

Comments on “The role of different institutional investors in Asia-Pacific bond markets during the taper tantrum”

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Ng, Shim and Pastor examine the dynamics of bond prices during the 2013 taper tantrum. During times of high uncertainty, bond markets can become illiquid as some of the investors experience funding liquidity shocks. This can lead to sharp drops in bond prices, ie sharp increases in bond yields, beyond what are warranted by the changes in fundamentals.

The authors analyse the markets for bonds issued by countries and corporates of Asia-Pacific countries. Such sovereign and corporate bonds have increased significantly over the past two decades. Given the still relatively low trading volumes in these markets, they seem particularly vulnerable to shocks in funding liquidity to the bondholders.

Studies of bondholders typically focus on the durations of their fixed income assets. In contrast, the authors focus on the variation in the durations of bondholders' liabilities, and how these can affect prices in the bond markets. Due to the long duration of their liabilities, insurance companies and pension funds can hold bonds until maturity, and do not have to react to changes in market conditions. In contrast, bond mutual funds tend to have short liability durations, as they are likely to face fund outflows, ie redemptions, particularly during adverse market conditions. These short-duration bondholders can have a disproportionate effect on bond prices in the absence of sufficient capital from long-duration bondholders. This can end up exacerbating adverse market conditions and lead to downward spirals in bond prices.

The goal of the authors' study is to characterise the roles of different types of bond investors during the taper tantrum. Their data allows for an examination of who were the sellers and buyers in bond markets during this period. Using detailed security-level data on bond holdings by institutional investors from Thomson Reuters eMAXX, they find that short-duration bondholders, eg mutual funds, were more likely to liquidate their bond holdings during this period. The sell-off was concentrated among bonds issued by corporations and governments of emerging countries in Asia, for which long-duration bondholders are the likely liquidity providers. To finance this provision, long-duration bondholders tended to sell their holdings of bonds issued by more developed Asian countries.

Another set of liquidity providers in the market for emerging Asian corporate bonds are local (Asia-domiciled) funds. In contrast, global (US-, UK- and Europe-domiciled) funds tend to sell these bonds. This provides some early evidence of global retrenchment by bond mutual funds during this adverse market condition.

The authors' study is related to the line of research on fire sale by mutual funds in the equity market. Coval and Stafford (2007) and Frazzini and Lamont (2008) document that trading pressure emanating from extreme fund flows into and out of

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equity mutual funds can result in significant price impact. This is subsequently followed by return reversals that take place over a relatively long period of time. These studies argue that this type of mispricing is likely to stem from wide-spread fund-level liquidity problems rather than the fundamentals of the underlying securities themselves. Several studies have also documented similar effects in the bond market, including Goldstein et al (2017) and Morris et al (2017).

This flow-driven fragility in asset markets can have a significant effect on real investment decisions. Recent studies document that mutual fund flow-driven mispricing in the equity market can affect various corporate activities ranging from mergers and acquisitions, secondary equity offerings (SEOs) to corporate investments (Edmans et al (2012), Khan et al (2012) and Hau and Lai (2013)). As such, it is important to understand the liquidity provision by other market participants that can mitigate the potentially negative effect of flow-driven fragility. Unfortunately, while some sophisticated investors may be able to recognise the source of large price movements following fund flow-driven trading pressure, many of these investors are often constrained by limits of arbitrage due to correlated capital flows, margin calls, and risk limits (Ben-David et al (2012)).

It would also be useful to develop an infrastructure of information production that reduces the uncertainty regarding the source of large price movements. Sulaeman and Wei (2019) identify security research from equity analysts as a potential source of such information; developing a similar infrastructure for the bond market may prove effective in mitigating the flow-driven fragility and other types of liquidity-driven mispricing events. It is important to note that while the authors' study examines a large set of bondholders with varying liability duration, the data does not allow the authors to capture the full set of bondholders. It would be quite useful to examine the variation in the dataset coverage as that would allow the readers to get a sense of the potential liquidity provisions by other groups of bondholders, eg sovereign wealth funds, with relatively long liability duration.

It is also important to note that the results in the paper seem to indicate a flight to quality by institutions with short duration, ie bond mutual funds: they sell emerging Asian bonds and buy developed Asian bonds during the taper tantrum. This pattern is likely to be due to their relatively short liability duration, and therefore their preference for assets that can be liquidated more easily to fulfil redemption requests. This again indicates the importance of developing an information production infrastructure to improve liquidity in the emerging Asian markets and mitigate the need for such flight to quality in the future.

Unfortunately, it is quite difficult to measure the effect of such flight to quality on the prices of both the source (emerging Asian bonds) and the target (developed Asian bonds) of the flight, due to the scarcity of pricing data for Asian bond markets. Adding this piece of the analysis to the study would be very useful in deriving strong policy implications.

In conclusion, market regulators and other policy makers should consider the distribution of investor characteristics not only in each market but also for each security, eg the liability duration of the holders of each bond. The authors' study can be extended to a cross-sectional analysis focusing on the variation of dominant investors in each bond. Presumably, bonds whose ownership structure is dominated by mutual fund investors should see steeper declines in their price around the taper tantrum, or even more generally, during periods of outflows from the bond mutual fund sector.

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