Poor Performance is Disappointing; Poor Liquidity can be Agonizing

"It's better to be right than wrong, but the worst thing of all is to be surprised." – Channeling Niccolo Machiavelli, had he been an investment analyst

Plan sponsors (and their consultants) have grown more sophisticated in their decision-making regarding the hiring and firing of investment managers over the last 20 years. Fiduciaries have grown more patient, and information proliferation has led to greater understanding of under and outperformance. However, fund cash flow and liquidity, which are far more likely to present an immediate emergency to a retirement plan than underperformance or a manager change, remain under-monitored or ignored by many DC consultants and investment committees.

SUMMARY

- Liquidity issues involving plan investment options are among the most challenging investment issues fiduciaries will face.
- Unlike other investment issues, they often require immediate action, presenting particular difficulty given DC plans' extended reaction timelines.
- Though these issues usually come as "surprises", the vast majority are avoidable with foresight.
- Fund size and cash flow should be part of a quarterly review process, just like performance.
- Plan fiduciaries are particularly reliant on their consultants' knowledge, experience, and competence when it comes to avoiding liquidity crunches.

A FRUSTRATING SOURCE OF FIDUCIARY EXPOSURE

In two decades of working with defined contribution plans, Jay and I have had the "good fortune" to have encountered an incredible array of messy investment situations (generally, we're the ones who show up with the mops). Among the messiest are investment option liquidity issues. These issues can result in a plan being unable to complete a transaction when they want to, facing a more complicated transaction (potentially with higher costs), or experiencing degraded investment performance due to their own fund termination order or orders from other investors. When liquidity issues arise, they generally need to be dealt with in short order, unlike other investment issues such as poor performance or management team changes which can be dealt with over one or more quarters.

In general, liquidity issues occur with "funds" (mutual funds, collective trusts, or separate accounts) under four primary scenarios:

- ***The market for a fund's underlying holdings dries up***
  - The prime example (or subprime, in this case) of this scenario came during the Financial Crisis of 2007-2008. As the market for subprime securities evaporated seemingly overnight, stable value funds and securities lending pools (used chiefly by index funds to boost performance) were unable to find buyers for their subprime holdings. These funds remained liquid for plan

participants. However, the plan sponsors who held these funds were often either barred from liquidating their positions or were forced to sell off over an extended period.

- *Too many investors want to sell the fund at the same time*
    - Several things can trigger a "run" on a fund. Often, this can come in the form of poor performance, a disorderly fund dissolution, or a large holding becoming "radioactive." In the DC world, the trigger is frequently the departure of a "star" manager. For example, PIMCO Total Return Fund's assets fell from $221 billion to $98 billion between August 2014 and 2015, following Bill Gross' departure. While PIMCO was able to meet these redemptions (and did an impressive job doing it), the run created the risk of compromised performance.

- *A plan owns too much of a fund*
    - While the previous examples are surprises, this last case is often of the "slow-motion car crash" variety. In our experience, nearly all fiduciaries and consultants review fund size and determine some minimum asset base requirement before investing in a fund. Often, however, fund-level assets and cash flow aren't carefully monitored thereafter and don't become a topic of discussion until a potential problem is imminent. A prototypical case is a once-promising fund hitting an extended period of poor performance, which causes investors to abandon it over time. This can lead to a plan fiduciary finding that the $50 million investment they made when the fund had $2 billion in assets has become 20% of the fund's now $250 million asset base.

- *Withdrawal provisions aren't clearly understood*
    - Collective trust funds may constrain liquidations of accounts that make up a significant portion (typically 10%) of the fund. Mutual funds usually reserve the right to make an in-kind distribution (where the seller receives a share of the fund's underlying holdings rather than cash) when they feel it's necessary. A more commonly understood example, stable value funds impose conditions or restrictions on plans that wish to liquidate their position. For example, they may enforce a "put period," where a liquidation takes place over months or years, or a "market value liquidation," where the fund is distributed at a market value that may be lower than the fund's book value.

In any of these scenarios, the severity of the impact on a plan can range anywhere from inconvenience to emergency:

- A recordkeeper may have to work extra hours to coordinate an in-kind transfer between managers.
- The performance of a fund held by a plan may suffer as the fund raises cash to fund other liquidations.
- The plan may be forced to take an extended trade settlement and be caught out of the market (a dangerous potential exposure in volatile times).
- A sponsor may be forced to sit on an investment that they would otherwise consider imprudent.

However, the bottom line is that all of these irregular events carry potential risk for plan fiduciaries.

Obviously, it's challenging to fault a consultant or sponsor for failing to see some of these problems coming (the Financial Crisis, for example). However, most of the liquidity problems we've seen over the last 20 years could have been avoided with proper due diligence and proactive intervention. As a result, these foreseeable issues may not simply be the most frustrating, they may create the most fiduciary exposure.

AVOIDING THE CRUNCH

Here are a few suggestions that may help avoid nasty liquidity surprises - and the fiduciary exposure that comes with them:

- *Ensure you understanding withdrawal provisions*
  - This seems obvious, but history would indicate it isn't. All investments, including mutual funds, will reserve some sort of right to manage liquidations. Before investing, make absolutely certain that your committee understands all of the possible constraints and contingencies they could face when liquidating a position (especially the ones where the manager's representative says, "we've never enforced that before.")

- *Know how much of a fund you own*
  - As mentioned, consultants and plan fiduciaries generally review fund size during the manager search process. Fewer review fund assets and cash flow as part of their ongoing obligation to monitor plan investments (especially for mid and small-sized plans). Monitor fund assets and cash flow as part of your quarterly review process.

- *Know if other investors hold significant positions (and what type of accounts they are)*
  - As an addendum to the item above, don't just look at assets: consider the number and types of accounts investing in the fund. For example, investing $20 million into a $1 billion fund seems a safe bet, unless three other accounts own $900 million of it (true story, by the way). Your consultant should be conducting a robust due diligence process, and questions about fund ownership should be part of that.

- *Remember that DC plans are like oil tankers*
  - Like an oil tanker changing direction, the timeline for a DC plan to liquidate a fund is inherently long. Even in pressing situations, committee meetings take time to organize, recordkeepers have scheduled pipelines, and participants usually need notification prior to a change. Even the quickest fund changes can take more than a month. That contrasts starkly with an RIA's separate account, for example, where a manager can decide to liquidate a fund position and complete the act in a few days at most. The liquidity of a fund filled with retail accounts or dominated by RIA separate accounts may be less stable in a "crisis." Your slow-moving DC plan could quickly become the last man standing (thus absorbing the follow-on impacts of the others' liquidations). As part of your due diligence process, consider the other types of accounts investing in the fund in question and how their actions (or ability to act) might impact the plan's investment.

- *Remember that fund management firms are businesses*
  - Fund management firms are in the business to make money. At some point, if a fund doesn't have the asset base or the promise of future assets needed to justify its cost, the fund will likely be merged or dissolved. This is especially true for smaller fund shops or for funds that aren't part of a firm's core business (for example, a single bond fund at a shop with multiple equity funds). The greatest impact to investors by, say, the firm's need to raise cash to fund redemptions is often most keenly felt by the last movers (see the suggestion above). Understand how a fund fits into a management firm's business before buying, and once purchased, periodically consider the fund's position in the firm's business and the potential ramifications.

FINAL WORDS

We aren't suggesting that the scenarios discussed above will always evolve into a crisis. For example, selling a 20% position in a fund isn't impossible or necessarily dangerous; it's just not straightforward and can negatively affect other investors if it forces the fund to raise its cash allocation. Likewise, a position in a fund that's being merged away isn't the end of the world, but it may force you to rush a fund search or lead to unexpected recordkeeping project fees.

What we are saying is that, whether crises or simple inconveniences, the vast majority of liquidity crunches and the corresponding fiduciary exposure are simply avoidable. It just takes some thoughtful due diligence and the application of experience and competence (especially on the part of your consultant).

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