KIM: Junk fund investors: Welcome to the Hotel California

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Third Avenue Management LLC ("Third Avenue") stunned investors when it announced on December 10 it was effectively barring investor withdrawals from its Third Avenue Focused Credit Fund ("FC").

This news was shocking on two levels. First, the ability of investors to receive cash for their shares promptly is the "bedrock" principal of mutual fund investing. Second, Third Avenue is no "Johnny-come-lately." Marty Whitman (92) founded M.J. Whitman & Co., the predecessor to Third Avenue (assets peaked at $26 billion in 2006), in 1974 and is one of the most highly-respected investors in "distressed" situations.

Third Avenue launched FC in 2009, the perfect time. FC made large, concentrated bets in "junk" (i.e. non-investment grade) and non-rated bonds and other securities that typically traded at deep discounts to face value. In the wake of the financial crisis, there was no shortage of distressed investment opportunities. Bond investors, desperate for yield in an environment of 0% short-term interest rates, poured tens of billions into junk bond funds.

FC rode the wave, topping out around $3.5 billion in 2014.

Commodity producers account for about 10% of the junk market. The collapse in commodity prices put many producers under severe financial stress, causing bond prices to drop. Junk fund shareholders sensed the party was coming to an end and started heading for the exits. According to Morningstar, FC had experienced a whopping $1 billion in outflows (leaving $789 million) and was down 27% year-to-date when Third Avenue determined it could no longer withstand the flood of redemptions without resorting to "fire sales" of its remaining assets and pulled the plug.

FC shareholders who did not redeem before December 9 are locked-in and will be paid over as many months as it takes FC to liquidate its holdings. Welcome to the Hotel California.

The SEC has been concerned about exactly this scenario caused by the mismatch between a fund offering its shareholders daily access to their money while a significant proportion of its assets are *illiquid* (i.e. cannot be sold quickly without impacting price). On September 22, 2015, the SEC proposed new Rule 22e-4, which would require funds to implement liquidity management programs and enhance disclosure regarding fund liquidity and redemption practices.

The SEC's proposal is designed to better insure investors can cash out promptly and at current prices. The SEC is particularly concerned about the "first mover advantage" in times of market stress, caused when a fund sells its most liquid assets to pay departing shareholders, leaving the remaining shareholders holding the bag with a portfolio of riskier, illiquid assets.

According to Oaktree's Howard Marks, liquidity is both critically important and situational; changing depending on which way you want to go (buy/sell) and which way everyone else wants to go. Post-crisis rules have eliminated banks as market stabilizers and providers of liquidity. His bottom line is, "No investment vehicle should promise greater liquidity than is afforded by its underlying assets."

Investors in junk and "liquid-alternative" funds, in particular, need to know what their funds own. What was true with the Bailey Bros. Building and Loan in "It's a Wonderful Life" still rang true with FC. You need to be sure there is sufficient liquidity in case there is a "run" on your building and loan or fund.

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