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ICI VIEWPOINTS

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The Market Crash That Never Came

By Mike McNamee

Third in a series of Viewpoints *postings on funds and financial stability.*

U.S. and international banking regulators, who seem convinced that mutual funds and their managers could threaten financial stability, have come up with a simple story: fund investors and asset managers "crowd or 'herd' into popular asset classes or securities" and thus "magnify market volatility." And then when markets turn, a fund might have to "liquidate its assets quickly, [which] may impact asset prices and thereby significantly disrupt trading or funding in key markets."

We have heard this story before. Unfortunately for the regulators' argument, there's no historical support for it.

Throughout the 74-year history of modern U.S. mutual funds, the historical evidence is consistent and compelling: stock and bond funds and their investors do not create the kinds of systemic risks that regulators imagine. During even the most turbulent periods in financial markets since World War II, investors have redeemed only modestly from stock and bond funds and funds' sales of stocks and bonds have accounted for a small fraction of market trading. Those patterns held through 2008—the second-worst year for the U.S. stock markets since 1825—and the bond market turmoil of 2013.

We all understand the appeal of a simple narrative: fund investors panic, markets tank. But financial regulation ought to be based on facts, not stories—and the facts don't support this tale.

An Old, Old Legend

The misperception that mutual fund investors could cause market crashes has been around for a long time—at least since 1929. The claim made its way into a *Time* cover story in 1959, when the magazine speculated that "in a failing market, millions of panicky, inexperienced shareholders would redeem their shares, forcing the funds to liquidate huge blocks of stock and collapse the market." In 1994, economist Henry Kaufman argued that "The technology is in place for a cascade of selling by investors in mutual funds ... excesses originating in the mutual funds area may be the source of an economic shock should an asset price bubble be suddenly burst."

The latest version of this tale comes from regulators with a bank mindset. The U.S. Treasury's Office of Financial Research (OFR) hangs its fears about asset management and systemic risk on a hypothesis about "herding" and "fire sales." The Financial Stability Board (FSB)—composed of financial regulators and central bankers from around the globe—speculates that funds can spread systemic risk through a "market transmission channel" driven by rapid fund redemptions.

It's notable that this round of speculation is being driven by banking regulators—not by experts on capital markets or securities trading.

Time for Some Facts

ICI has been investigating—and knocking down—this false narrative for at least two decades.

The notion of "herding" is undercut by the very academic research that OFR cites. That research actually concludes that on average there is little evidence of herding among mutual funds, and not enough evidence to conclude that mutual fund trading moves securities prices away from their fundamentals.

The idea of "fire sales" fuelled by fund investors' massive redemptions also falls short on facts. ICI's research has looked at every episode of turmoil in the U.S. stock and bond markets since World War II—essentially, the entire history of the modern mutual fund industry in America. It shows that flows out of stock and bond funds are small relative to funds' assets even when markets are falling sharply.

For example, when the S&P 500 Index fell by 42 percent in 1973-74, the cumulative outflow from stock funds over those two years was just 5.8 percent of assets. In October 1987, when the S&P 500 lost 22 percent in one month, stock fund investors pulled out just 3.2 percent of assets. From October 2007 to February 2009—when the S&P 500 was cut by more than half—outflows from stock funds totaled 3.6 percent of assets. And while the dot.com bubble was deflating in 2000–2001, investors actually put *more* money into stock funds.

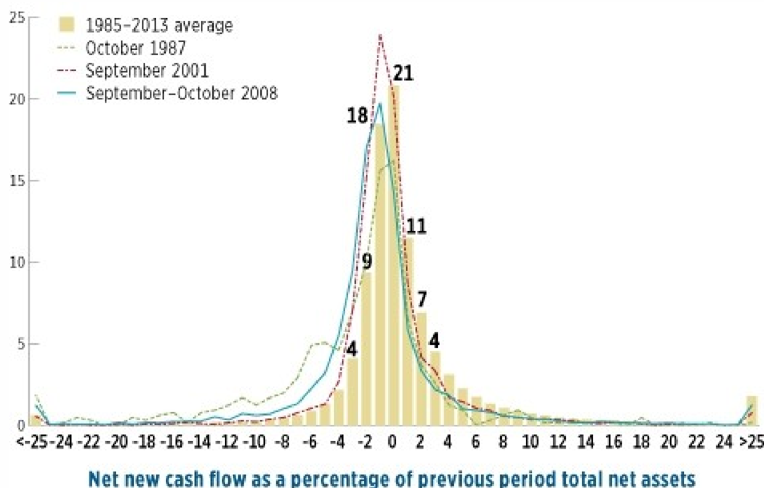
The data for bond funds is similar. For example, when long-term bond interest rates spiked by more than 1 percentage point in May and June 2013, the cumulative outflow from bond mutual funds totaled only 3 percent of assets. Notably, the outflows from bond funds *followed*—and did not precede—declines in bond returns.

Fund Flows Aren't Likely to Drive Asset Prices

Could industry-wide flow figures be masking destabilizing gyrations in individual funds? The data don't support that story, either. ICI charted monthly flows as a share of assets for every stock and bond fund with at least $10 million in assets from 1985 through 2013, comparing the distribution of flows during turbulent markets with the normal pattern for the entire period. The result: some funds did experience slightly larger-than-normal outflows during periods of market stress, but there were no spikes in the number of funds with large outflows. For more information, see the chart below.

Market Crises Have Not Spurred Large-Scale Flight from U.S. Equity Mutual Funds*

Distribution of monthly flows as a percentage of total number of funds



*Net percentage flow is calculated as U.S. mutual fund net new cash flow as a percentage of previous period U.S. total net assets.

Note: Data exclude funds with less than $10 million in average assets.

Source: Investment Company Institute

Clearly, fund investors don't panic when markets hit turbulence. And funds' sales of stocks and bonds aren't likely to drive asset prices. Over the last decade, stock mutual funds have held roughly one-quarter of the value of all U.S. corporate equity—but U.S. domestic equity stock funds' stock sales accounted on average for less than 10 percent of the trading on the New York Stock Exchange and NASDAQ markets. Similarly, since 2002, bond mutual funds' trading never exceeded 10 percent of overall trading.

Why So Stable?

Why aren't fund investors panicky, hair-triggered, and flighty?

The main reason: stock and bond mutual funds are overwhelmingly held by households—and those individual investors tend to take the long view. Of the $12.3 trillion in assets in stock, bond, and hybrid funds at year-end 2013, 95 percent were held by households.

More than 90 million Americans own mutual funds—and surveys show that virtually all of them say that saving for retirement is one of

their goals. In fact, about three-quarters of fund owners indicate that retirement savings is their primary financial goal. That's reflected by the fact that half of stock and bond fund assets are held through defined contribution retirement plans—such as 401(k) plans—or individual retirement accounts (IRAs).

As for the other half—80 percent of individuals who own funds outside of retirement accounts rely upon professional financial advisers. Such advisers help investors stay focused on their long-term goals and asset allocation at times when markets are in turmoil. And in a diverse group of 90 million people, it's inevitable that when some pull back from stocks or bonds, others will see buying opportunities and plunge in.

What Crash?

It's been at least 85 years since market pundits first speculated about a destabilizing market crash led by stock and bond mutual fund investors—yet it hasn't happened.

Actual data provide positive, compelling evidence that stock and bond mutual funds, and their investors, do not threaten financial stability. And the character of fund investors—individuals focused on retirement and other long-term goals—is one of the important reasons why funds don't play that role.

Regulators have the data they need to put this legend to rest, once and for all.

For more information on ICI's views and research on financial stability, please visit our Financial Stability Resource Center or read the other entries in this Viewpoints *series:*

- SIFI Designation for Funds: Unnecessary and Harmful
- Size by Itself Doesn't Matter—Leverage Does
- The Market Crash That Never Came
- Who Are the FSB 14?
- How SIFI Designation Could Lead to a New Taxpayer Bailout
- Overseas Overreach
- For Concerns About Risk, a Better Way Forward

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