Investor Flows and Fragility in Corporate Bond Funds

by Goldstein, Jiang, and Ng

BIS Discussion:

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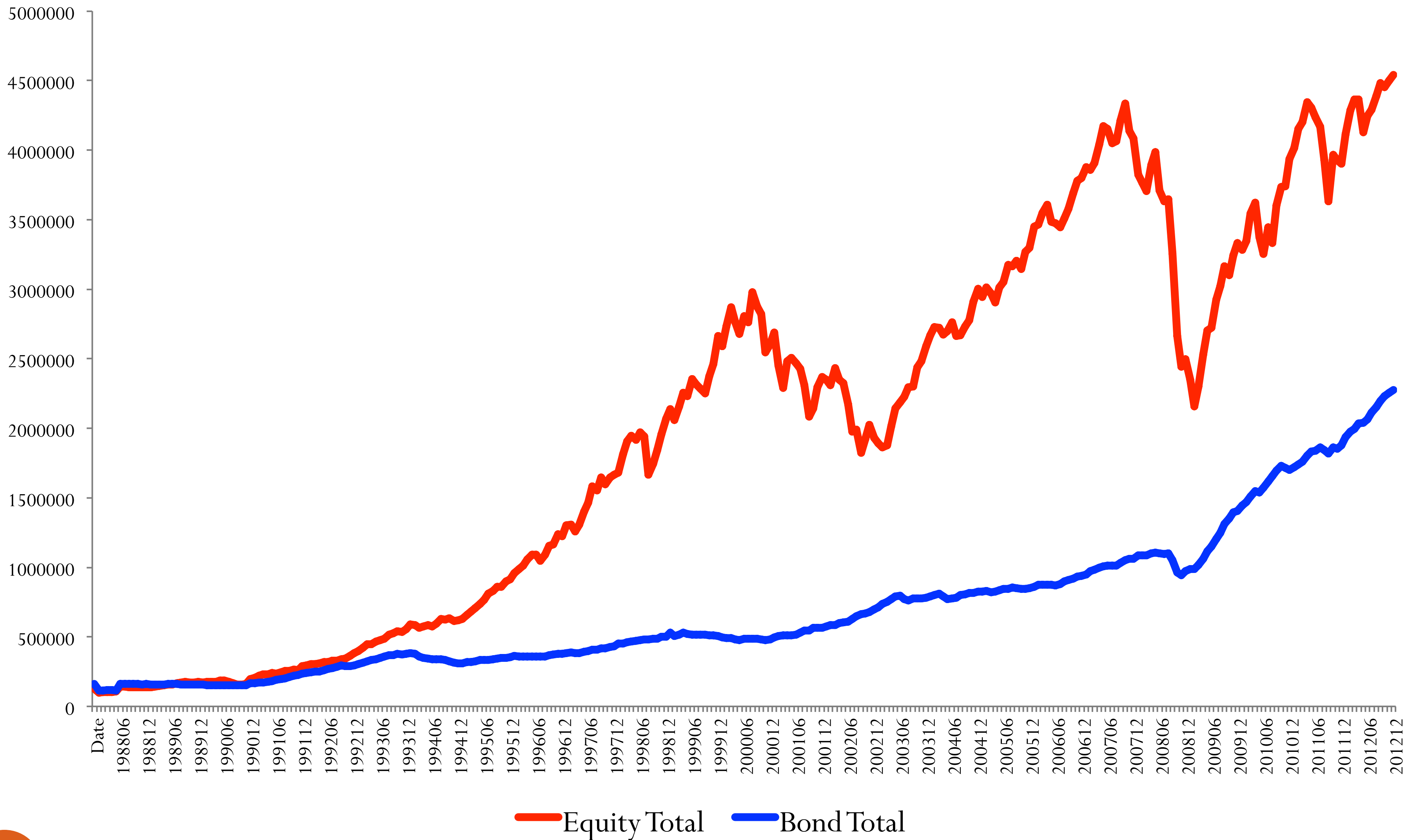
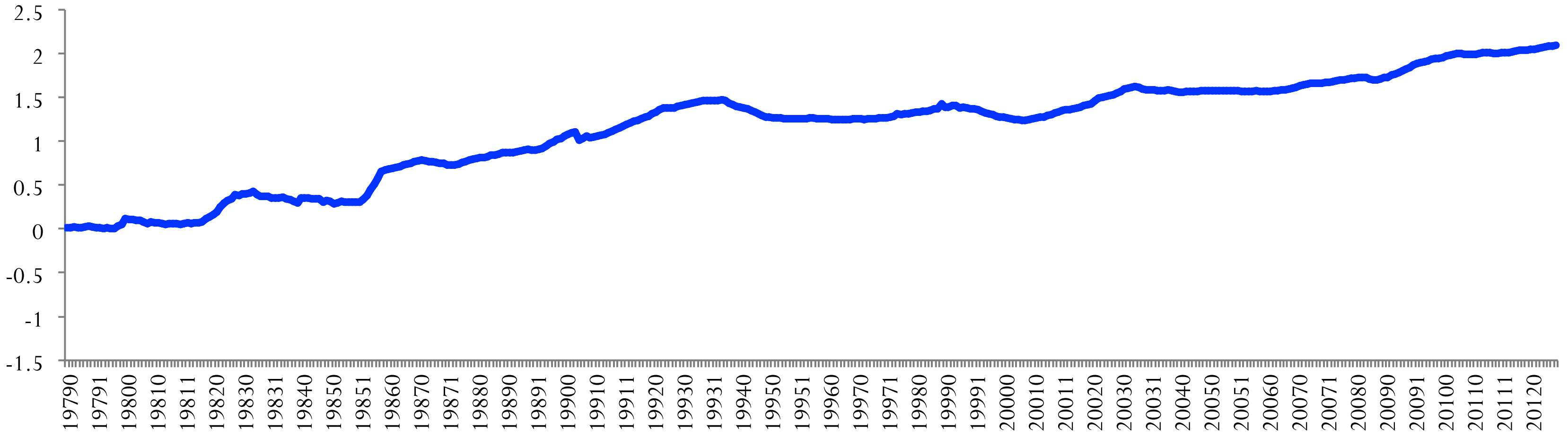
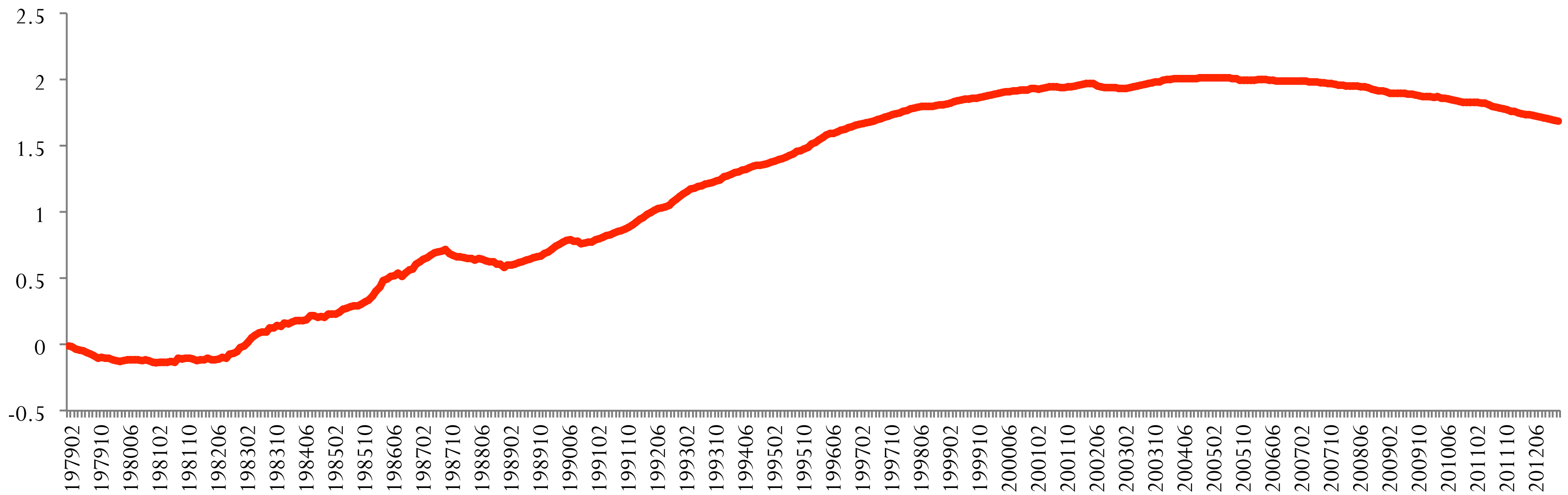
Motivation: U.S. Mutual Funds' Active Assets

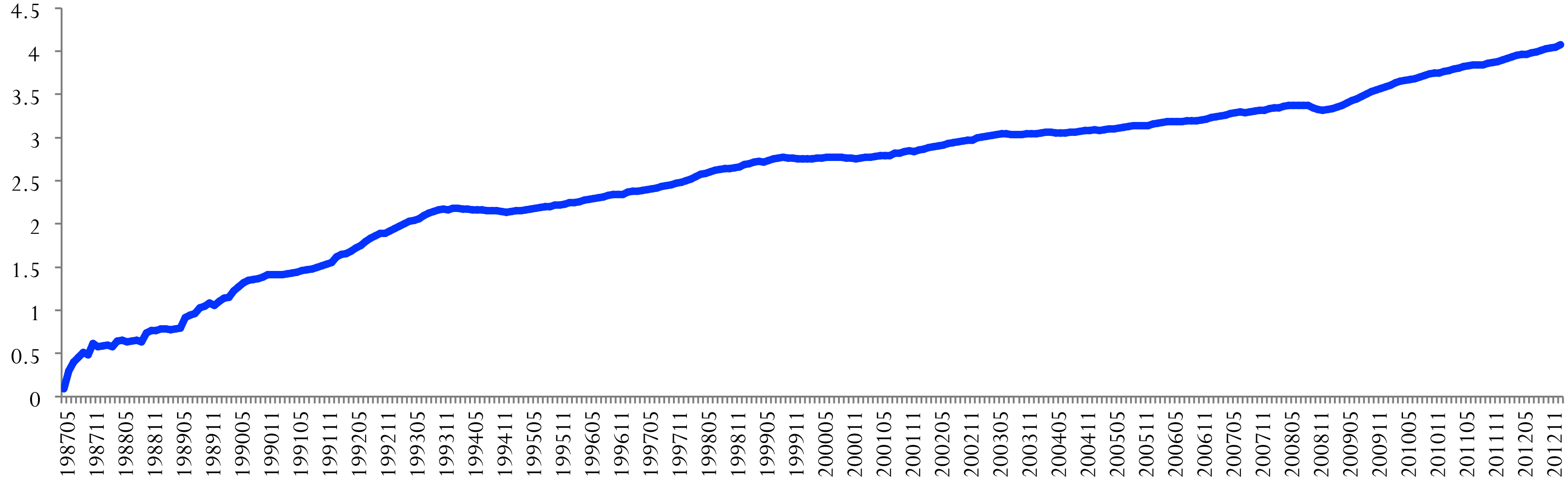


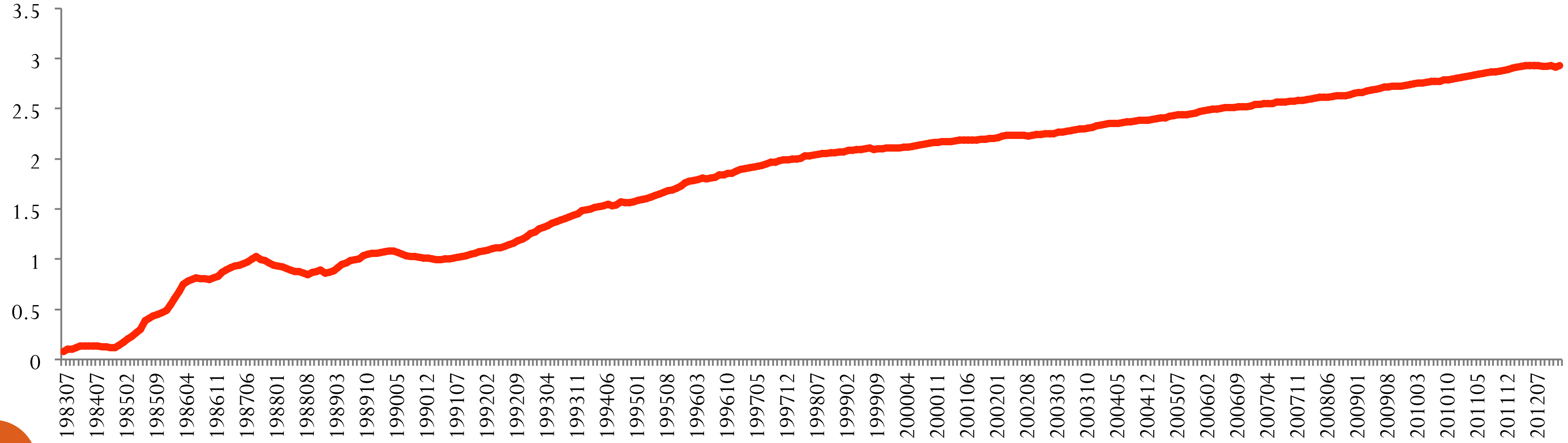
Motivation: Cumulative Retail Flows





Motivation: Cumulative Flows Inst. Funds





Motivation

- Mutual funds experienced a massive growth in size in the last decades
- The growth driven by asset appreciation and fund flows
- Fund flows are sensitive to fund performance
  - Well documented for equity funds (convex relationship)
  - Less understood for non-equity funds
- Understanding fund flows is crucial for financial stability

- **This paper:** Look at the sensitivity for bond funds both in the time series and the cross section. Implications for real outcomes

Main Ideas

- Strategic complementarities in mutual funds:
  - Redeeming assets makes non-redeeming investors worse off: Redemption values are determined at the end of the day but portfolio adjustment may take longer than that
  - Investors internalize this effect and amplify redemptions
  - Like in Chen, Goldstein, and Jiang (JF, 2010)
- The repricing effect should depend on how far redemption prices depart from fair values
  - Asset illiquidity increases the distance (argued highest for corporate bonds)
  - Investor illiquidity amplifies the wedge (low cash/unsophisticated)
- Outflows create fragility in the asset space
  - Implications for asset prices and real economy

Key Results

- 1) Concave flow-performance sensitivity for bond funds (convex for equity funds)
- 2) Effect stronger in times of low aggregate liquidity and for funds which hold less liquid assets
- 3) Effect stronger for retail investors
- 4) Implications for credit spreads

Summary of Comments

- Current state:
  - Important research agenda
  - New insights for bond mutual funds
  - Potential implications for real economy and financial stability

- Room for improvement:
  - Conceptual framework
  - Economic mechanism
  - Implications for stability

Comment 1: Conceptual Framework

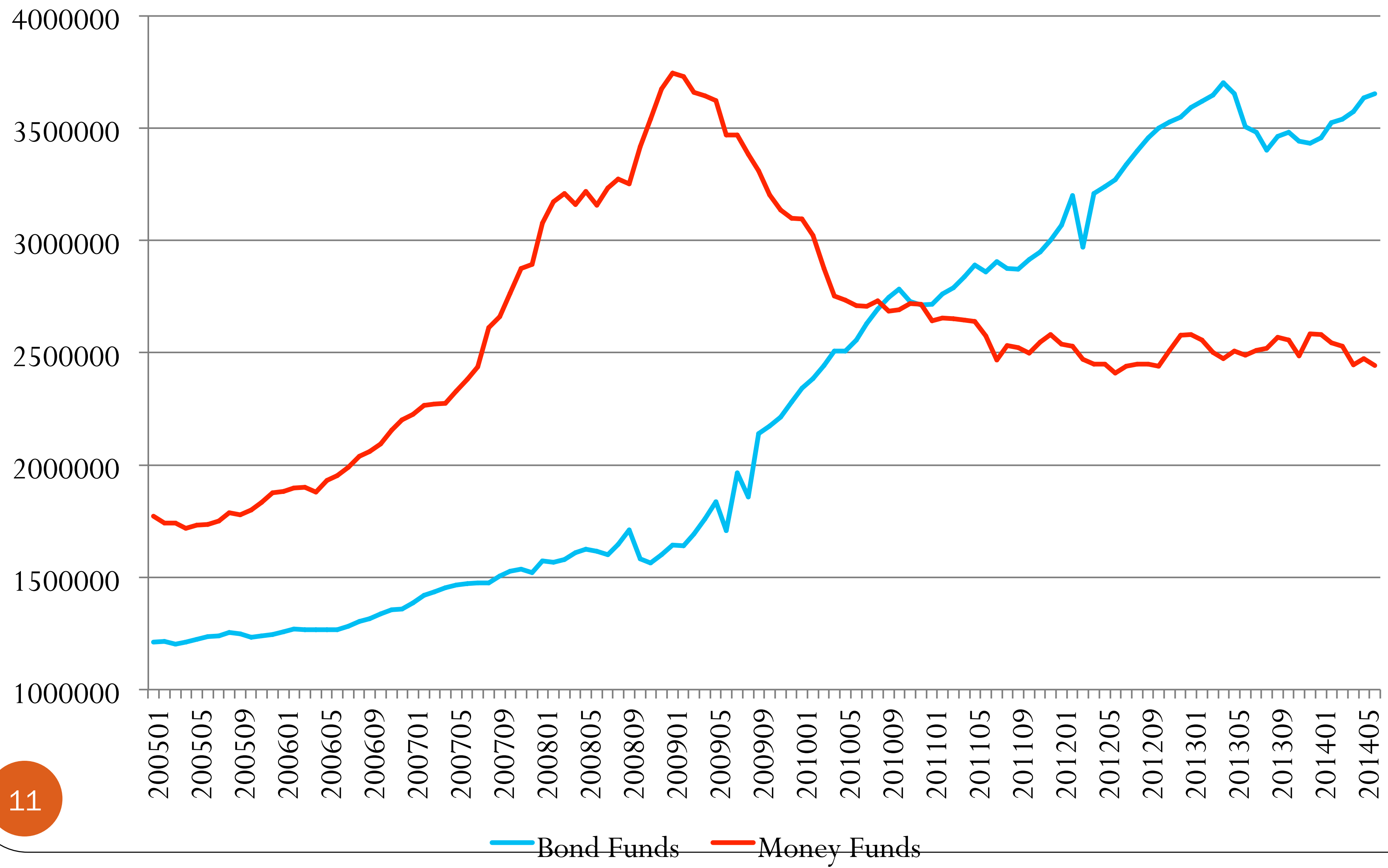
- Main idea is based on strategic complementarities (investors run for exit)
  - Idea is plausible but requires some degree of belief
  - Many other asset classes do not show similar patterns => must be some inflection point in terms of asset illiquidity. Can you show that? Can you identify other (illiquid) asset classes with similar concavity patterns?
  - Kacperczyk and Schnabl (2013) show convexity in fund flows for prime money funds (arguably close substitutes for short-term bond funds)
  - The idea requires a great degree of investors' impatience. Many investors are fairly patient, especially when compared to equity funds
- Additional story (???): information insensitivity of Gorton and Penacchi
  - Corporate bonds are largely information insensitive
  - Investors are insensitive to asset values in good times but more sensitive in bad times (consistent with the rhetoric of financial crisis)
  - Bad times interact with times of low asset illiquidity

Comment 2: Economic Mechanism

- Paper is focused largely on the cost side of the fund-flow sensitivity
  - Might be useful to discuss more the benefit side
  - Why would bond funds hold illiquid assets if this makes them more prone to runs?
- What is the role of mutual funds as supposed to other intermediaries?
  - Would be useful to dig deeper into family structure (implicit guarantees?)
- No difference between young and old funds. Why would bond funds not react to reputation effects/career concerns? Equity fund managers are known to respond to career concerns
- Risk taking as a mechanism to respond to incentives. In equity funds (money funds) convexity triggers more risk taking. Do you observe less risk taking in funds with more concavity?
- Bond funds may act as a substitute for prime money funds, especially in times of stress of money funds (low interest rates/runs). Composition of investors changes. They may be less patient with their capital

Money Funds vs. Bond Funds AUM

(DiMaggio & Kacperczyk, 2016)



Comment 3: Implications for Stability

- Bond funds increase their asset size and flows but their relative importance is not growing as fast
  - Constitute about 20% of total asset holders (for corporate bonds)
  - Not clear why they would be systemically important (might want to condition on markets in which the share is highest)
  - Look at the composition of assets: do they cherry pick issuers who are systemically more risky?
- Relationship between bond outflows and spreads is interesting but difficult to interpret as causal: fund flows might respond to falling (or anticipation of) bond prices
- Concavity in fund flows might endogenously mitigate risk taking in the industry (positive for financial stability)
- More broadly, the provision of capital from bond funds might improve economy (credit constraints)