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Simple Answers to the Federal Reserve's Quandaries

By Mike McNamee

The Federal Reserve System can't get past its perplexities on the role of mutual funds in financial stability. Time and again, the Fed's governors, regional presidents, and staff return to the same hypothetical risks and speculative scenarios in which mutual funds somehow pose a threat to the financial system.

The latest: a section of the Fed's annual *Monetary Policy Report*, delivered to Congress on February 24, warning that "the growth of bond mutual funds and exchange-traded funds (ETFs) in recent years … heightens the potential for a forced sale in the underlying markets if some event were to trigger large volumes of redemptions."

Certainly the Fed has reason to fret about the market reaction it may trigger when it raises interest rates after this prolonged period of easy money. But as history has shown, these concerns shouldn't be focused on mutual fund and ETF investors. The answer to the Fed's quandaries can be found in *ICI Viewpoints:*

- First, investors in long-term funds don't run. We've provided data to demonstrate that point on stock funds ("The Market Crash that Never Came," May 12, 2014) and—as recently as last week—on bond funds ("Why Long-Term Fund Flows Aren't a Systemic Risk: Past Is Prologue," February 18, 2015). Even in 2008–2009—the worst financial crisis since the Great Depression—investors in long-term funds did not flee *en masse*.
- Second, there are fundamental reasons why funds don't suffer such mass outflows, as we also detailed last week ("Why Long-Term Fund Flows Aren't a Systemic Risk: *Plus Ça Change, Plus C'est La Même Chose*," February 19, 2015). We showed that 95 percent of the assets in long-term funds are held by households, who tend to be long-term savers—as reflected by the fact that half of all long-term fund assets are held in retirement accounts. We've done extensive research showing that retirement savers don't flee in hard financial times—they keep contributing and don't withdraw. Tax considerations, the risks of market timing, and frictions around fund trading also tend to suppress any urge for fund investors to "trigger large volumes of redemptions."
- Third, ICI research has demonstrated that the vast majority of investors' sales and purchases of ETF shares don't affect the underlying markets for bonds or other securities ("A Look Inside ETFs and ETF Trading," September 23, 2014). In fact, 81 percent of trading activity in bond ETFs occurs in the secondary market—ETF shares traded among investors on an exchange. Only 19 percent involves creating or redeeming new ETF shares—actions that affect the underlying markets. We've also shown that the same pattern persisted in the face of a sharp market shock—the relatively steep increase in interest rates in May–July 2013—even for ETFs in relatively thinly traded sectors like high-yield and emerging-market bonds ("Plenty of Players Provide Liquidity for ETFs," December 2, 2014). More importantly, even if creations or redemptions were to cease—an unrealistic scenario—ETFs could continue to trade in the secondary market.

It's troubling that the Fed keeps returning to its hypothetical scenarios without providing any analysis or evidence of why it clings to them. It's worse that the Fed's report appears to leap to an unfounded conclusion on a question where the Financial Stability Oversight Council, in its latest request for information, has asked for data and insight. Indeed, FSOC acknowledges in its request that "pooled investment vehicles may employ a variety of techniques to manage liquidity risks"—i.e., to deal with large redemptions without triggering "forced sales" on the markets.

The Fed has a significant influence over the FSOC and its global counterpart, the Financial Stability Board. Getting the facts first—and getting them right—should be its top priority. Leaping to conclusions, as the Fed appears to do in its latest *Monetary Policy Report,* does little to further the public dialogue on these important issues—nor to lend confidence in those agencies' financial stability policymaking.

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