FIELDPOINT PRIVATE

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Waddell & Reed Financial Inc., one of the biggest beneficiaries of the recent boom in mutual funds, has hit a rough patch. Nervous investors pulled $12.5 billion out of the investment company's two largest mutual funds over the past 12 months.
Waddell & Reed has grown primarily by marketing to mom-and-pop investors, which make up 86% of its clientele. That makes it more susceptible to shifts in popular sentiment than larger competitors that also invest for pension plans, insurers and sovereign-wealth funds.

The Overland, Kan.-based firm almost tripled in size from 2009 to 2013—it now manages about $123 billion—and pioneered a trend in "go-anywhere" mutual funds that, much like hedge funds, can trade almost anything, from stocks to bonds to precious metals. Now, investment dollars are going the other way.

The go-anywhere fund took big losses from bets on gold and Asian casino stocks last year, rattling investors.

Separately, Waddell & Reed abruptly fired the manager of its junk-bond fund, triggering a wave of redemptions. Combined outflows from the funds since April 2014 amount to about 10% of the firm's assets.

Waddell & Reed's outflows don't qualify as a run, in which investors worried about getting their money back line up to redeem shares, creating a cash crunch that forces the firm to raise cash, sell assets or temporarily halt redemptions.

Outflows have reached 12 consecutive months in Waddell & Reed's $24.8 billon go-anywhere Ivy Asset Strategy Fund and 10 months in the $8 billion Ivy High Income Fund. A year earlier, the funds together held $47.5 billion, according to Morningstar Inc. data.

"Both funds have experienced portfolio-management teams in place," a Waddell spokesman said in an email. "Few funds in the industry experience the rapid growth that the Ivy Asset Strategy and High Income funds have, and fewer still don't see growth slow or reverse at some point."

Wealth adviser Fieldpoint Private Advisors Inc. had more than $10 million invested in the junk-bond fund last July, when Waddell & Reed announced the firing of the fund's manager, William Nelson.The firm said only that Mr. Nelson was fired for cause unrelated to the fund's operation. Waddell declined to comment on the firing, and Mr. Nelson couldn't be reached for comment.

"We removed the fund from our platform immediately," said Nick Markola, Fieldpoint's director of research, who parked his clients' money in exchange-traded funds until it could be reinvested in actively managed mutual funds. "You don't see managers terminated for cause often and in that situation we shoot first and aim later."

The Asset Strategy Fund also experienced leadership changes last year when co-manager Ryan Caldwell left the fund. Poor performance also contributed to the outflows, analysts say.

Fund manager Michael Avery has a reputation for aggressive trades, including the sale of $4.1 billion of futures contracts credited in some published accounts with triggering the stock-market "flash crash" in May 2010. The Justice Department in April charged a U.K.-based trader with helping to cause that crash by manipulating stock-index futures.
Mr. Avery's strategies attracted $12 billion of net inflows from 2009 to mid-2014.

But the fund lost 5% in March and April of 2014, according to Morningstar, when gold prices fell, then took more losses on Asian casino stocks after a Chinese anticorruption campaign suppressed gambling in the region.

Regulators are increasingly worried that a large asset manager will fall prey to a panic. The Securities and Exchange Commission proposed in May more rigorous reporting requirements for investment firms to help the regulator analyze the impact of market shocks and "identify funds that might be at risk...due to increased redemptions," according to the proposal.

New SEC regulations allow money-market funds to use exit fees and “redemption gates” to slow or halt outflows during a run but mutual- fund managers cannot under the new regulations.

“This makes no sense to me at all,” said Andrew Hofer, the head of bond research at wealth-management firm Brown Brothers Harriman & Co., at a conference for bond-fund managers in Boston this month. “If gates are now required features of money market funds, why are regular [mutual] funds unable to gate?”

The SEC developed new rules for money-market funds in response to runs on such funds during the financial crisis and is evaluating new guidelines to address risk in mutual funds, a person familiar with the regulations said.

Mom-and-pop investors are notoriously fickle and can move in and out of funds quickly, said Michael Kim, an analyst covering asset managers at Sandler O’Neill + Partners LP.

The herdlike movement of “retail” investors has more impact than ever before because mutual funds have grown dramatically since the financial crisis through a combination of inflows and investment returns.

The Ivy Asset Strategy Fund grew by about 30% to a record of $36 billion in the 12 months through February 2014.

“The fund is much bigger today, so the levels of outflows on an absolute basis are much bigger than in prior cycles,” Mr. Kim said.

Other small managers like Artisan Partners Distributors LLC andVirtus Investment Partners also suffered significant outflows from franchise funds in recent months. A spokesman for Virtus declined to comment on the outflows beyond the firm’s disclosure in a May conference call that it had experienced net outflows of $2.2 billion in the first quarter related primarily to its Alpha Sector fund strategies. Artisan couldn’t be reached for comment.

Individual investors have flocked to alternative bond funds in recent years because low interest rates have dragged down the yield of more traditional money-market and government-bond funds.

One concern is that when redemptions hit, bond funds can dump high-quality investments first because they are more liquid, or easy to sell at high prices. The strategy can avoid immediate losses but leave remaining shareholders holding a portfolio with fewer safe bonds and a higher proportion of risky ones.

The proportion of high-risk bonds in the Ivy High Income fund jumped in the last six months of 2014, as investors bailed out and the firm sold bonds to pay redemptions. Bonds with credit ratings at or below triple-C, the lowest category of junk debt, made up 47% of the fund in December, compared with 35% at the end of June, according to data from Morningstar.

“The change in portfolio composition is unrelated to redemption,” Waddell & Reed’s spokesman said.

Lower-rated bonds are risky for mutual-fund investors because they are less likely to be repaid and harder to sell quickly. Mutual funds that invest heavily in such assets “thereby create large mismatches between the market liquidity of assets and the liquidity offered to end investors,” and such liquidity mismatches are on the rise, according to an April report from the International Monetary Fund.

The Ivy Strategies Fund’s 5% loss last year compares with an average 1.5% gain by competitors. The fund returned 24.3% in 2013, more than twice what comparable funds averaged, according to Morningstar.

While the fund has had mixed performance in recent years, its 10-year returns rank fifth among 166 comparable funds, according to Morningstar.

Mr. Avery has weathered several periods of large outflows, but the current exodus is larger and faster than anything his fund experienced before. Investors pulled $2.9 billion from the fund over 16 months in 2011 and 2012. In contrast, investors withdrew $3.4 billion in the first four months of 2015.

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