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ICI VIEWPOINTS

DECEMBER 4, 2023

The Ghosts You Chase but Never Catch

By Shelly Antoniewicz and Shane Worner

Halloween season is well past, but some banking authorities seem happy to continue chasing the perceived "ghoul" of bond fund stress amplification. In trying to make the case that bond funds amplify market shocks, systemic risk regulators have for years twisted and contorted the data. The latest example is an article published by the Federal Reserve Bank of New York (NY Fed), *Bond Funds in the Aftermath of SVB's Collapse*, that suggest outflows from bond funds in March 2023 may have been an unintended consequence of exceptional measures taken to strengthen banks' balance sheets during that time. The article wants to make much of the fact that bond funds saw net outflows for about three weeks after the run on Silicon Valley Bank (SVB) in March 2023, as if bond fund outflows and the bank run were closely intertwined, and as if that somehow suggests bond funds pose systemic risks.

The data, however, strongly challenge this perspective and provide countervailing evidence that other factors were also at play in investors' decisions to redeem from bond mutual funds in March 2023.

First, bond mutual funds had very little exposure to the debt of troubled regional banks—only about 0.3 percent of bond mutual funds' assets. So, any suggestion that SVB's collapse and the establishment of the Bank Term Funding Program instigated a big reaction from bond mutual fund investors' is incorrect.

Second, net outflows from bond mutual funds were a logical result of the Fed's decisions to sharply increase interest rates—ironically the same monetary policy decisions that created problems at SVB. The NY Fed blog highlights that after the run on SVB, outflows from bond mutual funds persisted for almost three weeks, which it argues was "quite unusual." On the contrary, it had been more the rule than the exception since March 2022, when the Federal Reserve began tightening monetary policy. To combat inflation, the Fed drove short-term interest rates up at nearly the fastest pace in history, which in turn raised long-term interest rates and depressed returns on bonds and bond mutual funds. Not surprisingly, bond mutual funds saw consistent outflows. In addition to the 21 consecutive daily stretch of outflows in March 2023, bond funds experienced 11 other episodes of outflows spanning 10 days or more (see table). Six of those episodes spanned 19 days or more, and in each of those six cases (denoted † in the table), cumulative outflows totaled considerably more than the cumulative outflows seen in March 2023 (denoted * in the table).

Date	Days of consecutive outflows	Total outflow
3/2/22 – 3/18/22	13	$22 billion
4/4/22 – 4/29/22	19	$41 billion†
5/3/22 – 5/27/22	19	$49 billion†
6/2/22 – 7/20/22	33	$60 billion†
9/2/22 – 9/30/22	20	$41 billion†
10/4/22 – 10/28/22	19	$40 billion†
11/2/22 – 11/16/22	11	$13 billion
12/6/22 – 12/19/22	10	$17 billion
3/2/23 – 3/30/23	21	$21 billion*
8/17/23 – 8/30/23	10	$5 billion
10/3/23 – 10/31/23	21	$26 billion†

* Bond mutual funds had been in outflows for 7 consecutive days prior to the collapse of SVB

Source: ICI Research calculations of Morningstar data

Third, the outflows in March 2023 reflected other important inflation and monetary policy developments. For example:

- The Consumer Price Index for February, published on March 14, came in at a 6 percent year-over-year rate—stubbornly high and thus bad news for fixed income investors.
- The Fed raised the federal funds rate on March 22—which may have caught some fixed income investors by surprise because there was some chance the Fed might have stood pat to ease pressures on certain regional banks.

Fourth, significantly tighter monetary policy caused investors to rebalance their portfolios. There is good reason to believe that investors were shifting their holdings from bond funds toward money market funds (MMFs). As the Fed raised short-term interest rates, yields on MMFs rose from near-zero to a quite attractive level of over 5 percent. Reflecting this, retail investors had been substituting away from bond funds toward MMFs for some months. For example, over the six months ending February 2023, inflows to retail MMFs averaged $54 billion per month.

Finally, bond ETFs saw net **inflows** in March 2023, which further undercuts the article's thesis. It is likely that some of the outflows from bond mutual funds in March 2023 reflected substitution toward bond ETFs. For a number of years, investors have shifted from equity mutual funds toward equity ETFs. Since early 2022, a nascent but similar shift has apparently been occurring between bond mutual funds and bond ETFs. For example, although bond mutual funds saw $20 billion in outflows in March 2023, that same month, bond ETFs saw inflows of nearly $30 billion.

Being vigilant to the specter of financial market uncertainty is important, but sometimes a bank collapsing is nothing more than a textbook case of a bank mismanaging its balance sheet.

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