Rt Hon Nicky Morgan MP
House of Commons
London
SW1A 0AA

14 June 2019

Dear Ms Morgan

Woodford Equity Income Fund

The suspension of Woodford Equity Income Fund has implications for the FCA, product providers, advisers, platforms and, most importantly, consumers. Long-term lessons must be learnt to limit the damage when open-ended funds invest in illiquid assets. They should also identify how to prevent harm arising in the first place. This should include taking steps to protect the wider financial system. I am concerned that, despite previous problems and repeated warnings, including recent comments by Mark Carney, the FCA is still failing to address these fundamental questions.

Consumer detriment

Though Woodford raises unique questions, the problem of holding illiquid assets in open-ended funds is not new. Issues arose during the 2009 financial crisis, and again after the Brexit referendum when most open-ended property funds were forced to suspend dealing. Some funds closed for six months.

The FCA has been exploring regulatory options following the problems in 2016. Its conclusions have been very slow to emerge. Perversely, their expected impact will be more frequent suspensions. It is difficult to accept that this should be the preferred regulatory option and I do not believe that consumers or the media will see it in these terms. Most retail investors see rights to redemption as fundamental. Far better would be to minimise the need for suspension.

A worrying and emerging narrative sees suspensions as somehow a good thing. Of course, when problems arise, it is important to have mechanisms in place to protect investors. But suspensions should be a last resort, used in wholly exceptional circumstances, not hard-wired into the system and engaged every time there is a downturn in investor sentiment. They only make a bad position slightly better. They are not a solution to the problem. A key function of suspension is to allow assets to be liquidated in a more orderly manner. But this should not disguise the fact that this will still be a forced sale which is unlikely to secure the best price for investors.

If the FCA’s proposals go ahead to require more frequent redemptions, fund providers will inevitably seek to minimise the potential for suspension by holding even higher levels of cash, as happened with open-ended property funds. They currently hold an average of around 20% in cash, but this reduces investors’ exposure to the asset class they are seeking to benefit from and suppresses returns.
Faced with more frequent suspensions or lower returns due to increased cash holdings, investors may conclude that illiquid assets are a bad thing despite offering alternative sources of income and superior long-term returns. This will have knock on implications for attempts to help individuals better prepare for their retirement. It will also reduce the capacity of the fund sector to mobilise capital for investment in infrastructure and smaller unquoted businesses.

Systemic dangers

The market for illiquid assets is significant and problems arising from liquidity mismatches have structural implications. In a speech last week Mark Carney noted that $30 trillion of global assets are held in investment funds that promise daily liquidity to investors despite investing in potentially illiquid underlying assets. He stated that over half of investment funds have a structural mismatch between the frequency with which they offer redemptions and the time it would take them to liquidate their assets. Mr Carney warned that:

"Under stress they may need to fire sell assets, magnifying market adjustments and triggering further redemptions – a vicious feedback loop that can ultimately disrupt market functioning".

Preventing future problems

One way to prevent further problems is to encourage consideration of fund structures which do not have this inherent liquidity mismatch. Closed-ended, listed, investment companies are one example. They do not offer redemption. Instead investors buy and sell their shares on the stock market. This trading has no impact on the composition of the underlying portfolio. Therefore, the manager is not forced to sell holdings (potentially at lower prices and reinforcing falling asset valuations) when investors seek to exit. There is no risk of forced asset sales creating the systemic risks identified by Mr Carney.

It is hard to see why such alternatives to open-ended funds are not being actively considered by the FCA. Andrew Bailey’s Financial Times article (“Woodford episode raises questions for regulation”. 10 June, page 21) focusses on changing requirements for open-ended funds’ liquidity and redemption arrangements. The potential benefits of utilising other structures without the inherent liquidity mismatch does not even merit a mention. The FCA’s approach continues to explore ways to best force a square peg into a round hole rather than questioning if the overall approach is correct.

Conclusion

There are numerous ways in which fund providers, promotors and advisers could be encouraged to take a more sensible approach to investing in illiquid assets for the benefit of their customers. However, as long as the regulatory debate fails to address the fundamental question of the illiquidity mismatch, problems will inevitably continue, with more frequent suspensions and/or lower returns for investors.

I would be pleased to discuss these issues with you or your team before your evidence session with Mr Bailey if that would be of assistance.

Yours sincerely

Ian Sayers
Chief Executive

cc Peter Stam