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Why Long-Term Fund Flows Aren't a Systemic Risk: Plus Ça Change, Plus C'est La Même Chose

By Sean Collins

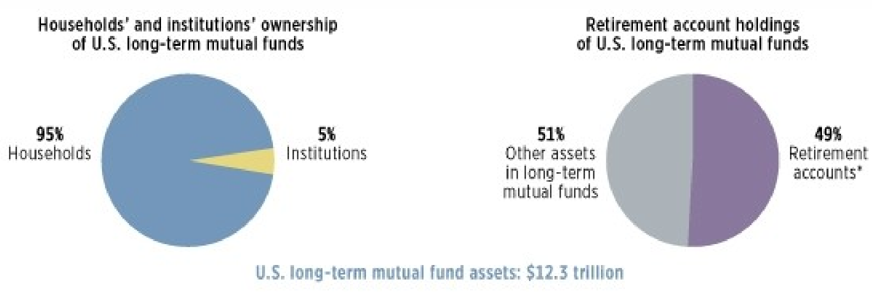
Second in a series of Viewpoints *on long-term funds and systemic risk*

As discussed in a previous *ICI Viewpoints* post, regulators and others have voiced concerns that long-term funds—funds that invest primarily in stocks, bonds, or both—might experience large outflows during a financial crisis, adding pressure on financial markets. This concern is an old and recurring one, dating all the way back to the Great Depression. But throughout repeated and occasionally severe financial market downturns, outflows from long-term mutual funds have remained quite muted.

Those data haven't quieted the skeptics. Some commentators argue that "things have changed"—because, for example, the assets in mutual funds—especially bond funds—have grown substantially in the past few years. Consequently, they argue, past fund flows may not be a useful guide to future fund flows.

The argument that historical fund flows have no predictive value because "things have changed" is, simply put, not convincing. One reason is that the "things have changed" view ignores the "things that haven't changed." There are a number of fundamental characteristics that remain unchanged about funds and their investors that are likely to mitigate fund outflows during periods of stress. And even where some of these characteristics have changed, they've changed in ways that make large outflows from funds even *less* likely.

Households Hold the Vast Majority of U.S. Long-Term Mutual Funds



* Retirement accounts include defined contribution plans (e.g., 401(k) plans), as well as individual retirement accounts (IRAs).

Note: Data are for December 2013 and exclude assets in exchange-traded funds.

Source: Investment Company Institute

First, and perhaps most significant, is the fact that the assets of long-term funds remain held almost entirely by households—or, in other words, retail investors. In fact, 95 percent of these funds' assets are held by retail investors. (In a subsequent *ICI Viewpoints* post, we'll explore the data behind that 95 percent level—and why so many regulatory bodies are getting it wrong.)

Retail investors generally respond less strongly to market events than do institutional investors. Why is this? One reason, suggested in the academic literature, is that retail investors may be less adept than institutional investors at interpreting market information and may therefore be reluctant to try to "time" markets. In addition, many long-term fund shareholders seek the advice and assistance of financial advisers, who may provide a steadying influence during market downturns.

Second, households continue to use mutual funds to save for the long term. Twenty years ago, Donald Morgan,a Federal Reserve economist, argued that the chances of mutual fund flows destabilizing markets were remote because households invest in mutual funds to save for retirement, allowing them to ride out bumps in the market. And as of December 2013, half of the $12.3 trillion in the assets of long-term mutual funds were held through tax-deferred retirement accounts, such as 401(k) plans and individual retirement accounts (IRAs). Investors in these accounts may have horizons of 10, 20, or even 40 years, enabling them to look through market downturns.

Consistent with this, those investing in mutual funds through 401(k) plans tend to make stable contributions through periodic payroll deductions, even during periods of market turmoil. Indeed, ICI research shows that only 3 percent of defined contribution plan participants stopped making contributions to their plans during 2008—at the depths of the recent financial crisis.

Third, other tax considerations are likely to continue to mitigate redemptions from long-term funds. Investors who hold fund shares outside of tax-deferred accounts may realize capital gains if they redeem and thus incur a current tax liability, creating a disincentive to redeem. In addition, if an investor redeems shares held for less than one year, any gains on those shares are taxed at the higher rates applying to ordinary income, rather than the lower rates associated with long-term capital gains. This creates a disincentive to try to time the markets.

Fourth, timing the markets remains a risky proposition. Financial economists and financial advisers have long advocated a strategy of buy-and-hold for most mutual fund investors, in part because of "reinvestment risk." As noted, long-term fund investors often have very long investment horizons. Thus, redeeming out of a long-term fund today is not a riskless proposition—the investor has to decide when to get back in. While he or she is deciding, the market might move lower or *higher*. Unless an investor has a strong view on which is more likely, he or she may just remain in the fund, riding out the bumps.

Finally, fund trading fees or other trading "frictions" may promote stability of long-term fund flows. More than 20 percent of U.S. long-term funds impose some kind of a redemption fee (see Collins and Plantier 2014). In addition, most funds limit "round-tripping" by preventing investors who redeem from reinvesting within the same fund within a set period, such as 30 days. Some 401(k) plans independently set round-tripping or frequent-trading restrictions on plan participants' investments in funds. Funds also generally monitor shareholder accounts for excessive trading and may limit or block trades of investors who engage in such practices. Though intended to limit frequent trading, these kinds of frictions may also make it harder for an investor to time the markets. The number of funds imposing these kinds of limits has increased in the past decade.

In short, outflows from long-term funds have in the past been muted in the face of financial market shocks. And while "things have changed," many other things—including a range of investor, market, or tax law characteristics—remain and are likely to mitigate fund outflows during future stress periods.

Read the other entries in this Viewpoints *series*:

- Why Long-Term Fund Flows Aren't a Systemic Risk: Past Is Prologue
- Why Long-Term Fund Flows Aren't a Systemic Risk: Understanding the Data on Institutional and Retail Investors
- Why Long-Term Fund Flows Aren't a Systemic Risk: Multi-Sector Review Shows the Same Result

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