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New ICI Empirical Analysis of High-Yield Bond Sector Contradicts FSOC's Contentions

Washington, DC, July 18 - The Financial Stability Oversight Council (FSOC) has not substantiated its contentions that liquidity and redemption risks in mutual funds could raise financial stability concerns, the Investment Company Institute (ICI) said today [in a letter](#) responding to [FSOC's Update on Review of Asset Management Products and Activities](#). Using data on the experience of high-yield bond funds and other investors, particularly during recent stress in the high-yield market, ICI offers a new analysis that casts serious doubt on the validity of FSOC's contentions.

FSOC Has Disregarded Data and Analysis Provided by ICI and Others

ICI's letter, signed by President and CEO Paul Schott Stevens, said that FSOC "appears to prefer what is essentially a conjectural narrative about mutual funds" in disregard of extensive data and commentary submitted by ICI and others in March 2015. Those data demonstrate that "net redemptions from most individual mutual funds, and from mutual funds collectively, are modest even in times of market stress."

FSOC points to selected academic studies, but as detailed in an appendix to ICI's letter, those studies provide little, if any, support for FSOC's concerns. Stevens called upon FSOC to reconsider its conclusions, which are at odds with "the consistent—and very successful—experience of an investment product used by tens of millions of Americans to help achieve their most important goals."

FSOC's 'First-Mover Advantage' Concerns Are Unfounded

The Council posits that fund investors may have incentives to redeem their shares ahead of other investors during times of market stress (a so-called first-mover advantage), ICI's letter noted. According to FSOC, a first-mover advantage may result from the mutualization, or sharing, of redemption costs, or from funds selling their most liquid assets first to meet redemptions.

As ICI [first explained](#) to FSOC in March 2015, the first-mover advantage concept is highly unlikely to raise financial stability concerns. First, though the costs of redeeming fund shares are spread among all fund investors, other fundamental characteristics of mutual funds and their regulation severely restrict any benefit to "early" redeeming investors and mitigate the impact of redemptions on investors who remain in the fund, the letter said. Second, the FSOC update does not accurately depict how mutual funds actually manage liquidity, ICI explained. (See pages 3 and 4 of ICI's letter.) Empirical data suggest that mutual funds have managed their portfolios effectively by meeting redemptions without impairing their holdings of short-term assets, ICI said.

FSOC Fails to Substantiate Its Concerns About Destabilizing Redemptions from Funds

FSOC's concerns about destabilizing redemptions from mutual funds are strikingly similar to those voiced by the Office of Financial Research (OFR) in its widely criticized report, [Asset Management and Financial Stability](#) in September 2013, and by the Financial Stability Board (FSB) in [its initial consultation in January 2014](#) on how to identify nonbank non-insurer global systemically important financial institutions. (See pages 4 and 5 of the letter.)

As in prior submissions to OFR and the FSB, ICI's March 2015 letter to FSOC highlighted historical data showing that since the mid-1940s, despite periods of severe market stress, stock and bond funds have not suffered destabilizing redemptions. The historical data paint a remarkably consistent picture of modest net redemptions and modest fund sales of portfolio securities—across different market cycles and different types of funds. In today's letter, ICI reminds FSOC that there are compelling and enduring reasons for

mutual funds' long history of success in meeting investor redemptions. (See pages 5 and 6 of the letter.)

FSOC Misconstrues Lessons of Recent Experience in High-Yield Bond Fund Sector

While the FSOC update points to the suspension of redemptions by the Third Avenue Focused Credit Fund (FCF) in December 2015 to illustrate the Council's concerns about the potential systemic impact of outflows from funds investing in less liquid assets, ICI contends there are different lessons to learn from the FCF closure. (See pages 7 and 8 of the letter.)

"We strongly agree that the FCF example is a useful one. It provides relevant and recent market experience demonstrating that redemption difficulty at one mutual fund portends neither the same fate for other mutual funds nor destabilizing impacts for markets and market participants more broadly," Stevens said in the letter.

"In fact, this example is all the more compelling, because it occurred during a period of market volatility and it involved mutual funds that invest in a less-liquid asset class," Stevens continued. "In our view, the success of other high-yield bond funds in meeting redemptions during this period should serve to allay significantly FSOC's concerns about 'the potential for outflows to cause fund distress, and hence broader distress.'"

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