



## Slamming the door before the horse bolts

Could the Fed stop investors from exiting bond funds?

You've got to sit up and take notice when you hear that Federal Reserve officials have been discussing measures to avert a potential run on bond funds. Lurking beneath a few of the newspaper headlines and buried on the inside pages is one of those articles which becomes more alarming as you read on and it starts to feel like a potential time bomb. It seems that the Federal Reserve is mulling the idea of imposing exit fees on US bond funds in order to counter the threat of a run on funds in a crisis. What crisis? Does the Federal Reserve Chairman, Janet Yellen and her merry band know something we don't? After all, US Government Treasury bond yields have fallen 0.4% to 2.5% over the last year. If that's a problem, it sure doesn't feel like it. Over the years, we've grown used to central banks reacting to situations but this looks like the Fed. is contemplating shutting the stable door before the horse bolts.

It seems the problem, in the eyes of the Fed, is that interest rates are so low that investors have moved cash into short term Treasuries, and bond funds generally, just to get some yield, ANY yield, on their cash. If so, bond funds have effectively become a store of cash and essentially another form of banking.

The funds have become “shadow banks” according to Jeremy Stein, a Federal Reserve Governor (2012-14). He said “So much activity in open-ended corporate bond and loan funds is a little bit bank-like”. He added “It may be the essence of shadow banking is giving people a liquid claim on illiquid assets.”

Whilst it is currently perfectly easy to sell bond funds for cash, the fact that bond funds are deemed liquid is because there are relatively few people selling on any given day. But the market is nowhere near as liquid as some people think. As we have said, even before the bond tapering started, the only important question being discussed behind the scenes at the Fed is the timing of actual interest rate hikes. What they’re worried about now is what will happen to bond fund holders when rates (inevitably?) go up. If the “shadow bank” holders made a swift exit for the door, the bond market could be in for a full blown crisis with bid-offer prices blowing wide open and investors unable to sell for lack of buyers. There is precedence because this is what happened during the Lehman crisis. We remember a senior fund manager trying to reassure clients at that time that “It’s not that bond prices have fallen, it’s just that there is no price”. That is a deeply unpleasant situation to be in and not something we want to hear again.

How big is the problem and could this happen? The mutual bond market is worth over \$10 trillion and data suggests US retail investors have put over \$1 trillion into bonds since 2009. That’s a lot of money to try and lock up and keep from fleeing.

As is often the case with leaks there are no details as to how any fee would be implemented to discourage investors from selling their bond funds. It could be by pricing, by widening spreads, or a hard exit fee – either a percentage of fixed, perhaps. There are obvious problems with all them, we think and we don’t even know who would get to keep the proposed fee!

Actually, this isn’t the first time the Fed. has tried it on. They sprung something similar on us in the summer of 2012 as it openly considered suspending all fund redemptions to allow for orderly liquidation of funds. That, like this would have been a quite remarkable market intervention. At TAM, we recognise this as “gating” and were unsettled by a similar situation which developed in property funds in 2007-8.

It may be that the Fed. is simply flying kites to see what kind of reaction it gets from the market. That’s dangerous. It would be a hugely unpopular move for retail clients invested in bond funds should it happen. Furthermore, it would also send the message that the Fed. believes that bonds are vulnerable to a mass sell-off which could actually cause the bond market to vote with its feet – the opposite of what they want. Contagion from US bond funds to the UK would be inevitable.

However, we at TAM have felt a twinge of unease on the issue of bond market liquidity for some time. We are very aware that liquidity in the bond markets is poor relative to the colossal size of some of the best known bond funds and there is an undeniable risk that a bolt for the door en masse would cause short term pricing chaos.

This risk forms part of our thinking behind moves earlier in the year to sell some of the very largest bond funds held in TAM client portfolios (in addition to high valuations at the time) in favour of smaller more specialised fixed interest and credit funds. But we will continue to watch this development closely and

watch for signs that the stable door is about to get pre-emptively bolted shut. Watch this space!

“One way to stop a runaway horse is to bet on him” Jeffrey Barnard.

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