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# Bond Fund Investments 'Stickier' Than Headlines Indicate


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## By Brian Reid

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*The following special commentary was written by Brian Reid, chief economist at Investment Company Institute.*

It’s been a long two months for bond fund investors. There has been a lot of news about rising interest rates and falling bond prices, and what this means for investors. Withdrawals from bond mutual funds picked up, with nearly $70 billion taken out since May.

### The Latest Numbers

Though the numbers look big, our weekly estimates (which cover more than 95 percent of industry assets) show that redemptions from bond mutual funds in June totaled less than 2 percent of the nearly $3.8 trillion invested in bond funds.

And it appears investor reaction is leveling out. Weekly withdrawals slowed sharply this past week to $6 billion, or roughly one-fifth of bond fund outflows the week before. The pace of withdrawals that bond funds have been experiencing is are typical in a rising interest rate environment.

Let’s take a look, in context, at what has happened.

### What Started the Withdrawals?

Long-term yields for Treasury bonds began to rise in early May, following comments from numerous Federal Reserve officials indicating that the Fed’s massive bond-buying program would begin to slow if

the economy continued to improve. By the end of that month, yields on the 10-year Treasury note had climbed by nearly one-half of one percent—yet money continued to flow in to bond funds.

Investors began to withdraw money from bond funds as interest rates continued their climb in June. That said, redemptions were moderate during the first two weeks of June and even slowed for the week ending June 19—the day that Fed Chairman Ben Bernanke held a press conference and announced that the Fed would likely begin backing away from its bond-buying program by the end of the year. After that, the yield on 10-year Treasury bonds jumped 13 basis points (0.13 percent)—and shot up another 19 basis points the next two days.

Withdrawals from bond funds accelerated after the rate hikes, hitting record levels (in dollar terms) for the week ending June 26. However, the leveling out of long-term rates and slower pace of withdrawals since then suggests that the market has "digested" the news from the Fed, and is settling into a more moderate pattern.

## Withdrawals Are Not Moving the Market

Some have claimed that investors' withdrawals are driving the bond market and the rise in interest rates. But it's the other way around. The withdrawals in June lagged the market—always picking up after rates rose, not before or during the market movements.

Another way to look at the issue is to determine whether withdrawals were large enough to have affected the markets. The Federal Reserve Bank of New York publishes the amount of bond trading by primary dealers—the large brokerage houses that are authorized to trade with the Federal Reserve. Each day these dealers, on average, trade about $700 billion of bonds (including Treasury, government agency, corporate, and municipal bonds) with clients, and billions more in trades among themselves. Their client trading in government securities alone averages more than $600 billion per day. Over the course of a month, their gross trading volume with clients runs close to $15 trillion.

How do recent bond-fund withdrawals stack up in this market? Facing redemptions of less than 2 percent of assets, it's possible that many bond funds could have met redemptions simply by drawing down cash or other liquid assets (after all, bond mutual funds held more than $200 billion in short-term liquid assets at the end of May). Even if bond funds had to sell securities to meet shareholder redemptions, the amount of redemptions in June would have equaled less than 1 percent of the trading volume of the primary dealers.

Bond fund withdrawals might have had a greater effect on markets where there is less trading, such as municipal securities—but even there, redemptions from bond funds would have accounted for less than 10 percent of the primary dealers' trading. And those numbers overstate the effect of bond fund trading because they exclude bond trading at regional brokerages, which play a large role in the municipal securities market.

Based on this data, it is safe to say that recent withdrawals from bond funds have had minimal impact on broader markets and liquidity.

## Demand for Bonds Will Continue

As interest rates rise, we will continue to see redemptions from bond funds. But it's important to look at the data and the full context of broader markets.

We believe that investors will continue to want bond exposure. Among other things, demand for bonds will be driven by an aging population looking for diversification beyond stocks, and by such investment vehicles as target-date and balanced funds, which allocate a certain portion of their investments to the fixed-income sector. Bond fund assets could likely be far "stickier" than many believe.

*Brian Reid is chief economist at the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.3 trillion and serve more than 90 million shareholders.*

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