



Regulated Fund Shareholders' Reactions to Market Turmoil

1944–OCTOBER 2018

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Remarks by Paul Schott Stevens
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History has not been kind to the destabilizing-fund-flow hypothesis. Since the late 1920s, assets in US long-term mutual funds have grown tremendously and there have been numerous stock and bond market cycles. But...investor response to these cycles has been muted; during the sharpest market downturns, investors have not redeemed heavily or rapidly from mutual funds. In addition, empirical studies have had difficulty finding a destabilizing feedback from mutual fund flows to financial market prices.¹

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The notion that investors in regulated funds are flighty, prone to panic, and likely to trigger “runs” and “fire sales” of assets—events that would propagate and exacerbate turmoil in financial markets—is not new.

- » In the 1930s, US Supreme Court Justice Louis Brandeis and others pushed the idea that investment companies helped cause the crash of 1929 by dumping stocks.
- » In 1940, an official at the then-new US Securities and Exchange Commission testified that a “run” on a mutual fund could trigger “an undesirable effect upon the stock market.”
- » In 1959, *Time* magazine claimed that “in a falling market, millions of panicky, inexperienced investors would redeem their shares, forcing [mutual] funds to liquidate huge blocks of stock and collapse the market.”
- » In 1994, famed economist Henry Kaufman warned that “the technology is in place for a cascade of selling by investors in mutual funds,” creating “an economic shock.”
- » And since the global financial crisis, a host of academics and US and global regulatory bodies have promoted theories about fund investor runs, first-mover advantages, asset-sale “waterfalls,” and other speculative phenomena that could pose severe risks to the financial system at large.

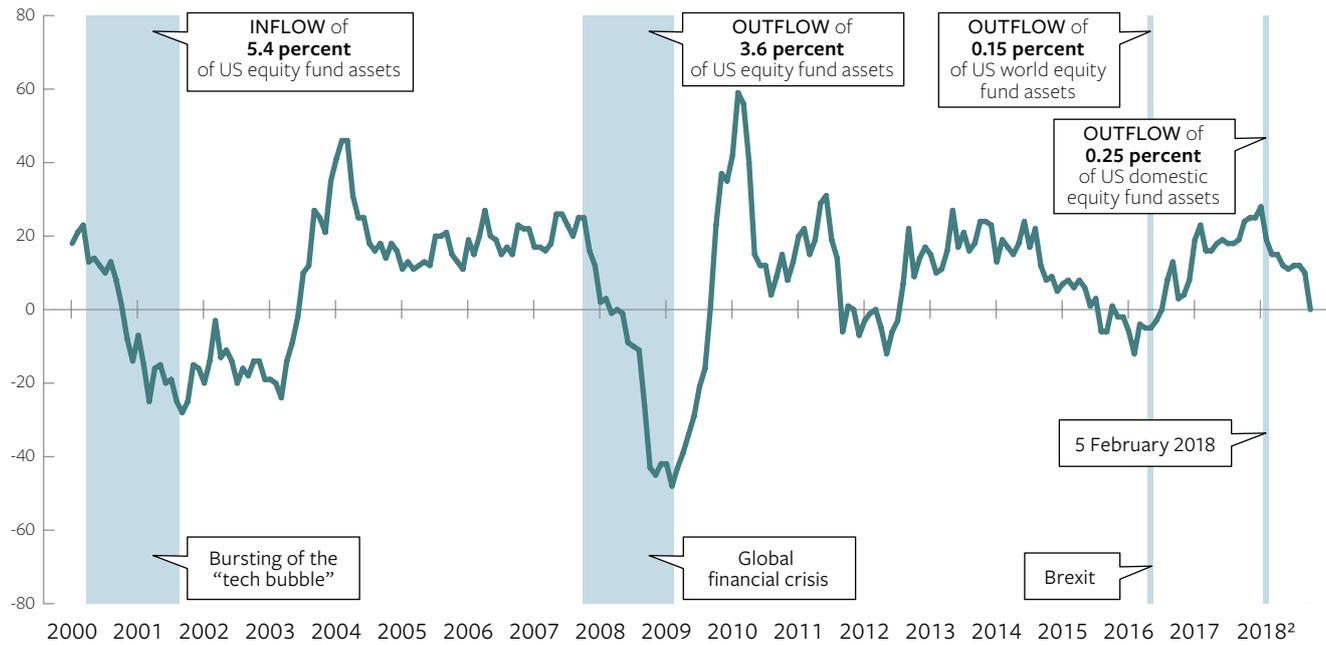
These theories, however, find little support in history, data, or empirical analysis. Since the mid-1990s, the Investment Company Institute has conducted extensive research on market cycles affecting US equity and bond funds, as well as US funds investing in emerging markets. In the past decade, that work has been extended to funds based in Europe and Canada.

In episode after episode, the message is the same: shareholders in regulated funds do not panic or redeem heavily in the face of market downturns or turmoil. In fact, funds often have inflows during falling markets. When funds do have net outflows, they do not occur precipitously. And even when funds are in net outflow, they frequently are buyers of securities in the market. In the pages that follow, we detail the reactions of regulated fund investors to market episodes, from October 2018 back to the early days of the US regulated fund industry.

Since the financial crisis, ICI has amassed a considerable body of work—comment letters, research papers, speeches, and *ICI Viewpoints* commentaries—on these and other issues related to regulated funds and financial stability. That work can be found at https://www.ici.org/ICI_Work_On_Financial_Stability.

US Equity Mutual Funds: Net Flows Are Modest During Market Events

Total return on equities, percent;¹ 2000–2018²



¹ The total return on equities is measured as the year-over-year percent change in the MSCI All Country World Daily Gross Total Return Index.

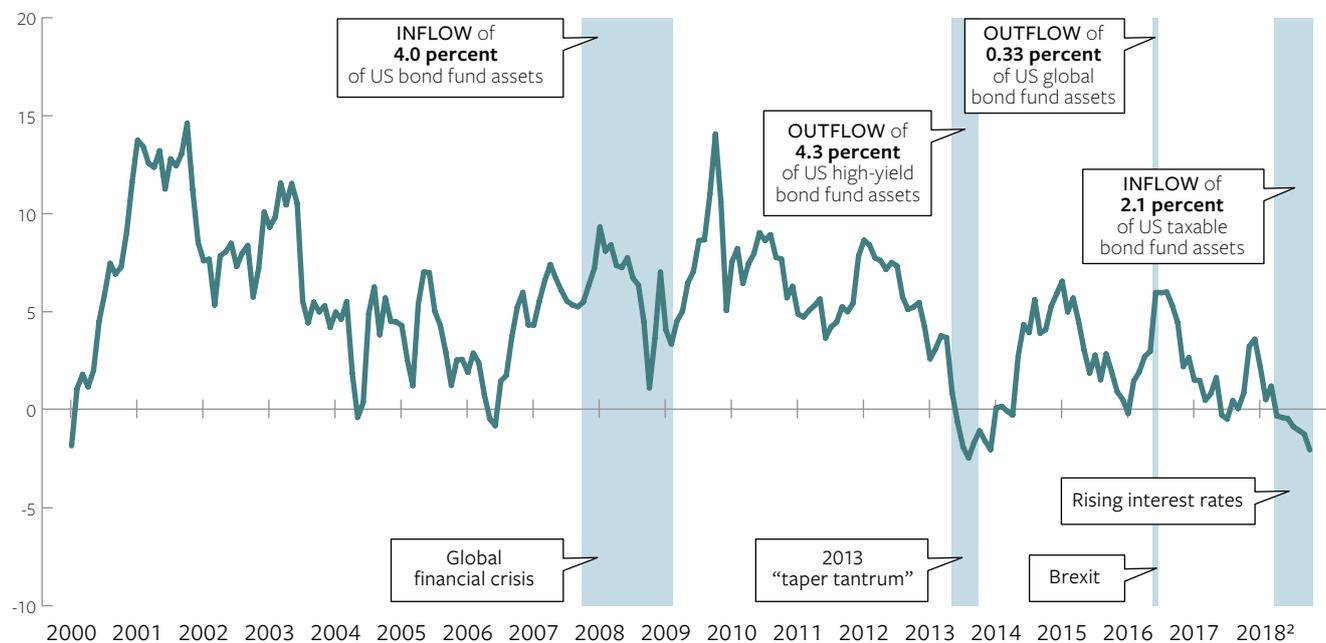
² Data are through October 31, 2018.

Note: Net new cash flow data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, MSCI, and Bloomberg

US Bond Mutual Funds: Net Flows Are Modest During Market Events

Total return on bonds, percent;¹ 2000–2018²



¹ The total return on bonds is measured as the year-over-year percent change in the Citi US Broad Investment Grade Corporate Bond Index.

² Data are through October 31, 2018.

Note: Net new cash flow data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Citi, and Bloomberg

Market Events and Investor Reactions

Since the Global Financial Crisis (2010–Present)

OCTOBER 2018 | US bond funds; European equity and bond funds

Rising interest rates, global trade tensions, and concerns about the aging of the bull market caused falling bond prices and volatility in global stock markets.

Although US bond returns went negative in April, US taxable bond funds had cumulative inflows of 2.1 percent of assets from April through October 2018. US bond mutual funds had outflows of 0.8 percent of assets in October, but US bond mutual funds were net purchasers of all categories of bonds during that month.²

European-domiciled funds experienced outflows in October described as the largest (in euro terms) since the eurozone debt crisis. Those outflows, however, totaled only 0.4 percent of assets in European-domiciled funds.³

FEBRUARY 5, 2018 | US equity funds

On February 5, 2018, the Dow Jones Industrial Average suffered its largest single-day point drop ever—down 1,175 points.

US domestic equity exchange-traded funds (ETFs) had net redemptions in February, but domestic equity mutual funds had net purchases of \$8.6 billion in stocks. Net fund redemptions accounted for just 0.25 percent of trading.⁴ Federal Reserve Board Chairman Jerome Powell testified, “I don’t think [ETFs] were particularly at the heart of what went on, on those days.”⁵

BREXIT, JUNE 2016 | US global equity and bond funds; European equity and bond funds

On June 23, 2016, British voters shocked markets by voting to leave the European Union. In the first two trading days after the vote, stocks lost \$3 trillion in value worldwide.

In the week ended June 29, US funds invested in world equities had outflows of 0.15 percent of assets; US global bond funds had outflows of 0.33 percent.⁶

Bond UCITS had estimated inflows totaling 0.1 percent of assets during the Brexit period.⁷ Equity UCITS had estimated outflows of 1.2 percent of assets.⁸

In repeating the common narrative...regulators and others are following the lead of academic economists who form hypotheses about how investors *might* react to market conditions. It seems to us, however, that the research challenge in economics is to explain what *actually* happens, as demonstrated by empirical data.⁹

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OIL PRICES, 2015–2016 | Canadian equity and bond funds

From April 2015 to January 2016, Canadian stock prices fell more than 20 percent as global oil prices tumbled.

Investor purchases of Canadian-domiciled equity funds exceeded redemptions for most of the period, with net inflows of 0.8 percent of assets. Canadian-domiciled bond funds saw net inflows of 2.5 percent during the period, and global and high-yield bond funds domiciled in Canada saw strong inflows.¹⁰

DECEMBER 2015 | US high-yield bond funds

The US high-yield bond market—generally considered less liquid than the market for Treasury or investment grade corporate bonds—was under considerable stress due to falling oil prices and signs of slowing growth in emerging economies. Yields on below-investment grade bonds rose 100 basis points from early November to December 9. On December 9, Third Avenue Focused Credit Fund, a US high-yield bond fund, announced that it had suspended investor redemptions and would liquidate.

US high-yield bond funds saw outflows of 1.2 percent of fund assets over a two-week period. But US mutual funds remained buyers of high-yield bonds, and outflows quickly tapered off and remained subdued.¹¹ US high-yield bond ETFs added liquidity to the market.¹²

AUGUST 24, 2015 | US equity exchange-traded funds

After a disorderly opening in US stock markets, many ETFs experienced multiple trading halts amid rapidly fluctuating prices. Some ETFs traded at substantial discounts to their underlying value.

Investigations by securities regulators and exchanges showed that conflicting rules on trading halts and re-openings exacerbated selling pressures and led to multiple trading halts. Exchanges revised many market structure rules.¹³

GERMAN BUND SELL-OFF, 2015 | European bond and equity funds

In spring 2015, the market for the German 10-year bund sold off rapidly, driving the yield up 75 basis points in two months.

Bond UCITS had estimated inflows of 0.4 percent of assets during the sell-off. Equity UCITS had estimated inflows of 1.5 percent of assets.¹⁴

“TAPER TANTRUM,” 2013 | US high-yield bond funds; European bond funds; Canadian bond funds; emerging market bond funds

US Federal Reserve Board officials indicated that they were planning to “taper” purchases of US Treasury bonds. US interest rates rose about 100 basis points from late spring through the fall of 2013—the sharpest four-month rise in interest rates since 1994—with spillover to European and Canadian bonds. Yields on emerging market debt denominated in US dollars widened by 94 basis points relative to Treasury yields.

US high-yield bond mutual funds experienced cumulative outflows of 4.3 percent of assets from May through October.¹⁵

Bond UCITS had estimated outflows of 2.2 percent of assets.¹⁶

Canadian-domiciled bond mutual funds had outflows of 1.7 percent of assets.¹⁷

Detailed analysis of bond trading in emerging markets shows no destabilizing effects from fund flows during this episode.¹⁸

Several member states in the eurozone experienced difficulties refinancing their debts in 2011. Bond yields rose sharply, and some banks with heavy exposure to these debts faced higher funding costs.

Bond UCITS had estimated outflows of 1.8 percent of assets during the eurozone debt crisis.¹⁹

Equity UCITS experienced estimated outflows of 4.1 percent of assets.²⁰

Another version of the “things have changed” view involves investor behavior. Financial experts at the International Monetary Fund have suggested that investors are now more likely to redeem heavily than in the past. Others have suggested that even if investor behavior has not changed to date, there is no guarantee that it won’t change tomorrow. In other words, long-term fund investors haven’t yet redeemed heavily during market stresses, but there is no way to guarantee that won’t happen in the future. According to that view, we should dismiss the historical data on fund flows because they provide no guidance about the future.

If these are the arguments, economics as a discipline is in deep trouble. A fundamental tenet of economics is that people’s behavior is relatively stable over time. It is on that basis that economists routinely use historical data to predict people’s future behavior.

One example involves risk aversion. Economists generally *assume* that individuals are risk-averse. Why? After all, there is no genetic test for “risk aversion.” One reason is that risk aversion is consistent with the historical data. For example, we have not yet seen US consumers en masse dropping their life savings on the lottery—behavior that is consistent with risk aversion.

But there is no way to guarantee that won’t happen tomorrow. And, what’s more, things have changed: we now have way more lotteries with much bigger prizes. Does that mean we should take seriously the possibility that the populace *might* arise tomorrow morning and risk every nickel on Powerball? Of course not.²¹

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During the Global Financial Crisis (2007–2009)

GLOBAL FINANCIAL CRISIS, 2007–2009 | US equity and bond funds; European equity and bond funds; Canadian equity and bond funds

During the global financial crisis, stock and bond markets globally suffered intense pressure and heavy losses. In the United States, the S&P 500 fell 53 percent—losing more than half of its value—from October 31, 2007, to February 27, 2009. From August to December of 2008, spreads between yields on lower-rated bonds and Treasury securities widened by nearly 300 basis points.

US equity mutual fund outflows totaled 4.1 percent of assets from November 2007 to February 2009. US bond mutual funds experienced inflows totaling 4.0 percent of assets for the entire crisis period. From September to December 2008, however, US bond mutual funds had outflows totaling 3.6 percent of assets.²²

Equity UCITS had estimated outflows of 2.5 percent of assets. Bond UCITS had estimated outflows of 12.9 percent of assets, exacerbated by German officials' decision to guarantee all bank deposits, drawing assets out of bond funds.²³

Canadian equity funds had outflows of 2.4 percent of assets during the crisis. Canadian bond funds had outflows of 5.5 percent of assets.²⁴

1996–2006

BURSTING OF THE “TECH BUBBLE,” 2000–2001 | US equity funds

The dot-com bubble began to burst in mid-March 2000. From February 29, 2000, to September 28, 2001, the NASDAQ and S&P 500 indexes declined by 68 percent and 24 percent, respectively.

Over this same period, US equity mutual funds received net inflows totaling \$227 billion, or 5.4 percent of assets. Equity mutual funds did experience outflows in five separate months, but none were precipitous: the largest monthly outflow was 0.9 percent of assets in September 2001.²⁵

ASIAN FINANCIAL CRISIS, 1997 | US emerging market equity funds

Rapid appreciation of the US dollar and economic problems in Southeast Asia caused stock markets in Thailand, Malaysia, Indonesia, and the Philippines to fall by more than 40 percent from July to September. In a second round of turmoil between September and year-end, the stock markets of Asian emerging economies plummeted an average of 31 percent. Latin American stocks were also affected.

US global emerging market equity mutual funds, which held 1.2 percent of the market capitalization of emerging markets at year-end 1996, experienced net inflows throughout 1997, except for December. Mutual funds focused on Asian and Latin American emerging markets experienced moderate outflows. US emerging market mutual funds were net buyers of Asian stocks throughout most of 1997.²⁶

The First 50 Years (1944–1995)

THE BOND MELTDOWN, 1994–1995 | US bond funds

The Federal Reserve sharply tightened monetary policy, boosting its target for the federal funds rate from 3 percent to 6 percent. The yield on the 10-year Treasury note rose 1.85 percentage points, sending bond returns into negative territory for months.

During this time, US bond mutual funds experienced net outflows totaling 11.3 percent of their assets. These net outflows, though, occurred smoothly rather than precipitously. In no month during the 12-month period from February 1994 to January 1995 did net outflows exceed 2 percent of bond mutual funds' assets.²⁷

BLACK MONDAY, OCTOBER 1987 | US equity funds

On Monday, October 19, 1987, the Dow Jones Industrial Average fell by a then-record 508 points. From October to December 1987, the stock market declined by 23 percent.

Over these three months, net outflows from US equity mutual funds totaled 4.2 percent of their assets. The largest one-month net outflow from equity mutual funds during this period was 3.2 percent in October 1987, when the S&P 500 declined by 22 percent in a single month.²⁸

BEAR MARKET, 1973–1974 | US equity funds

Global tensions and a sharp spike in oil prices triggered a deep and long-lasting recession in the United States and elsewhere. From January 1973 to December 1974, the S&P 500 declined 42 percent.

Outflows from US equity mutual funds over this period were modest, cumulating to \$3.2 billion, or 5.8 percent of fund assets. During this period, the maximum one-month net outflow from US equity mutual funds was 0.6 percent of assets.²⁹

STOCK MARKET CYCLES, 1945–1990 | US equity funds

From 1945 to 1990, there were 12 additional major US stock market cycles (as identified by peaks and troughs in the S&P 500 index) of varying magnitudes and lengths (in addition to the 1973–1974 bear market and 1987's Black Monday).

In eight of these 12 cycles, US equity mutual funds experienced inflows even during the contraction phase of the cycle. In the four cycles with outflows during the contraction, the largest monthly outflow was 1.1 percent of assets.³⁰

Time and time again, however, US 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.

(*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.)³¹

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Notes

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- ⁵ Monetary Policy and the State of the Economy, Hearing Before the Committee on Financial Services, House of Representatives, February 27, 2018, Serial No. 115-76, page 29, available at <https://financialservices.house.gov/uploadedfiles/115-76.pdf>.
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- ⁹ “Matching Models to Reality: In a Falling Market, the Real ‘Movers’ May Be...the Buyers,” *ICI Viewpoints*, July 15, 2016, available at https://www.ici.org/viewpoints/view_16_bond_fund_series_03 (“First Mover Viewpoints”).
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- ¹⁶ FSB Letter.
- ¹⁷ FSB Letter.
- ¹⁸ “Taper Tantrum” Paper.
- ¹⁹ FSB Letter.
- ²⁰ FSB Letter.
- ²¹ “Why Long-Term Fund Flows Aren’t a Systemic Risk: Past Is Prologue,” *ICI Viewpoints*, February 18, 2015, available at https://www.ici.org/viewpoints/view_15_fund_flow_01.
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- ²³ FSB Letter.
- ²⁴ FSB Letter.
- ²⁵ SEC-OFR Letter.
- ²⁶ Mitchell A. Post and Kimberlee Miller, “US Emerging Market Equity Funds and the 1997 Crisis in Asian Financial Markets,” *ICI Perspective* 4, no. 2 (June 1998), available at <https://www.ici.org/pdf/per04-02.pdf>.
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- ²⁸ SEC-OFR Letter.
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- ³⁰ John Rea and Richard Marcis, “Mutual Fund Shareholder Activity During US Stock Market Cycles, 1944–95,” *ICI Perspective* 2, no. 2 (March 1996), available at <https://www.ici.org/pdf/per02-02.pdf>.
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