But as open-ended funds venture into more exotic and less liquid assets, the gap has continued to widen between the liquidity that these funds promise investors on the one hand, and the liquidity that they can obtain from their underlying investments on the other.

At a micro level, failing to manage this risk properly could mean that funds cannot meet redemption requests or can only do so in a way that may be prejudicial to the interests of remaining investors. At a macro level, some are concerned that mismanagement of liquidity risk associated with open-ended funds could lead to fire sales in the underlying asset markets, potentially causing market volatility or making it worse.

This is why both market regulators and macro-prudential regulators have taken a keen interest in the liquidity risk management of open-ended funds. For instance, recently the Financial Stability Board identified liquidity risk as a potential vulnerability in the asset management sector.

Next time may be different

But not everyone is convinced about the severity of these liquidity risks. Historically, the fund sector has generally been resilient in the face of market and liquidity events, even during the tumultuous time of 2008, with the exception of constant NAV[1] money market funds. But some regulators, particularly macro-prudential regulators, are seeing signs that next time may be different.

Their concern stems from a major liquidity illusion, which works like this: asset managers pile into a certain asset class. As a result, price rises and the risk premium falls, together with volatility. Liquidity seems plentiful amid high turnover. Market participants come to see assets as safe and liquid, and underestimate the difficulties of exiting their investments when the music stops.

This is not unlike what academics call the turkey illusion. Feed the turkey good food every day, and the turkey will come to expect more good food in the days to come. So far so good

This turkey analogy probably resonates among some of you managing funds with exposure to the A-share market. Some markets, such as emerging market fixed income securities, are known to be illiquid and investors are alert to this. But equities markets are generally seen as liquid.

Events in the past 12 months have challenged this accepted wisdom. First there was the A-share market correction last summer. More than half of the listed stocks suspended trading after hitting price fall limits or c3(d)13( )-4(l)26 Tm[(k)Bumit1c are gen(hi)6(t)6(0ket)8( )-413u0B60056000300

NAV. We also asked managers to report to us if their funds have problems meeting redemptions or face other liquidity issues.

Our worst fears of fire sales and systemic instability did not materialise. But at the individual fund level, we have seen major redemptions many exceeding 20% and some even reaching 80%. The funds concerned were able to meet redemptions and did not have to take extraordinary actions such as suspending dealing or winding down the funds. But it was clear that redemption rates could be much higher than what we have seen historically. Or to put it in statistical terms, the redemption rate bell curve may have a low average, but it could have a fat tail.

Then in December last year, just as the Mainland market was regaining its footing, another incident broke out, this time with the announcement that the Third Avenue Focused Credit Fund, a regulated publicly offered mutual fund in the US, suspended redemptions and was wound down.

In that incident, when a sizable high yield bond fund was liquidated we did not see spillover to other high yield bond funds or a fire sale in the underlying asset markets. But although no wider financial stability issues were touched off, this event demonstrated that a large, sudden redemption and liquidity crunch is not just a distant theoretical possibility. As a regulator, we are concerned about how prepared fund managers are for these liquidity events and whether investors are treated fairly in these episodes.

Complexity and its implications

There is no doubt that liquidity risk management is a complex subject. At a very basic level, it is about making sure that funds have sufficient liquidity to meet large and sudden redemptions. But this is only part of the story. Just as importantly, it is about how to make sure that all investors are treated fairly. With this in mind, we recently conducted a focused review of the liquidity risk management practices of managers of SFC-authorized funds in Hong Kong.

In the course of our review, the most commonly seen issue involved how managers dispose of assets to meet redemptions and whether the cost was fairly allocated among redeeming and remaining investors. Some managers may simply sell the most liquid assets, which are the most likely to find a buyer at the current price. But if the redemption was large and was not accompanied by new inflows to facilitate rebalancing, this disposal strategy could leave the remaining investors with a basket of less liquid assets and put them on the hook for the cost of reconstructing the portfolio in line with the stated investment strategy.

In other cases, managers could dispose of assets in proportion to each type of asset holding. But that would mean selling less liquid, but potentially good quality, assets on the cheaph5(n pr)t(t)-58f asse

investors fairly. We have consulted t