The Behavior of Intoxicated Investors: The role of institutional investors in propagating the crisis of 2007-2008

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Overview

1. The authors have constructed a wonderful dataset.

2. The paper is very ambitious.

3. The results may be less robust and compelling than the authors suggest.

4. We could learn a lot more with far simpler tests.

One example: Flow-Performance Sensitivity

Performance: Percentile rank of fund α from 8-factor (equity-bond) model

Sensitivity: Slope in regression of 12 monthly flows on percentile rank.

$$\text{Flow} = a + b\ \text{Rank} + e$$

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  α: 36 Months
|-----------------------|
                     |--|
                    Flow

  |-----------------------|
                       |--|

     |-----------------------|
                          |--|
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1. Extreme rank more likely for equity than bonds, and more likely for lower grade corporates than AAA securitized bonds.
2. Overlapping data suggest regression may have problems

One example: Flow-Performance Sensitivity

Table II   Effect of Fund Types on the Propensity to Hold Securitized Bonds

Percent of securitized bonds in mutual fund regressed against "controls" and:

Turnover ratio	1.35		
	(4.84)		
Flow-performance sensitivity		0.05	
		(3.10)	
Flow volatility			0.18
			(4.78)

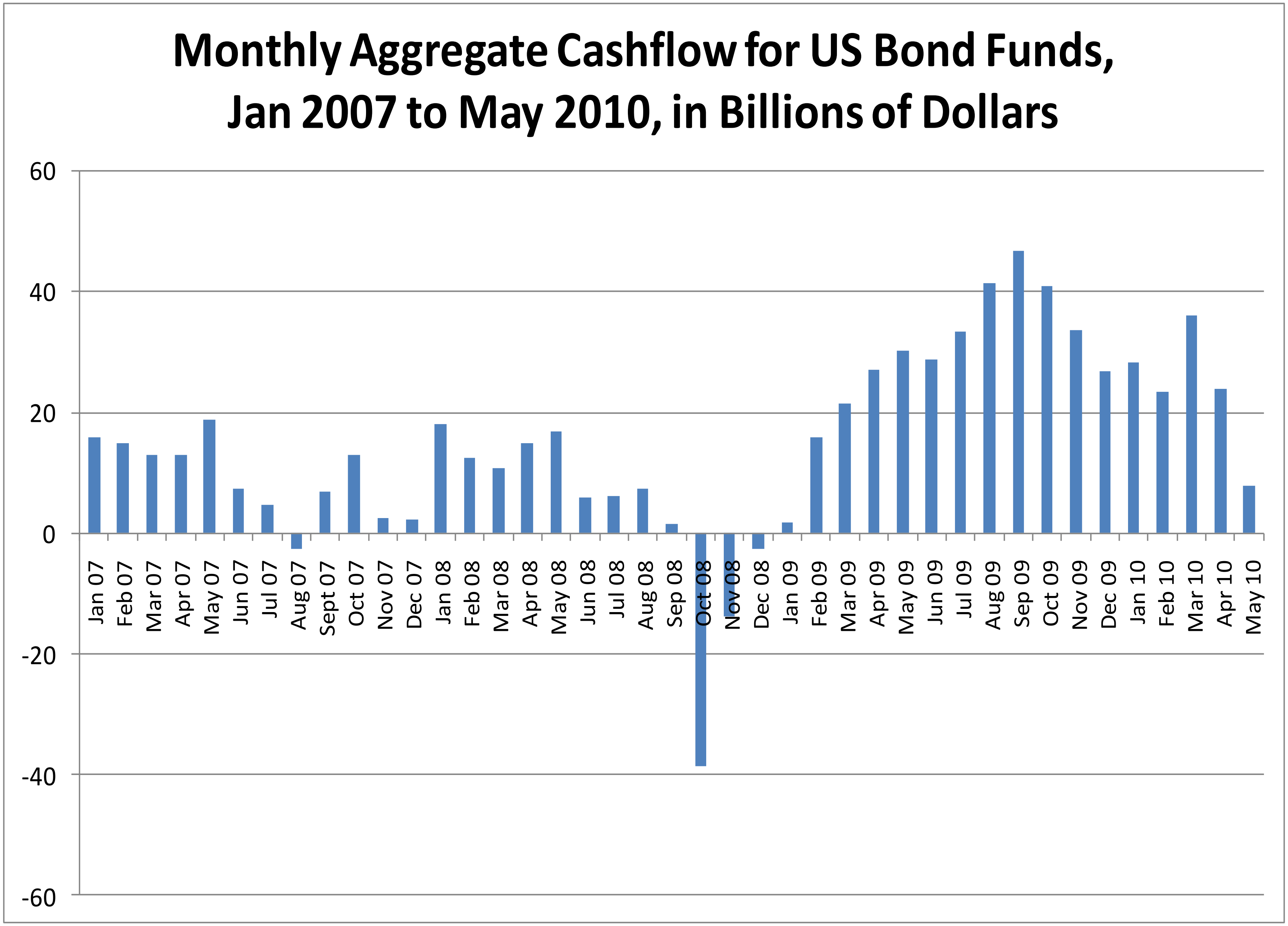
Slopes and t-stats from Fama-MacBeth regressions, 1998Q1-2007Q2

Identification of Liquidity Shock

Sale of security is not enough: There is a buyer for every seller

Unlike hedge funds, mutual funds are rarely levered

Liquidity needs come from client flows



Monthly Aggregate Cashflow for US Bond Funds,
Jan 2007 to May 2010, in Billions of Dollars
60
40
20
0
-20
-40
-60
Jan 07
Feb 07
Mar 07
Apr 07
May 07
Jun 07
Jul 07
Aug 07
Sept 07
Oct 07
Nov 07
Dec 07
Jan 08
Feb 08
Mar 08
Apr 08
May 08
Jun 08
Jul 08
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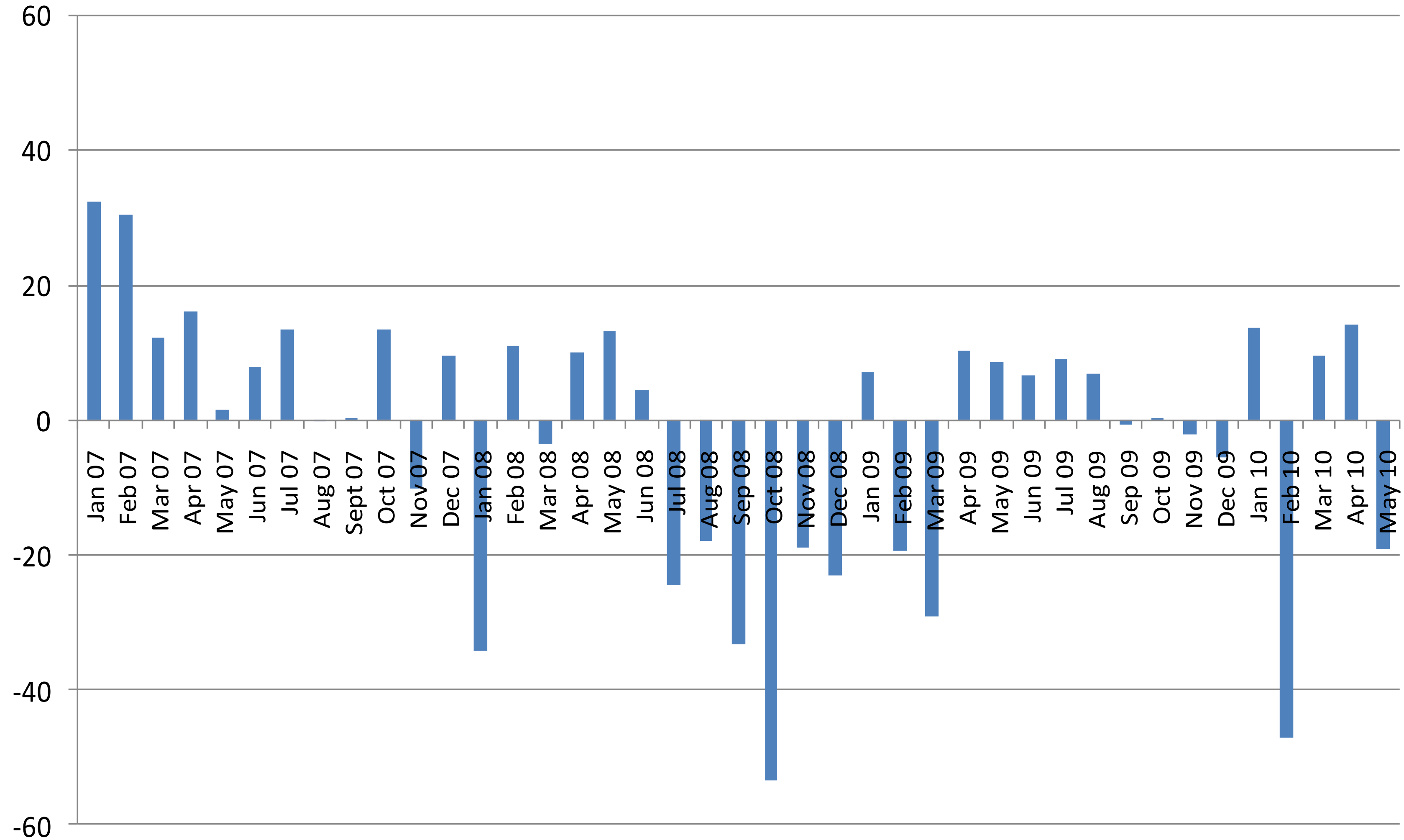
Apr 09
May 09
Jun 09
Jul 09
Aug 09
Sep 09
Oct 09
Nov 09
Dec 09
Jan 10
Feb 10
Mar 10
Apr 10
May 10

Monthly Aggregate Cashflow for US Equity Funds, Jan 2007 to May 2010, in Billions of Dollars



How would I look for propagation of shocks?

1. Group mutual funds by holdings.

   Only securitized bonds

   Only corporate bonds

   Securitized and corporate bonds

   Securitized bonds, corporate bonds, and equity

2. Rebalancing versus cashflows

   What do funds sell when they have net outflows?

   What do funds buy when they have net inflows?

   How do funds rebalance when they have only small flows?

How would I look for propagation of shocks?

3. Price impact of mutual funds sales

    Do prices of corporate bonds fall much when they are sold by funds?

    Are the price drops bigger if corporates are sold to raise cash?

    Are the price drops smaller if funds with net inflows buy the bonds?