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# The Collapse of the Third Avenue Junk Bond Fund

Mutual funds pool money from various investors and act as financial intermediaries to invest those proceeds in securities, such as corporate equity or various types of bonds. Led by fund managers, the funds attempt to generate capital gains and income for their investors who are typically given the right to redeem their fund holdings on a daily basis. In 2014, according to the Investment Company Institute, a fund trade group, the roughly 9,000 domestic funds held about $16 trillion in assets.

In early December 2015, Third Avenue Management, a company that manages several mutual funds, announced that it was freezing shareholder redemptions and involuntarily liquidating the assets of a financially troubled member of its mutual fund family, Third Avenue Focused Credit Fund (the Third Avenue fund). Launched in 2009, the Third Avenue fund was principally invested in high-yield or junk bonds, debt issued by companies with a relatively high risk of default (when a debt issuer is unable to make required payments on its debt obligations).

This collapse was the first by a domestic mutual fund since the failure of the Reserve Primary money market fund (such funds primarily invest in short-term debt) during the 2008 financial crisis. The potential broader systemic implications of the mutual fund's failure led the Treasury Department to adopt a temporary money market fund shareholder guarantee and the Securities and Exchange Commission (SEC) to adopt a series of new money market fund regulations. The Third Avenue fund, which had $790 million in assets on December 8, 2015, is being investigated by the Massachusetts Securities Division and the SEC, the primary fund regulator.

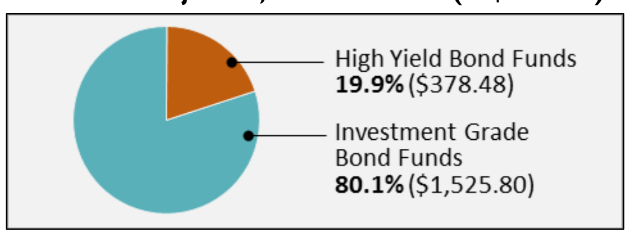
The fund paid out all shareholder redemption requests through December 8, right before fund officials closed the fund and prohibited further redemptions. It then transferred all of its invested assets into a liquidating trust, which issued fund trust interests to be distributed to the terminated fund's shareholders. Fund officials said that the redemption freeze was necessary to avoid liquidating its assets in a fire sale. The move was characterized by various industry observers as rather unorthodox: SEC permission is generally required before fund redemptions can be frozen. Later, on December 16, Third Avenue fund officials requested from the SEC exemptive relief for its earlier suspension of fund redemptions, and relief was obtained on that day. As part of the exemptive relief granted by the SEC, the fund was allowed to shift assets from the trust back into the fund while continuing to bar shareholder redemptions. The fund's investors will receive updated, daily net asset value (i.e., a fund's per share value as reflected in the valuation of its assets) reports on their fund holdings. Investors were also paid an initial distribution of about 9% of the total value of their holdings. Meanwhile, fund managers are liquidating the fund's remaining assets, which is likely to be a protracted process widely predicted to last many months. Some question whether the fund's shareholders, who include individual investors, nonprofit concerns, and pension funds, will ultimately be made whole with respect to the value of their remaining holdings on December 10, 2015, the advent of the redemption freeze.

### The Regulation of Mutual Funds

The SEC primarily regulates mutual funds such as the Third Avenue fund through the Investment Company Act of 1940 (P.L. 76-768). As described by the agency, the act

> [I]s designed to minimize conflicts of interest that arise in these complex operations. It requires these companies to disclose their financial condition and investment policies to investors … [It also requires] disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.

**Figure 1. Total Net Assets of Mutual Bond Funds by Investment Objective, Year End 2014 (in $ billions)**




**Source:** Data from the Investment Company Institute.

### High-Yield Bonds

Investment grade debt is debt that a bond rating agency, such as Standard & Poor's or Moody's, determines has a relatively low risk of being defaulted on by an issuer, such as a corporation or a municipality. As reflected in the axiom that potential return rises with an increase in risk, investment grade debt is associated with relatively low yields or interest payments.

By contrast, the Third Avenue fund was largely invested in long-term debt (i.e., maturities longer than 12 months) with high-yield or junk ratings from bond rating agencies. As described by the SEC,

> A high-yield corporate bond is a type of corporate bond that offers a higher rate of interest because of its higher risk of default. When companies with a greater estimated default risk issue bonds, they may be unable to obtain than investment-grade bond credit rating. As a result, they typically issue bonds

with higher interest rates in order to entice investors and compensate them for this higher risk. High-yield bond issuers may be companies characterized as highly leveraged or those experiencing financial difficulties. Smaller or emerging companies may also have to issue high-yield bonds to offset unproven operating histories or because their financial plans may be considered speculative or risky.

Over the past few years, various commodities-based companies in energy, metals, and mining funded through the estimated $1.2 trillion high-yield debt market faced significant commodity price declines. In return for the added risk, investors have reportedly demanded even higher yields on the junk bonds issued by such firms. Indices that track the difference between overall junk bond yields and those from U.S. Treasury bonds, benchmarks of investment safety, indicate that in the fall of 2015, those yield differentials were the highest that they had been in more than three years. *Bloomberg* reported that for every high-yield bond issuer that saw boosted bond ratings in 2015, two issuers experienced rating downgrades, a ratio that reportedly had not been observed since 2009. Meanwhile, according to some analysts, including Matthew Mish of UBS Investment Bank, the initial stress felt by high-yield issuers in the commodities sectors appears to have "spilled over" into "the broader high-yield market."

**High-Yield Bond Funds**

In the low interest rate environment of 2009, investors began pouring tens of billions of dollars into higher yielding junk bond funds. The Investment Company Institute, reports that total net assets of high-yield bond funds grew from $118 billion in 2008 to $198 billion in 2009, then advanced to $420 billion by 2013. Later, however, amidst the aforementioned junk bond market doldrums, junk bond fund investors withdrew more money than they invested in those funds (i.e., net outflows) in both 2013 and 2014. Net outflows had not been seen since 2005, according to Lipper, a fund researcher. In concert with this, junk bond fund total net assets fell from $420 billion to $378 billion between 2013 and 2014.

**The Third Avenue Fund's Problems**

Amidst the depressed junk bond environment, the Third Avenue fund saw the value of its assets fall from about $3.5 billion in July 2014 to $790 million by December 8, 2015. To date, among the 500 or so domestic junk bond funds, the Third Avenue fund has been the only one to involuntarily close its doors. Potential insight into the fund's reportedly precarious financial state may be found in statistics that illustrate the relative riskiness of the fund's portfolio vis-a-vis that of other junk bond funds. Funds must group their holdings into three categories based on the ease by which they can be valued. Holdings that are grouped into Level 3, the hardest to value group, also tend to be very illiquid (i.e., difficult to sell) with rather speculative valuations due to the absence of similar assets in active markets with actual valuations.

At the end of July 2015, the Third Avenue fund disclosed that Level 3 assets accounted for 20% of its total holdings. By contrast, most junk bond funds reportedly held no Level 3 assets. In addition, that 20% figure also exceeded the proportion of Level 3 assets reportedly held by other large junk bond funds with portfolios in excess of $500 million. In early 2015, analysts at Citigroup reported that 76% of the fund's portfolio carried a Standard & Poor's rating of CCC+ or below. (The CCC+ rating occupies the middle range of the various junk bond rating categories.) The median for junk bond funds said to have certain similarities to the Third Avenue fund reportedly was 22%.

Echoing this notion of the fund's uniqueness, Federal Reserve Board Chair Janet Yellen observed that the Third Avenue fund's problems seemed atypical as it "had many concentrated positions and especially risky and illiquid bonds." Still, there are some concerns that other junk bond funds could face liquidity mismatches with the potential for ensuing shareholder runs. A liquidity mismatch occurs when a fund with relatively illiquid assets is funded by investors who can make daily fund redemptions, as is typical with mutual funds. For example, Marty Fridson, chief investment officer at Lehmann Livian Fridson Advisors, observed that some bigger junk bond funds have large amounts of the industry's most illiquid and hardest to value assets and may have valuations that do not fully reflect the junk bond market downturn.

**Recent Related Regulatory Developments**

Citing the Third Avenue fund's example, a late 2015 report aimed at highlighting "key potential threats to U.S. financial stability," from the Treasury Department's Office of Financial Research observed that mutual funds could problematically "increase the liquidity mismatch in the corporate bond market because these funds may not be able to liquidate their investments as investments as quickly as their shareholders can withdraw capital, presenting redemption risk for the funds and fire-sale risk for the markets in which they participate."

In September 2015, the SEC commissioners voted to issue proposed new rules and amendments to older rules aimed at enhancing the ability of mutual funds (excluding money market funds) to better manage liquidity risks. Funds would be required to adopt new plans for managing liquidity risks and would also be required to keep a threshold level of cash or cash equivalents that could be easily converted into cash within three days (currently it is seven days). In addition, current agency guidelines that merely advise funds to cap the percentage of their net assets in the form of illiquid assets that cannot be sold within seven days (such as Level 3 assets) at 15% would be codified under the proposal. Critics, including fund industry representatives, claimed that the proposals would be unwieldy to comply with; would add significant fund compliance obligations; and could impede the ability of junk bond funds to conduct legitimate investment strategies.

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