Liquidity

- It seems we write on liquidity on a 4 year cycle (2008, 2012, 2015 and now).
- Liquidity is an insignificant issue for us (and our investors), but a major issue for investors in certain types of assets and structures.
- Liquidity problems come in 2 types: illiquid assets or too much exposure to liquid single assets. We've seen excellent examples of these in the last few months.
- We rerun a prime example of an investment disaster caused by liquidity from a decade ago.

Type 1; Illiquid assets meet tall poppies and Neil Woodford is gone

Neil Woodford was the uber UK fund manager as per the plaudits below.

> These include Hargreaves Lansdown's head of research Mark Dampier, who says he believes Woodford "to be the finest fund manager of his generation".

Woodford ran a fund for Invesco for 20 years with an impeccable performance record. He left to start his own fund in 2013. At one stage in 2016 he was outperforming the FTSE benchmark by almost 8% p.a. and had FUM of c10bGBP. But then it went pear shaped - performance for the last 3 years has been atrocious and so began the not unexpected liquidity death spiral.

- Investors started pulling money from the Funds and FUM dropped to c4bGBP.
- The liquid stuff went first, but that wasn't enough.
- After the first 5-6bGBP of redemptions, the Funds were left with the illiquid and unquoted securities that Woodford had started buying. Some commentators put this down to hubris (because he was such a good stock picker the early stage picks would do even better) nonetheless it was a shock to some investors to see these assets in a mainstream Income Fund.
- And there were cross holdings and cross transaction between his UCITS (similar to an unlisted fund/trust in Australia) and his investment company (similar to a LIC).
- And there were some fortuitous and hard to explain upward revaluations of his unlisted securities.

So, in early June, Woodford 'gated' his UCITS fund and suspended redemptions; initially only for a month, but we've seen this movie before and history isn't on the unitholders side. Months turn into years in these situations.

Closed end Investment Company (LIC) doing OK?

"Not happy, Jan" so went the 2000 Yellow Pages advertisement. Investors suddenly realised they were had bought a shares in a company which had illiquid assets with uncertain valuations, cross holdings with the UCITS "parent" and the UCITS "parent" owned a chunk of the shares of the LIC (which were potentially for sale to meet redemptions of the UCITS). As at writing the Investment Company had an NTA of 86p, but a share price of 54p. The NTA had fallen from high 90s in March and the share price was at 90p earlier this year. Clearly, the

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market is worried about valuations and the overhang of shares if the UCITS needs to sell. Lots of issues are raised here, including governance, but the biggest is how do you value illiquid assets. The obvious read through is to the recent spate of LIC/LITs investing in illiquid assets.

Type 2: too much of a good thing

Caledonia is a large Australian fund manager which has had an exemplary investment performance prior to 2018 (22.1% p.a. since launch in 2002: source SMH). Caledonia ran a $6b portfolio with concentrated positions. Many of their investments have fallen by up to 50% since mid-2018, but the best example of a liquidity issue is Challenger, an ASX100 company of which Caledonia own 13% (this translates to around 16% of the free float). This c$550m holding (it was worth $1b last year) is extremely large in proportion to the (healthy) daily turnover of CGF. This large relative holding means that if Caledonia has to sell CGF shares because it doesn't like the company anymore or has to meet redemptions, the cost of liquidation is much higher than if Caledonia was less concentrated or smaller i.e. didn't own $550m of CGF shares. When you buy and sell investments there is what is known as "market impact". At one end of the scale there are large highly liquid markets and the underlying investment is not volatile. Almost any size investor can enter and exit positions at low cost (government bond markets are a prime example). At the other end there are lobster pots (easy to enter, impossible to exit) which might result in the share price falling by 20% if there is a forced or quick exit. In the middle there is the Caledonia/CGF situation; i.e. a very large position in a liquid share.

What happens in the CGF situation: another 5% dusted?

If Caledonia had to reduce their CGF holding by, say, 50% either because they received redemptions or didn't like CGF anymore, we can calculate the market impact of selling that stake. Using our market impact formula and a variety of assumptions, the cost of selling 50% of the CGF holding over 6 months is between 5% and 6%. This is on top of the normal market movements which, for a 6-month period, are in the range of +/-20-25%. If the market understands that sales are happening because of redemptions or change in security allocation, there is an additional unquantifiable cost. It's hard to decide whether the latent liquidity costs of a concentrated investment strategy outweigh its potential benefits, but 5% is probably not much less than the average equity return for any one year.

Case study: choose your fiduciaries carefully

In our own backyard, the tale of the Challenger High Yield Fund is pertinent. The Challenger High Yield Fund (CHYF) was one of the success stories of the pre GFC era and grew to around $2.4b in 2008. During the funds' formative years, it was mostly invested in the ASX listed hybrid securities market which, in 2007, had a market cap of around $20b. Significant fund growth necessitated some reallocation to other higher yielding instruments. However, even with that movement Challenger was by far the biggest player in the hybrid market. There was one IPO in 2007 which Challenger's custodian owned around 40% of the IPO at issue. It is unclear just how much of the hybrid market Challenger owned, but we suspect it was between 5% -10% and they disclose that in 2010 they owned more than 10% of some

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securities (and that's after selling down for 2 years). From late 2007, the Fund started to generate negative annual return outcomes which was accompanied by redemptions throughout 2008 (with the big spike being the redemption by a large Super Fund who, it seems, was offered instant redemption rights). The charts below (source Challenger High Yield Fund: Notice of Meeting and Explanatory Memorandum (CHYF: NMEM) show the returns and NAV path.

Figure 7: CHYF historical NAV per unit and trailing annual gross return

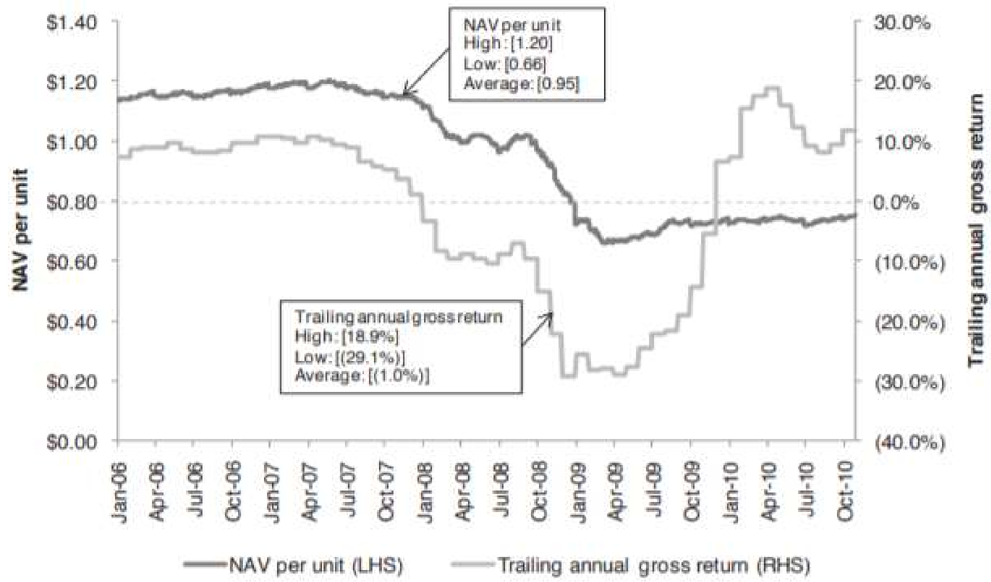
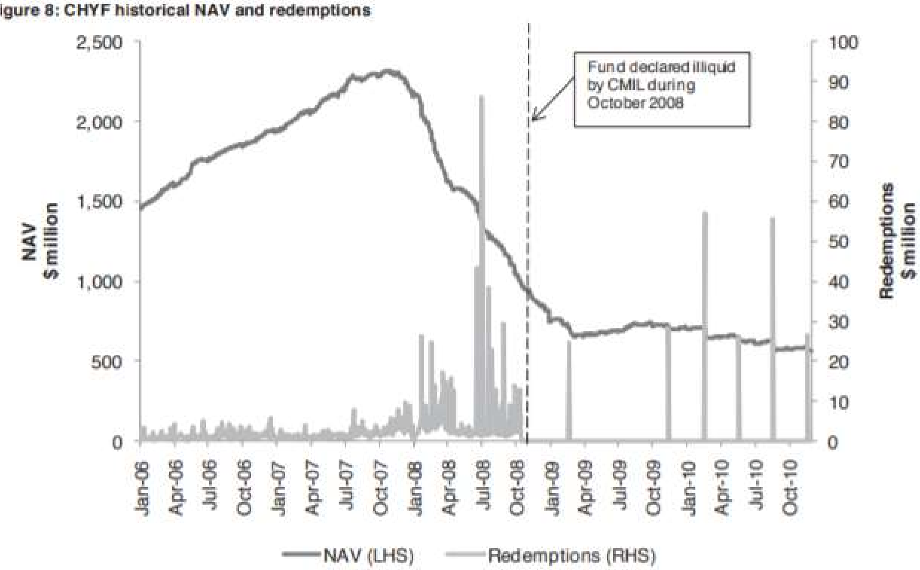


Figure 8: CHYF historical NAV and redemptions



Source: CMIL, Deloitte Corporate Finance analysis

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Guess what happened next?

In late 2008, Challenger declared the fund illiquid and ceased redemptions. Over the following quarters, Challenger offered limited redemptions of 5% - 10% per quarter. In late 2010, Challenger offered unitholders a scheme which would see their units in the frozen High Yield Fund replaced by a 20% cash repayment and 80% reinvestment into a 3-year security issued by Challenger Life at a margin of swap rate minus 0.5%. The alternative to not accepting the Challenger offer was a continuation of the then current situation of a frozen fund with limited redemptions. Challenger commissioned an Expert Report from Deloitte Corporate Finance which found the proposal was 'fair and reasonable'. Deloitte noted that the Directors had claimed that liquidity had become increasingly difficult and required high liquidity discounts, and that the quarterly redemption units may not be available.

We disagree and think the unitholder were disadvantaged to the tune of $24m. Details of our assessment of the Deloitte report are detailed in the appendix but the summary points are;

- By late 2010, credit markets were functioning again. Turnover had returned to both the ASX Listed market and the wholesale bond markets. The median hybrid price was $99.4 which was up from the $60.52 lows in the depth of the GFC. There was no impediment to selling securities. The table below (source CHYF: NMEM) shows the breakup of the Fund and our analysis of the liquidity position (note; we have had difficulty reconciling some of the numbers in the report).

Category	Estimated Holding	Liquidity issues
5 largest hybrids	$162m (29%)	On average, the holdings represent 5 months turnover of each security. Whole balance is saleable at limited cost within 2 years.
Cash	$80m (15%)	Instant liquidity
Investment grade Corporate Bonds	$166 (30%)	Whole balance saleable at limited cost within 1 year.
Other	$148m (27%)	A large proportion seems to be private debt with an average maturity of 2.7 years and some RMBS with maturities of >7 years. Assume 50% realisable within 2 years.
Total	$556m	70% realisable within 1 year.

- The security Challenger was offering was expensive and offered at too low a yield. The replacement security for the Fund was offering a margin of 3-year Swap minus 0.5%. At December 2010, the 3-year swap rate was 5.53%, resulting in a coupon of 5.03%. At December 2010, the 3-year Term Deposit rate was 6.4% (source RBA). If unitholders received cash, they could have invested in a government guaranteed term deposit that was yielding around 1.4% higher. If Challenger Life had to borrow from wholesale markets at that time, rather than from CHYF unitholders, it was likely they would have to pay around a margin of 1.3% to 1.5% over swap resulting in a cost of 6.8% to 7.0%.

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- We estimate that if the unitholders could immediately sell their new security, they would receive around $94/$100. On the other hand, it looked like Challenger Life, who bought all the CHYF securities at a discount of around 6% (or $24m) did a good deal and it stopped the complaints.

So, they voted Yes?

They did. Faced with an Experts Report that said they wouldn't get their money for a long time and a unit price of around 80c, they took the offer. In hindsight, it was not a great deal as the hybrid market returned 7% p.a. for the next 3 years compared to the security return of c5%.

Any lessons?

- The Challenger Fund was too large. In 2007, at Elstree, we stopped taking applications for our hybrid Funds at $150m as we had concerns about liquidity and the size of our funds. We operated our Funds through the GFC. Although we suffered material outflows, we never gated the Fund, or stopped redemptions. This was at least partly due to being of a small enough size to meet redemptions. We still believe that any hybrid fund bigger larger than $200m offering daily liquidity is going to have issues eventually.
- Understand the structural liquidity issues regarding the market. We price liquidity and understand how much it will cost us to enter and exit holdings (for whatever reasons; investment decisions or redemptions) and the costs are an important input into how much of a particular security we will hold. There are some securities where the market impact costs are so high we won't buy them. Our liquidity pricing seems to be reasonably accurate. A few years ago, we lost a mandate due (we believe) to a change in asset consultant, and the portfolio was sold by a transition manager. We estimated the cost of liquidating a $90m portfolio in the 3 weeks before Christmas to be around 0.35%. We could see the transactions going through the market and we estimated that the transition manager cost was slightly higher. In current market conditions and with our fund size, we estimate that the liquidation cost/market impact for the entire Elstree Enhanced Income Fund to be 0.08% (yes that is true: close to nothing).
- Understand the entity you are investing with. If we started managing the Challenger High Yield Fund in 2008, we would probably have had to suspend redemptions (it was a basket case) but we would have redeemed more earlier and would not have proposed the same 2011 Scheme. It's the unitholders money, they deserve appropriate fiduciary duty.
- Look for conflicts of interest. When Challenger Life was determined to be the provider of the replacement security it created an insoluble conflict of interest for the Challenger group. Challenger Life benefitted from the Scheme and the extent of the benefit and because it was a zero sum game, the clients of the Challenger Fund Management operation were on the other side.

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- Most investors don't understand liquidity issues until it is too late. One of the writers lasting memories from the earlier part of his career was his then, CIO, belting the desk and remarking that you can't change underlying liquidity by a structure (He was talking to a property fund manager). If the underlying investment is opaque and illiquid (i.e. property, private equity, loan funds), packaging it up in a unit trust and offering daily liquidity by holding a bit of cash and hoping to sell assets nearly always ends in disaster.

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Appendix

Deloitte assessed the asset value at $534.9m -$547.5m and the replacement security at a value of $543-$549m. Hence the value of the new assets was probably higher than the value of the existing units

Asset Value

	Deloitte	Elstree	Comments
Assets Market Value	$549.9-$557.5m	$556.2	Challenger NAV was $556.2m. Challenger RE has a responsibility to provide accurate valuations
Less management costs	($10) - (15.0)m	0	Methodological error. You only discount future management costs if you included future income in your valuation. If you sell the assets today at either market valuation or Deloitte valuation, there is no future management cost
Fair market value of CHYF	$534.9m $547.5m	$556.2m	.

Value of consideration

	Deloitte	Elstree	
Cash consideration	$111.0	$111.0	
Security consideration	$432m - $438m	$421.4m - $423.8m	Elstree estimated sales yield of replacement security if you had to sell on secondary market on day 1. Yield of 5.8%-6.0% is equivalent to other 3 year A rated issuers.
	$543m-$549m	$532.4m - $534.8m	
Fair and reasonable?	Yes	No; approx. $24m short	

Liquidity

	Deloittes	Elstree
Market Status	"liquidity is becoming increasingly difficult"	Liquidity was sufficient to sell most securities within 2 years (See below)
Volatility	"increasing volatility… remain exposed…to portfolio that is more volatile….than pre GFC"	Market volatility in Q4 2010 was 2.3% p.a., not materially different to pre GFC volatility of 1.5% p.a.
Rebalance	"Unitholders….limited ability to rebalance portfolio if they were not comfortable with the risk balance"	cf owning a 3 year illiquid bond with a strategy of Challenger returning 60% of cash within 1 year. The replacement security is far inferior to the controlled redemption option.
Tax losses	"with the significant level of …losses in CHYF, it is likely the level of distributions would be significantly reduced going forward"	Huh? If the securities have been written down, returns are already impacted. And, in any case, realised losses would shield unitholders against any tax on future capital gains.

Liquidity Analysis of CHYF

Challenger asserted that it would not be possible to realise the remaining securities within a reasonable time. We assert that you could realise the cash, investment grade corporate securities and 75% of the hybrids within 12 months. Along with natural maturities of other securities, this equates to around $400m of a total fund size of $556m

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Securities

		Hybrid Price	Turnover (monthly ave 6/2010 - 11/2010)	Comment
Total Fund size	$556m			
Cash	$80.2m			
5 Largest Hybrids				
Multiplex SITES (MXUPA)	$42.3m	$78.01	$7.5m (5.6 months to sell)	Security is unrated and perpetual in nature, but price was stable around mid $70s throughout 2010 and running yield was 11.5%.
Sydney Kingsford Smith Airport Interest (SAKHA)	$37.2	$98.8	$10.2m (3.7 months to sell)	Security was investment grade and had traded in the $90s for most of 2010. Market expected it will be redeemed at call date in January 2012 (i.e) 12 months hence. It was.
Australand SITES (AAZPB)	$28.9m	$90.31	$4.5m (6.3 months to sell)	Security was unrated and perpetual. Company had undertaken 2 large capital raisings since GFC and market price implied reasonable prospect of call by company. It was expensive debt for the company. Issue was called in 2014.
Dexus Rents Trust (DXRPA)	$28.9m	$93.00	$3.6m (7.9 months to sell)	Strong investment grade issuer. Market price implied DXS would call issue at first call date in June 2012. It did.
Orica SPS	$24.5m	$99.5	$8.7m (2.8m to sell)	Investment grade issuer (and issue?). Price implied company would call issue at first call date in Nov 2011. It did.
Other assets				
Investment grade Corporate Bonds	$166m			Saleable within 6 months due to short-ish average maturity; 3.3 years.
Private Debt	$57.9m			2.7 year average term. Looks like medium discount to cost, so probably credit performance is OK. Unsaleable but assume 50% redeemed within 2 years.
Domestic RMBS	$48.5			Large discount to cost and long term to expected maturity 7.3 years. In hindsight values recovered quickly after 2010.
Convertible Notes	$16.0			Not material
Non-performing securities	$9.4			Not material
FX Hedges	$2.7			Not material

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