	20.94	79.06	155.69
							Stocks	24.38	75.62	0.00
							Health Care	25.28	74.72	69.69
							Consumer Stap	30.48	69.52	106.78
							Materials	41.86	58.14	208.98
							Cash	100.00	0.00	0.00

Transaction Cost Summary						
% Part	10	20	30	50	95	100
5	17.18	82.82	148.37	302.10	891.69	1,064.55
10	37.89	113.79	182.21	339.32	930.87	1,103.92
15	69.27	147.76	217.10	375.04	967.87	1,141.07
20	101.89	181.32	251.15	409.80	1,003.72	1,177.04
25	134.13	214.39	284.67	443.94	1,038.83	1,212.27
30	166.09	247.12	317.79	477.64	1,073.41	1,246.95

Source: SCM Direct, Bloomberg LP

Schroder UK Mid 250

Liquidity Summary							Breakdown			
% Part	10	20	30	50	95	100	Security	% MV Sold	% MV Left	Cost Sold
5	9.28	21.26	37.01	83.60	649.30	4,839.36	Portfolio	20.00	80.00	106.12
10	4.64	10.63	18.51	41.80	324.65	2,419.68	Real Estate	3.14	96.86	85.34
15	3.09	7.09	12.34	27.87	216.43	1,613.12	Utilities	6.44	93.56	81.45
20	2.32	5.31	9.25	20.90	162.33	1,209.84	Consumer Disc	13.72	86.28	117.08
25	1.86	4.25	7.40	16.72	129.86	967.87	Health Care	15.19	84.81	98.97
30	1.55	3.54	6.17	13.93	108.22	806.56	Industrials	16.89	83.11	93.87
							Materials	20.90	79.10	68.76
							Information Te	24.33	75.67	83.16
							Energy	28.27	71.73	147.75
							Financials	35.37	64.63	143.69
							Cash	100.00	0.00	0.00

Transaction Cost Summary						
% Part	10	20	30	50	95	100
5	48.32	94.71	145.89	262.13	766.38	869.23
10	58.79	106.12	157.89	275.03	780.95	883.95
15	68.35	116.31	168.54	286.37	793.60	896.71
20	77.35	125.85	178.47	296.90	805.24	908.44
25	85.99	134.97	187.94	306.90	816.22	919.52
30	94.38	143.79	197.09	316.52	826.74	930.12

Source: SCM Direct, Bloomberg LP

Aberdeen Global Emerging Markets Smaller Companies

1) View 1) Actions 1) Settings Trade Simulation Portfolio & Risk Analytics										
Characteristics										
Main View Summary Cash Flows Liquidity Risk Key Rates										
Port: ABERDEEN UK vs Default (None) by GICS Sectors in GBP As Of 09/21/16										
Analytic: Liquidity Horizon										
Liquidity Summary					Breakdown					
% MV (Volume History: 6 M)					% Part 10 % MV 20					
% Part	10	20	30	50	95	100	Security	% MV Sold	% MV Left	Cost Sold
5	0.96	2.31	4.19	9.13	154.42	201,797.	Portfolio	20.00	80.00	39.20
10	0.48	1.16	2.10	4.56	77.21	100,898.	# Health Care	2.98	97.02	20.57
15	0.32	0.77	1.40	3.04	51.47	67,265.8	# Industrials	3.21	96.79	39.84
20	0.24	0.58	1.05	2.28	38.60	50,449.4	# Real Estate	3.73	96.27	34.59
25	0.19	0.46	0.84	1.83	30.88	40,359.5	# Consumer Stap	16.36	83.64	34.11
30	0.16	0.39	0.70	1.52	25.74	33,632.9	# Energy	19.40	80.60	37.60
							# Consumer Disc	19.93	80.07	49.85
							# Information Te	20.38	79.62	50.16
							# Materials	20.64	79.36	50.01
							# Financials	22.69	77.31	37.18
							# Telecommunica	28.67	71.33	27.45
							# Cash	100.00	0.00	0.00
Transaction Cost Summary					Unit BPS					
% MV (Volume History: 6 M)										
% Part	10	20	30	50	95	100				
5	17.71	31.83	47.76	81.48	260.32	281.53				
10	24.30	39.20	55.71	90.25	270.74	292.01				
15	29.98	45.50	62.47	97.65	279.46	300.78				
20	35.18	51.23	68.59	104.33	287.27	308.64				
25	40.06	56.58	74.30	110.54	294.50	315.90				
30	44.71	61.67	79.72	116.41	301.30	322.74				
(1) 12 Notices										
Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2016 Bloomberg Finance L.P. SN 824650 BST GMT+1:00 H441-569-1 22-Sep-2016 11:11:20										

Source: SCM Direct, Bloomberg LP

The value of investments can go down in value as well as up, so you could get back less than you invest. It is therefore important that you understand the past performance is not a guide to future returns.

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