For professional / qualified / Institutional clients and wholesale fund selectors investors and retail investors in Switzerland

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The safety of investment funds in times of uncertainty: what investors should know

UBS Asset Management

1. Traditional investment funds like mutual funds investing in stocks or bonds for example have characteristics that make them stable relative to single stocks and bonds in difficult market periods. However, downturns in stock or bond markets also affect funds.

2. While investment funds aren't immune against losses in value, they are protected from total failure thanks to diversification and their special legal status among investments. The fact that it's more likely that some underlying instruments in the fund may lose their value rather than all of them highlights the importance of diversification.

3. Investment funds are so-called "special assets" and not part of the bank's balance sheet, whereby investment funds are cheaper than direct investments due to the pooling of large assets, and they offer a high degree of diversification and professional management.

In the following, we will discuss individual aspects and questions regarding the safety of traditional investment funds licensed in Switzerland. The basis is provided by the Federal Act on Collective Investment Schemes (CISA) and the Banking Act (BankA).

A) Issues relating to investor protection

What happens to an investment fund if the fund management company is insolvent?
Basically nothing. Investment funds offer effective investor protection. The fund units (claims against the fund management company for participation in the assets and income of the investment fund or participations in the company) are secure, because investment funds are classed as "special assets" and not part of the balance sheet, therefore not part of the bankruptcy estate. The strict safekeeping of special assets by a custodian bank protects investors almost 100 percent against losses of the capital management company, even in the event of insolvency.

What happens to an investment fund if the custodian bank is insolvent?
Should the custodian bank fall into bankruptcy, the Banking Act prescribes the segregation of all securities account assets (shares, bonds and all investment funds) and would therefore not be part of the bankruptcy estate.

The only exception: investment funds must also hold cash and cash equivalents to a limited extent. The corresponding cash in accounts with the Fund's custodian bank would only be partially privileged in liquidation proceedings. Here there are differences between Swiss and foreign investment funds and the current law of the respective country would have to be applied (With a Swiss custodian bank, a maximum of CHF 30,000 is privileged. The Luxembourg Deposit Guarantee Fund and the Deposit Guarantee Scheme in Ireland both foresee a EUR 100,000 cash protection for depositors).

B) Fundamental risks associated with investment funds

Similar to equities and bonds, funds are exposed to price fluctuations depending on their investment orientation.

- A so-called issuer risk as with other forms of investment (e.g. bonds and structured products) usually does not exist with traditional investment funds.
- Individual underlyings within a fund can go bankrupt and lose all their value. This, in turn, would reduce the fund's NAV and negatively impact performance.
- However, since the fund is diversified (there are clear rules on diversification by law), a total loss is theoretically possible, but only if all investments would become worthless. This would also be the case even if the fund management company itself remained solvent.

Diversification
With investment funds, investors do not put all their eggs in one basket. The fund's assets are spread across a large number of securities (equities and/or bonds and other investment instruments) and – depending on the investment orientation of the fund – across different investment markets and currencies. This diversification reduces the overall risk of the investment.

- The broad diversification of investments and thus the distribution of individual risks are a central characteristic of investment funds.
- The Federal Act on Collective Investment Schemes (CISA) also stipulates a minimum distribution of risk.

Liquidity
When investing with investment funds, there are no-to-very-short waiting times (usually a maximum of 3 working days for traditional and open-ended investment funds).

- The determination of the redemption value is basically simple and transparent. It is carried out at the respective intrinsic value – the above-mentioned net asset value.
- The value of a fund unit is based solely on the performance of the underlying investments in which the fund is invested.
- In order for the fund itself to be liquid, it is assumed that the securities and shares held are also liquid or tradable. Should trading in the underlying investments be suspended or restricted, the fund cannot sell the securities held and must restrict liquidity.

Important: There are no reliable guarantees for financial investments. However, the Federal Act on Collective Investment Schemes (CISA) and the Swiss Financial Market Supervisory Authority (FINMA) ensure that fund investors are effectively protected against abuse and careless business conduct on the part of fund companies and fund providers.

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