TCW

Manager of the TCW, MetWest, and TCW Alternative Fund Families

INSIGHT

VIEWPOINT

Fixed Income Liquidity Risk Management

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As a regulatory matter, mutual funds generally may not invest more than 15% of their assets in illiquid securities, generally defined as securities that cannot be readily sold at their approximate market value within 7 days. TCW complies with this liquidity requirement. The SEC has recently proposed additional liquidity rules, which are not yet final. We have joined with the industry groups suggesting modifications to the proposed rules, which we believe will make the proposed rules more useful and workable. While some fairly significant changes would be required to adapt our processes to the proposed rules, we believe that we have the essential systems and processes in place, and could make the changes necessary to enable a transition to compliance with the new rules within the ultimately required time frames.

In addition to these regulatory requirements, we have developed, and refined over a period of years, a robust proprietary risk assessment methodology. This methodology is based on a 5-level liquidity tiering system in which we assign securities to relative risk tiers based on their fundamental characteristics and market data available to us. This methodology enables us to evaluate portfolio liquidity risk at a more granular level, to analyze anomalous results, and to oversee the risk composition of the portfolios. It is not designed to predict days to liquidity for particular securities, holdings, portions of portfolios, or whole portfolios. Rather, the tiering system provides an additional layer of risk management that informs portfolio construction and adjustment.

The relative risk tiers cover the liquidity spectrum, from highly liquid assets such as U.S. Treasury securities to assets with impaired liquidity such as halted trading securities or privately placed securities with trading restrictions. For example, U.S. Treasury securities would be classified as Tier 1, high-quality investment grade bonds, typically Tier 2, performing high-quality high yield bonds, typically Tier 3, other high yield bonds, typically Tier 4, and assets such as non-agency mortgage derivatives, bank loans, and true private placements, typically Tier 5. This tiering serves a different purpose from, and does not correspond to, the regulatory maximum 15% illiquid test. For example, we categorize many assets as Tier 5 that would meet the requirements of liquid assets under the regulatory 15% test.

The categorization of securities into these tiers depends on a number of factors, including the security type, quantitative analysis, trade data, information relating to the issuer, and subjective evaluation of the foregoing and other factors. Generally, once assigned, the classifications are updated monthly. We generate and review internal liquidity reports daily. On a quarterly basis, we prepare liquidity reports, analyzing the U.S. fixed income data and the trends, for the boards of the mutual funds. We have used the data and reports for purposes of internal review and board oversight purposes only, and have not otherwise used or distributed these data and reports.