

## ICI VIEWPOINTS

JULY 13, 2016

## Matching Models to Reality: Doomsayers Are Disappointed—Again—as Funds Weather Brexit Shock

By Paul Schott Stevens

*First in a series of ICI Viewpoints testing the hypotheses of academics and regulators about mutual fund and investor behavior during times of market stress.*

On Thursday, June 23, the electorate of the United Kingdom voted in a referendum on the country's membership in the European Union. The result—51.9 percent in favor of “Brexit,” 48.1 percent in favor of “Remain”—went against pollsters' and pundits' expectations and surprised the world.

It also shocked financial markets, which plunged over the course of the two trading days following the vote. The British pound fell to a 31-year low, and investors in stock markets worldwide lost more than \$2 trillion on June 24—the worst overall single-day loss in global market history—and an additional \$1 trillion on June 27.

Though markets have since largely recovered, uncertainty and volatility remain. The process surrounding the United Kingdom's exit from the European Union will be complicated and drawn-out—many experts expect it to take two years or longer. Economists are predicting recession in Europe (and perhaps beyond), while geopolitical analysts say that Brexit could simply be the first domino to fall as many other countries redefine their relationship with the European Union.

In the midst of this uncertainty, however, one thing did remain certain: during this real-life “stress test,” U.S. stock and bond mutual funds operated smoothly—just as they have for decades. Predictions of panic and herding by U.S. investors—leading to a massive disruption, broad sales of portfolio securities, and downward spiral of economic wrack and ruin—didn't materialize. Again.

### Focusing on the Facts

Dire warnings that the “structural vulnerabilities” of U.S. stock and bond funds could bring down the markets are as old as the modern fund industry itself. Notably, of late, these warnings come from bank regulators and finance ministry officials intent on subjecting funds and their advisers to new forms of regulation, in the interest of preventing “systemic risk” and promoting financial stability. Time and time again, however, U.S. mutual funds have proved the critics wrong, demonstrating remarkable resilience during even the worst market downturns. Among the persistent doomsayers, the sense of *glückschmerz*\* must be palpable.

Brexit provides yet another example. ICI data for the week ended June 29 show that, for funds issued in the United States, world equity funds had outflows of \$3.19 billion and global bond funds had outflows of \$1.41 billion. At 0.15 percent and 0.33 percent of May 2016 assets in each respective category, that hardly constitutes a “run” by investors. And in [the data we're releasing today](#), for the week ended July 6, we see that world equity funds had inflows of \$1.44 billion and global bond funds had outflows of just \$0.14 billion.

In other words, as shocking as the Brexit vote was, fund investors didn't panic or redeem heavily.

### Funds Are “Patient Money”—Despite What Critics Say

This is no surprise: ICI's research has consistently shown that long-term funds are resilient in the face of volatility, and that U.S. fund investors generally are focused on retirement and other long-term goals—thus representing “patient money,” or what some

economists have called “slow-moving capital.” Rather than destabilizing markets, funds and their investors actually exert a stabilizing force.

As ICI gathers more data from around the world on stock, bond, and money market fund flows and on other market events surrounding Brexit, we will report in more detail. In the meantime, I’d like to call your attention to a series of *ICI Viewpoints* posts that will follow this one in the coming days and focus on another significant, real-world stress test—the behavior of high-yield and corporate bond funds and their investors in 2014 and 2015.

The first, written by Sean Collins, senior director for industry and financial analysis, will raise three challenges to the “first-mover advantage” theory that’s been promoted by some industry commentators, and help readers to understand the differences in behavior between funds that hold commercial real estate—so-called property funds, which have [been in the news lately](#)—and those that hold securities. Chief Economist Brian Reid will follow Sean’s piece with two posts that will examine the behavior of fund buyers and sellers, demonstrating that investors do not move in lockstep but instead actually help to support markets during times of volatility.

## A Structural Strength

One mission of ICI, from its founding in 1940, has been to provide clear and objective information about the fund industry to regulators, policymakers, and other interested parties. As the fund industry has grown, so too has the need for our far-reaching and objective data and analysis—especially in the face of persistent and mistaken narratives from those who may not fully understand how funds and capital markets work.

There is nothing less practical than a bad theory. It is time for supporters of the “funds *could* destabilize financial markets” hypothesis to acknowledge that their theory doesn’t fit the facts—and to begin trying to understand *why* their models don’t match the real world. That means explaining the market and other forces that consistently align the behavior of funds and their investors.

During calm and stormy markets, U.S. stock and bond mutual funds have offered—and continue to offer—investors access to low-cost, diversified, and professionally managed vehicles through which to save for their most important long-term financial goals. Far from a “structural vulnerability,” these funds are a source of considerable strength to the financial system.

## Other Posts in This Series:

- [Matching Models to Reality: Doomsayers Are Disappointed—Again—as Funds Weather Brexit Shock](#)
- [Matching Models to Reality: The Real-World Challenges to Regulators’ “First-Mover” Hypothesis](#)
- [Matching Models to Reality: In a Falling Market, the Real “Movers” May Be...the Buyers](#)
- [Matching Models to Reality: Bond Market Investors Don’t Follow the “First-Mover” Script](#)

\* *Glückschmerz* is a term used as the antonym of *schadenfreude*. The more familiar *schadenfreude* refers to taking pleasure in someone else’s pain or misfortune. *Glückschmerz* refers to pain caused by someone else’s good fortune—in this case, the disappointment that doomsayers must feel when funds and their investors remain resilient through a volatile episode.

*Paul Schott Stevens was President and CEO of ICI.*