Liquidity Management

A MUTUAL FUND SUCCESS STORY

Because mutual fund investors must be paid promptly when they redeem their shares, liquidity management is a hallmark of mutual funds. These funds have had an excellent record of meeting redemptions, both before and after the current liquidity management framework was adopted by the Securities and Exchange Commission (SEC) in 2016. Funds' prudent liquidity risk management practices have worked as intended while meeting the needs of American investors.

However, the SEC is now incorrectly pointing to events in March 2020 and the potential for future market stresses to propose an overhaul of this framework. A closer and more comprehensive look at the events of March 2020—and indeed, funds' track record over many decades—tells a much different story:

> The SEC's proposal would change the operations and composition of funds, resulting in higher costs, lower investment returns, and reduced access to certain funds and investment strategies for Main Street investors.

Key Facts About Long-Term Mutual Funds Missing from the SEC's Analysis

Mutual funds have **successfully managed liquidity** for
83 years
since the 1940 Act.

For nearly 40 years,
99.94%
of mutual funds have successfully met redemptions.

Of the funds that suspended redemptions during this period:

- **2** were bond funds
- **0** were bank loan funds
- **0** occurred during 2008 and 2020

ICI survey data show that
0
long-term funds used the SEC's 2020 liquidity-related relief.

The proposal even admits that "funds generally did not use" the SEC's liquidity relief.

0
2020 Federal Reserve facilities were established to support mutual funds.

The Secondary Market Corporate Credit Facility was established "to support credit to large employers." Its purchase of bonds and ETFs "**did not result in losses for the Federal Reserve.**"

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Case Study: March 2020

The COVID-19 crisis and related March 2020 events are the impetus for the SEC's liquidity proposal. However, the analysis of this period is flawed and incomplete, so ICI collected actual data from mutual funds to clear up misconceptions.

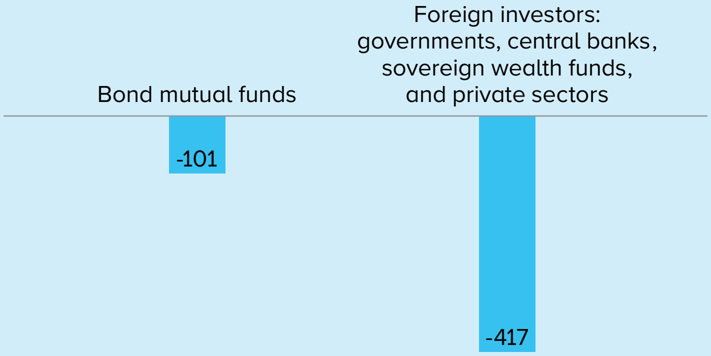
Bond Mutual Funds and the Bond Markets

Bond mutual funds had outflows of 5.2 percent of their net assets in March 2020, but these outflows did not amplify stress in underlying bond markets in March 2020.

Policymakers have repeatedly argued that bond mutual funds' sales of Treasuries amplified stress in the Treasury market. **In fact, this view is not supported by the data.** Liquidity strains in the Treasury market began several days before bond mutual funds started selling Treasuries in meaningful amounts. Furthermore, their sales represented just a fraction of overall Treasury trading volumes—just 5 percent during the week of March 16 to March 20, and were consistent with bond mutual funds' share of the overall market. Often unmentioned is the amount of Treasuries sold by foreign investors: **four times those of bond mutual funds.**

Net Sales of Treasury Notes and Bonds

BILLIONS OF DOLLARS



Bond mutual funds also have been blamed for corporate bond market stress in March 2020. Like the Treasury market, **evidence supporting these claims is lacking**. ICI's research shows that core bond mutual funds' sales of investment grade corporate bonds accounted for just **5 basis points of the 313 basis point in yield spreads** for investment grade corporate bonds—the remainder was from market fundamentals or other factors.

Dilution: Much Ado About Almost Nothing

Dilution occurs when fund shareholders redeem and the transaction costs of meeting those redemptions—such as commissions, bid-ask spreads, or market impact costs from selling portfolio securities—are borne by non-redeeming shareholders. If large enough, dilution raises the possibility of a "first-mover advantage," the theory that investors will redeem heavily from funds during a stressed period to avoid these costs.

Policymakers are hyperfocused on dilution, but is it warranted? **According to the evidence, no.**

Using methods taken from academic literature, ICI estimates that for high-yield bond mutual funds in March 2020, average dilution ranged between **1 to 5 basis points** per day and was trivial compared to high-yield bonds' daily losses during that time. Dilution is too small to motivate mass redemptions by fund shareholders, and shouldn't be used as any basis for extreme and costly public policy.

Bottom Line: History Does Not Support Extreme Regulation

ICI's study of March 2020 supports, at most, incremental change to existing regulations. Any reexamination of the liquidity management framework must provide data that identifies actual problems and results in tailored, cost-effective solutions. Instead, the SEC's proposal is extreme in scope, rigid and arbitrary in its proposed policy measures, and seemingly indifferent to the costs, both quantitative and qualitative, that it would impose on the more than 100 million mutual fund investors.

Scan this code for an extensive look at our response to the SEC's liquidity proposal.

Scan this code to dive into the facts around bond mutual fund sales and redemptions during March 2020.

For more information on dilution and first-mover advantage, scan the code below.

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