Structural Risks in Open End Mutual Funds

In my opinion, being in the industry for over 30 years trading investing in both liquid and illiquid markets globally, unfortunately Bangladesh is not yet ready for Open End Funds due to unintended structural risks. Unless it is a money market fund that has high level of underlying liquid securities, all open-end funds should be converted to closed End form and/or perpetual under section 20a of securities law in Bangladesh to reduce a potential of a spiraling liquidity crisis in an illiquid market.

The reality is we cannot have a managed fund providing frequent liquidity to investors when we do not have underlying securities that are liquid and easily tradeable without moving the market materially. Those of us who have been around the global markets understand -- short term funding with Long term or illiquid instrument is a formula for a liquidity crisis and serious consequences for any market. **Open End Funds are most certainly possible and required but not in the current market scenario with limited scrips, and no real depth of institutional investors outside of ICB.** In order to create the right environment for Open End Funds much work is required by all stakeholders including regulators for developing a **commercial paper market, tradable Treasury Bills market and other highly liquid investable assets including transferable Savings Certificates**.

To illustrate the liquidity challenge, the daily volatility of stocks in Bangladesh is more than 1.5%, therefore daily value at risk is approximately 3% (95% Confidence), implying when we buy or sell an instrument in size over 2-3 days the asset price can easily move **6-9% positive (buying) or negative (selling) adversely impacting buyer or sellers**. Therefore, any sizeable Open End Fund seeking liquidity in the secondary market in normal cases can have serious consequences for all investors. This is clearly not the fault of Open End Funds itself or the mangers but the market itself that is not prepared to absorb sizeable sale which is a basic requirement for an open end fund.

In a down market and/or relatively illiquid market in Bangladesh when unitholders reallocate redeem investments, the Open End Fund Managers are forced to sell in most cases the best quality and most liquid relative assets they hold. This imply the remaining Unit holders will have a much higher exposure to less liquid names, and some investors in Open End Funds can be left holding the worse possible illiquid investment. **Therefore, all Open End Unit Holders must be fully aware of incremental risks that exists in Open End Funds (relative to CEMFs) for providing liquidity based upon less liquid underlying investments and potential adverse consequences triggered by other investors in the same fund who can exit under more favorable terms – especially in bear markets.**

The decision by Bangladesh Securities Exchange Commission (under Section 20a) to allow to extend the tenor of Closed End Mutual Funds (CEMFs) under Section 20a was precisely to avoid such challenges and encourage long term investments and market stability. All participants must realize that the price of liquidity option is not cheap in less liquid markets and can have a material adverse impact not only for Open End Unit Holders but all market participants.

Reaz Islam, CEO of LR Global
Comments, observations, and suggestions please send to: reaz@lrglobalbd.com