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Woodford Equity Income Suspends Trading – A Lesson in Risk Management

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Neil Woodford, perhaps the biggest name in UK fund management has suspended trading on his flagship fund, Woodford Equity Income. This comes after many well documented troubles for the fund in recent years after a stellar launch in 2014 which garnered huge inflows and strong performance.

After peaking in assets at over £10bn, the fund is now valued at around £4bn, having experienced net outflows every month since May 2017. While initially the fund was able to fulfil outflows with typical asset sales, the methods used to meet redemptions and meet regulator obligations surrounding liquidity have become increasingly inventive with assets sold to his investment trust and privately held companies listed on the Guernsey stock exchange. While investors will eventually be able to withdraw again, this may not be for some time, as the current path of controlled liquid decline appears to have run out with the tipping point being the planned withdrawal by Kent County Council of their £250m investment.

Mr Woodford made his name at Invesco Perpetual in the dotcom crash of 2000, when – having been berated by investors and colleagues for not partaking in the tech bubble of the late 1990s on valuation grounds – he was proven fully vindicated by his large outperformance in the falling markets that followed. Strong performance over the next decade then cemented his name as a top fund manager, synonymous with prudent investing.

In 2013 Mr Woodford left Invesco Perpetual and launched funds for his own firm in 2014. Billions of pounds then followed him on the strength of his name and his reputation.

Having previously held Mr Woodford's Invesco funds the Future Money team were interested in his new venture and examined the structure.

When a new fund is launched we believe it is important to allow a bedding in period before investment to assess a process in practice rather than in promise. As such, we reviewed the fund in 2015 and at this stage decided not to invest. We held concerns that the strong performance was simply a result of the large volume of inflows pumping up prices. We also noted the departure of senior individuals from the operating and compliance teams within the early months of the firm's launch, which caused us unease over the corporate governance within the firm, fearing a lack of checks and balances over Mr Woodford's control.

Over the following years we reviewed the fund a number of times and noted that as the fund's inflows decreased, so too did its outperformance. From inception the fund had around 15% allocations in smaller stocks, both listed and unlisted, but over time this level was increasing and by the time the fund's inflows turned negative the fund had around 30%. Given the size of assets managed by the Woodford fund, holdings

in many of the underlying companies were extremely large, with many examples of the fund being a significant or controlling investor. As such, inflows being distributed to these holdings appeared to support strong price performance. However, once the outflows started then cash had to be raised and this was most easily done from the most liquid, large cap holdings. This meant that as the fund size shrank, its concentration in less liquid small caps increased, to the point where the fund now has approximately 65% in small cap stocks (using Morningstar Direct classification).

This has led to the position we are in today, where Woodford Equity Income has been forced to suspend trading given an inability to meet the liquidity needs of anticipated outflows. This period of gating is intended to allow the fund manager to raise the necessary liquidity in a less time sensitive manner, with the hope of achieving reasonable prices for his forced sales. However, the risk with this is that the duration of the trading suspension is unknown and when the fund does reopen there is likely to be a renewed surge in outflows as investors are keen to get their money back.

This case is an example of inadequate risk management allowing concentration levels which may appear innocuous during good times, but which deliver a lack of liquidity and overinflated prices at crunch time.

Reputation and past performance are important factors in fund selection, but they should not be relied upon. An assessment of a fund's investment process, team structure and risk controls are crucial in identifying potential pitfalls.

Important Information

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It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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