

ICI VIEWPOINTS

JANUARY 14, 2016

How the SEC's Six-Bucket Approach Could Provide a False Picture of Liquidity

By Brian Reid

As I explained in [a previous post](#), I filed [a letter](#) on January 13 with the U.S. Securities and Exchange Commission (SEC) in response to its liquidity risk management proposal and to *Liquidity and Flows of U.S. Mutual Funds*, a study by the Commission's Division of Economic and Risk Analysis (DERA). My letter was one of four components of ICI's [multipart response](#) to the SEC proposal.

Today's post focuses on one possible unintended consequence of the SEC's six-bucket liquidity classification scheme—that funds will need to rely on third-party vendors to place each security in a liquidity bucket, and that model-based classifications will depend on backward-looking, measurable inputs that could lead to perverse outcomes with false measures of liquidity. For example, models might use a fund's portfolio holdings, along with these holdings' average daily trading volumes. With such a model, larger funds would be more likely to appear illiquid while smaller funds would likely be classified as liquid—regardless of their approaches to liquidity management. Such a system would be of no value to portfolio managers, investors, or policymakers.

It's important to remember that funds have a 75-year history of successfully accommodating investor redemptions. In the past 15 years alone, long-term mutual funds (bond, equity, and hybrid mutual funds) and exchange-traded funds (ETFs) have met tens of trillions of dollars of redemptions. In fact, the DERA study itself presents ample evidence consistent with the view that funds have successfully managed portfolios to ensure that they are able to meet shareholder redemptions.

The SEC's liquidity proposal is intended to further improve funds' ability to meet redemption requests and reduce any potential adverse effects on remaining shareholders. ICI supports that goal. Yet the Commission provides no evidence that its proposal to classify assets into six distinct liquidity "buckets" on an ongoing basis, based on the fund's ability to convert each of its portfolio holdings to cash without materially affecting the value of the holding prior to sale, would achieve this. In fact, there is a clear risk that this requirement could be harmful.

What Effect Might the Six-Bucket Approach Have?

ICI understands the SEC's desire for comparable classification schemes and reporting across funds. There are, however, a number of real problems with this aspect of the proposal, which we detail in our [comments to the Commission](#). To put it simply, ICI and its members believe that liquidity risk is too multifaceted, and attempts to monitor and manage it are appropriately too subjective and methodologically diverse, to be classified in such a uniform manner across the industry.

The onerous requirement to place each of a fund's securities in one or more liquidity buckets would likely drive the industry toward third-party vendors to help classify the liquidity of each portfolio holding. Because funds would be required to release these liquidity assessments to the SEC each month and to the public each quarter, over time these third-party models would likely converge toward similar assumptions and inputs. Though such an outcome could facilitate comparisons across funds, they would no doubt also create an artificial sense of precision about fund liquidity.

Another problem is that model-based estimates of liquidity would, by necessity, be based on measurable, backward-looking inputs. Although it is completely appropriate to assess liquidity at some level based on historical data, doing so exclusively would risk ignoring the specific market intelligence and expertise that fund advisers can bring to bear in real time to assess the liquidity of markets.

Models also involve measurement and statistical error, as well as structural uncertainty—features that could be masked by the apparent precision of the six-bucket approach. This problem—known as “model risk”—is an issue that banking regulators have become extremely aware of in light of the poor performance of risk models (such as value-at-risk models) during the financial crisis. To the extent that the proposed rule would cause liquidity models to become fairly standardized, risks could be increased because all funds would essentially be using the same models. If the models turn out to be wrong, the risk would be increased that all funds are wrong together.

These models could also lead to perverse outcomes. Though the SEC proposal provides no specific guidance on how to assess the effect on the markets of a fund’s portfolio purchases or sales under stressed conditions, trading volume and portfolio positions are two observable and measurable inputs that market participants sometimes use to help assess the liquidity of their portfolios, and could likely be included in such models. Given this, let’s assume that a fund can sell up to 20 percent of the daily trading volume in a particular security without materially affecting the value of the underlying security, and consider the liquidity buckets that various types of funds might report.

Bigger Would Be Viewed as Riskier

Under this approach, it’s evident that the SEC’s proposed bucketing approach could lead to anomalous outcomes, such as classifying rather plain-vanilla equity funds (for example, S&P 500 index funds) as illiquid. It’s also evident that the proposed bucketing approach could, almost mechanically, disadvantage large funds and create the impression that small funds are highly liquid, regardless of their holdings, cash management strategies, or other factors.

Let’s look at how the six-bucket approach might affect S&P 500 index funds, which are among the most straightforward—and liquid—mutual funds. The portfolios in such funds are essentially identical. They typically hold relatively little cash, in part to reduce the tracking error that can potentially be caused by “cash drag.” Investors in these funds tend to be oriented heavily toward retirement saving; consequently, flows to such funds tend to be rather stable, even among smaller funds. Finally, these funds are able to accommodate net cash flows by taking temporary positions in S&P 500 futures, which are among the most liquid of all financial market instruments.

The figure below provides a plausible outlook for the liquidity buckets that S&P 500 funds of various sizes might report if liquidity measures relied on trading volumes and portfolio holdings. Given that the total daily trading volume in S&P 500 stocks currently averages about \$30 billion, and working with our assumption that an S&P 500 index fund can sell up to 20 percent of market volume per day without materially affecting its net asset value (NAV), such a fund should be able to sell up to \$6 billion of securities per day. Let’s assume further that the fund would hold 1 percent of its assets in cash or cash equivalents.

Possible Outcomes for SEC-Proposed Liquidity Buckets of S&P 500 Index Funds

Selected fund sizes

Percentage of fund portfolio convertible to cash within:							
Fund size \$ billions	Business days		Calendar days				
	0–1	2–3	4–7	8–15	16–30	> 30	> 7
1	1.0%	99.0%	0.0%	0.0%	0.0%	0.0%	0.0%
2	1.0%	99.0%	0.0%	0.0%	0.0%	0.0%	0.0%
4	1.0%	99.0%	0.0%	0.0%	0.0%	0.0%	0.0%
8	1.0%	75.8%	23.2%	0.0%	0.0%	0.0%	0.0%
10	1.0%	60.6%	38.4%	0.0%	0.0%	0.0%	0.0%
20	1.0%	30.3%	60.6%	8.1%	0.0%	0.0%	8.1%

30	1.0%	20.2%	40.4%	38.4%	0.0%	0.0%	38.4%
40	1.0%	15.2%	30.3%	53.5%	0.0%	0.0%	53.5%
50	1.0%	12.1%	24.2%	60.6%	2.0%	0.0%	62.6%
60	1.0%	10.1%	20.2%	50.5%	18.2%	0.0%	68.7%
80	1.0%	7.6%	15.2%	37.9%	38.4%	0.0%	76.3%
100	1.0%	6.1%	12.1%	30.3%	50.5%	0.0%	80.8%
150	1.0%	4.0%	8.1%	20.2%	40.4%	26.3%	86.9%
200	1.0%	3.0%	6.1%	15.2%	30.3%	44.5%	89.9%

Under these assumptions, the rule proposal's six-bucket scheme would convey to investors a false impression that any mid- to large-sized S&P 500 index fund is a virtual illiquidity trap—that is, one that risks being unable to meet its redemptions in a timely manner. For example, an S&P 500 fund with assets of about \$40 billion could be faced with the prospect of having to categorize the majority of its assets as "illiquid" within seven calendar days. To put this into perspective, there are currently three S&P 500 index funds whose assets exceed \$40 billion; another seven equity index funds using other indexes whose assets exceed \$40 billion; and another 11 actively managed domestic equity funds whose assets exceed \$40 billion.

On the other hand, models using trading volumes and portfolio holdings could convey to investors the impression that smaller funds are far less risky. The example above shows that an S&P 500 index fund with assets of \$4 billion or less would appear able to convert everything to cash within three business days with no material impact on the price of its shares.

Given this and other examples in our letter, it follows that mechanical application of models to classify portfolio holdings into liquidity buckets has the potential to be incorrect and provide false signals about the liquidity of a fund. We strongly question whether these kinds of outcomes are likely to have value for fund managers, investors, or for the SEC—and there is a real risk that such models would amplify and compound liquidity risks in the market and for funds.

For more information about ICI's response to the SEC proposal, read the Institute's [news release](#), which contains links to all four letters to the Commission.

Brian Reid was Chief Economist of the Investment Company Institute.