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The haircut solution

The introduction of government guarantees for banks appears to have had the desired effect of stabilising the banking sector, but has worsened the situation of non-guaranteed investment vehicles. Rightly, the government opposes providing blanket guarantees of such market-linked investments, but desperate times call for innovative measures. A 'haircut guarantee' might be warranted to prevent continued outflows and the forced asset sales by funds/unit trusts which can only further depress asset prices.

The essential problem is with unlisted funds which provide investors with a withdrawal option, even though the assets held are illiquid (and sometimes heavily leveraged). Property and mortgage trusts are prime examples, and even cash funds may face difficulties liquidating their assets at a reasonable price in current market conditions.

This business model is fundamentally flawed, and ultimately leads to freezes on redemptions when markets turn sour (as also occurred in the early 1990s). Listed trusts do not face the same problem, because investors wanting out can sell their units on the stock exchange. In that case, unit values fall until well-informed investors step in to profit from the valuation gap between unit prices and the underlying asset values. Of course, if asset values have fallen and the funds are too heavily leveraged due to borrowing, the fund may fail – but that is a natural possible outcome for risky investments.

The danger we currently face is that withdrawals from unlisted funds can only be accommodated by the fund selling assets into a depressed market. Not only might the fund incur losses (relative to the asset purchase price) but such widespread sales further drive down asset values and induce nervous investors to jump ship from such funds before unit values fall further.

How can this be prevented? Freezing redemptions is one, undesirable, solution. Converting to a listed fund is a desirable, longer term solution. But in the short term some other solution is needed.

This is where the 'haircut guarantee' starts to look appealing. When a fund is frozen the value of its assets can be estimated – albeit with much uncertainty in the current market climate. But it should be possible to place a lower bound on what those assets are worth. For example a fund which had raised $1 per unit from investors might have bought assets which are now valued at somewhere between $0.50 and $0.80. Obviously, the investors in the fund should bear that loss of value – since they were, after all, investing in a risky venture in the hope of gains.

In that example the haircut guarantee involves the government providing a guarantee over, say, $0.40 per unit, and the fund being reopened for redemptions up to that amount per unit (with the remaining value per unit – however much that is – remaining frozen until some later date). Because the $0.40 is government guaranteed, there should be no incentive for investors to make redemptions to invest elsewhere. The fund therefore does not need to sell assets to meet a flood of redemptions.

Gradually, as normality returns and asset values stabilise, the value of the fund's assets can be determined, the guarantee can be removed, and investors allowed access to the residual value of units above the $0.40. Ideally this would involve converting the fund to a listed fund, whereby investors could sell their units on the market.

Does the taxpayer face a risk from such haircut guarantees? Not if the haircut is large enough, and in which case the guarantee should not involve any fee. Does the investor in the fund benefit? Yes, they get access to some part of their funds if they need cash. They also do not need to participate in a value destroying run on the fund. Of course, if the fund has made bad investments they will not receive all of their investment back – but that is the nature of investing.

Will the fund survive, or will investors withdraw the guaranteed amount anyway? That is, admittedly, a potential risk. Hence, there may be merit in attaching some conditions to the haircut guarantee which inhibit withdrawals. For example, the fund could be split temporarily into guaranteed and frozen units, with investor claims over frozen units being lost (to some degree) if guaranteed units are withdrawn.

A haircut guarantee is worth considering in the current dire circumstances.

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http://www.businessspectator.com.au/bs.nsf/Article/The-haircut-solution-KSURD?OpenDocument&src=sph