A Perspective on Mutual Fund Redemption Activity and Systemic Risk

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Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: The Report on Asset Management and Financial Stability of the Office of Financial Research

Dear Ms. Murphy:

Strategic Insight ("SI") is a mutual fund research and business intelligence firm founded in 1986. SI has studied the U.S. and global mutual fund industry for nearly 30 years. I hope our comments in the attached report are helpful to the Commission.

During every financial crisis over the past three decades, and longer, capital preservation driven net withdrawals by mutual fund investors were always very limited in magnitude (generally under 2% of assets monthly even during the most alarming periods). Furthermore, atypical high redemptions were very short in duration (just a few days, or a few weeks).

Even more reassuring, stock fund portfolio managers always buffered investor redemptions in times of crisis. For example, during the harrowing October 2008, stock funds' portfolio managers net sold an amount equal only 0.4% of all assets held in such funds. During that month, stock net liquidations by portfolio managers equaled to less than one-third of stock fund investors' net redemptions (also negating the "Herding" theory, investors net redemptions were under 2% of all stock fund assets under management during October 2008).

Large stock and bond mutual funds have relationships with tens of thousands or hundreds of thousands of investors, each with their own unique circumstances. Large mutual fund management companies have relationships each with millions of investors. It is not surprising that the mutual fund industry never experienced harmonized redemption behavior implied by the "Herding" theory and its implied systemic risk.

The heterogeneous nature of mutual fund investors, and the rising and dominant share of mutual funds invested through buy-and-hold asset allocation programs, both suggest that stock and bond mutual funds will never pose systemic risks.

I believe that the U.S. lessons and observations, as suggested in our report, equally apply to funds offered globally in other sizeable and maturing mutual fund markets.

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U.S. Mutual Fund Shareholder Activity During Past Periods of Financial Markets Duress

The mutual fund vehicle continues to expand in importance as a key savings tool for an increasing number of investors around the world. Today, mutual funds (including ETFs) account for more than $30 trillion in assets globally, including $16 trillion in the U.S. As the growing acceptance of mutual funds across a widening range of countries and regions persists, the worldwide mutual fund marketplace continues to become ever-more interconnected in a variety of ways – from the synergies of a truly global economy to the widening focus of fund firms' global fund distribution efforts to match the expanding range of investor demand around the world.

Within this context of expanding global acceptance and usage of mutual funds, the perception, focus, and policymaking initiatives of fund regulatory bodies around the world also continue to increasingly converge – with many fund rule-makers often looking to the experiences of the mature U.S. marketplace to guide their efforts.

One area of emerging interest of both regulators and market participants is the concern related to the systematic risks triggered by mutual fund shareholders redemption activity.

Strategic Insight's observations in this report are based on a number of sources, including SI's proprietary database (Strategic Insight Simfund) which tracks the $30 trillion mutual fund industry. Also used for this study are data and findings published by the Washington D.C. based Investment Company Institute, the national association of U.S. investment companies.

This report includes commentary based on Strategic Insight's past studies. A number of previously published Strategic Insight studies also addressed the topic of mutual fund shareholder redemptions and have been shared with the fund management industry, industry observers, and regulators. The studies referenced below are available upon request to Strategic Insight (Research@sionline.com):

- What Will Investors in Equity Mutual Funds Do Now? (9/17/2001)
- Equity Fund Historical Retention Patterns Reassuring, Not Alarming (7/18/2002)
- Perspectives on Taxable Bond Fund Redemption Patterns (11/6/2009)
- Perspectives on Redemption Patterns Across Intermediary-Sold Distribution Platforms (8/10/2011)
- Lessons from Taxable Bond Funds' June 2013 Redemption Activity Across Distribution Channels (8/27/2013)

Looking Back, Looking Forward

- Mutual funds are widely accepted in the U.S. Their ownership is encouraged by the marketplace and enabled through regulatory initiatives. More than 80% of wealthy households in the U.S. invest in mutual funds.

- The $16 trillion U.S. fund industry has benefitted over the past three decades from the emergence of funds as the primary savings vehicle for retirement income, as well as from innovations in investment strategies. In combination with these factors, the open architecture culture in the U.S. for fund selection and portfolio construction has also contributed to the fund industry's ability to serve the expanding and diverse needs of a wide range of individual and institutional investors across a wide range of distribution channels.

- The U.S. mutual fund industry is dominated by retirement savings, and has benefited from a number of U.S. government initiatives since the 1970s encouraging such investments. U.S. mutual fund investments dedicated for retirement savings within tax-advantaged accounts exceed $6 trillion. About two-thirds of the total assets in all U.S. equity and balanced mutual funds are held in such accounts, and during both bull and bear markets new stock fund investments are dominated by retirement savings. In addition to these tax-advantaged retirement account structures, a significant portion of U.S. mutual fund investments in taxable accounts are also intended for long-term savings and retirement income. Indeed, according to the Investment Company Institute, the majority of U.S. fund investors (62%) have been introduced to mutual funds through their corporate retirement Defined Contribution plan. Overall, 94% of U.S. mutual fund investors (according to the ICI) use funds to "save for retirement" (whether in taxable or tax-advantaged accounts).

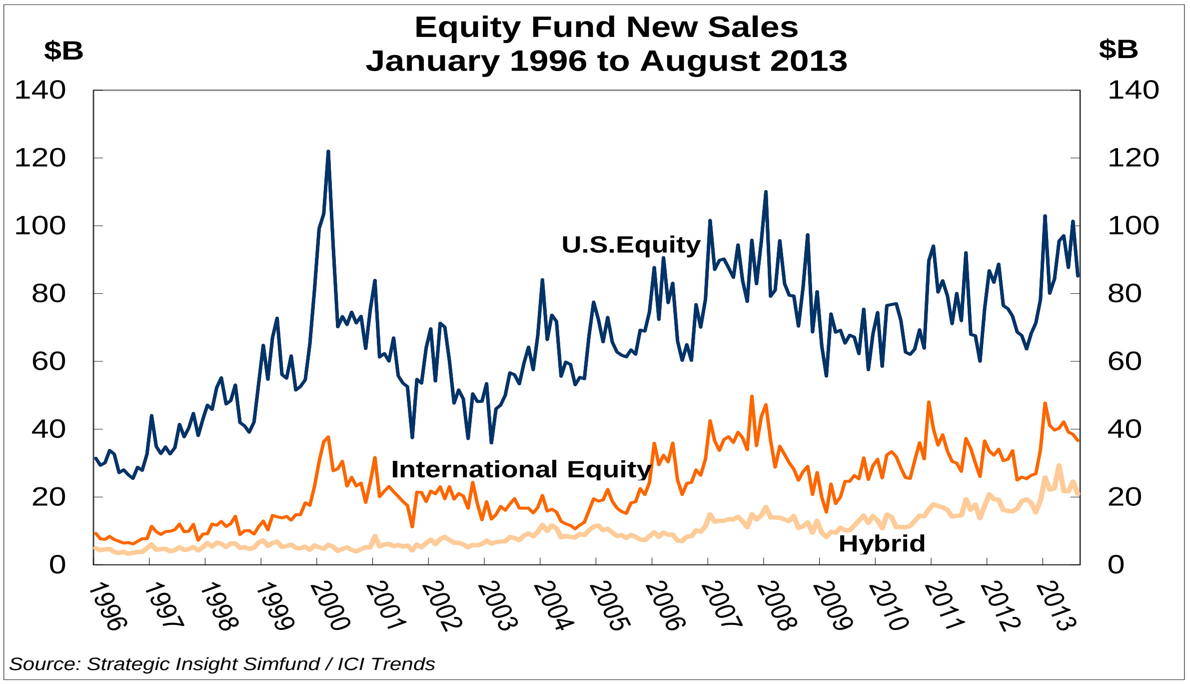
- About one-quarter of all stock and bond mutual fund assets under management in the U.S. are held in Defined Contribution (DC) retirement plans.

- Outside of DC plans, about four in five individual investors in mutual funds have made the choice to be helped by a financial advisor (FA) for the management of the majority of their mutual fund investments. For investors choosing to be assisted by a FA, the methods through which funds are sold have dramatically changed over the years. During the 1980s-1990s, most funds were sold one-fund-at-a-time and FA compensation was primarily paid at the point-of-sale. Today, most funds are purchased wrapped within an asset allocation portfolio, and compensation to the FA is mainly structured as a fee-for-advice encouraging long-term investment perspective. Strategic Insight estimates that today over 80% of fund purchases with the assistance of a financial advisor incorporate some form of asset allocation wrappers or are of a single fund with a balanced investment strategy.

- Today, the majority of the fund industry's assets shifted to be heavily weighted by asset allocation programs using multiple funds, or held in a single fund offering a combination of stock and bonds (balanced funds, flexible asset allocation funds, target data funds, etc. oversee over $2.5 trillion of mutual fund assets in total already). Consequently, the risk of large, harmonized, and persistent redemption activity, already trending down, has declined further.

- Fears of a vicious circle of mutual fund redemptions following stock market breaks, which would in turn feed further price declines and even more redemptions, were time and again disproved by actual events during past stock market declines. Looking back at 50 years of mutual fund history, Strategic Insight has concluded that capital preservation driven withdrawals were always short lived, non-recurring, and limited in magnitude. During times of lengthy financial uncertainty, investors reduce (not increase) the turnover of their financial assets; thus redemption activity tends to decline during a bear market, with the exception of brief and modest spikes during sharp down-market days or weeks. Investor psychological aversion to realizing losses explains part of such bear-market behaviors.

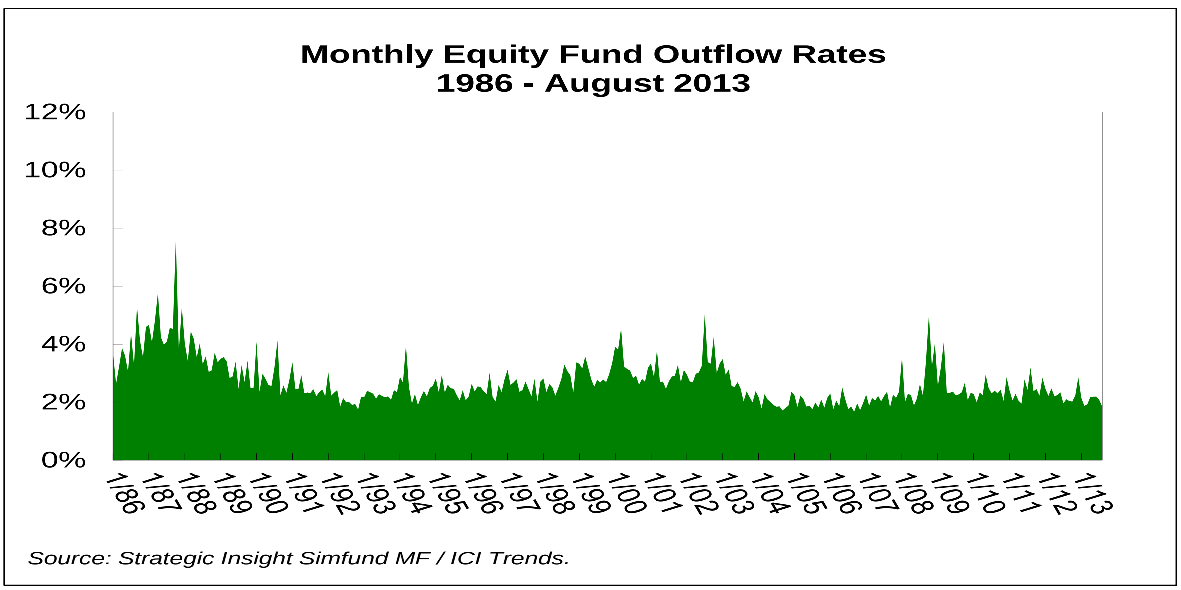
- Overall, the major change for equity mutual funds in an extended period of market uncertainty, as in the past, will not be overwhelming redemptions but rather a decrease in new purchases. But benefiting from steady retirement investing, dollar-cost-averaging deposits, and opportunistic buying will prevent equity fund net redemptions from remaining sustained and large. The uptrend, downtrend, and recovery of stock fund sales over the past 18 years are illustrated below.



Source: Strategic Insight Simfund / ICI Trends

- The data below shows equity fund redemptions for each month since 1986, a period during which assets held by such funds grew nearly 100 times, from about $100 billion to over $8 trillion. Yet, average monthly turnover rates have remained stable, actually trending down. Opportunistic switching, common among some fund investors in the late 1980s, has become marginal in the fund business today. The industry’s rejection of many such clients, and the poor performance results of many over-confident active traders, both contributed to lowering the frequency of timing activity in funds over the years. Also, the migration of such traders to Exchange-Traded Funds (ETFs) further reduced their relevancy to core mutual funds.

- The chart below captures the reassuring phenomenon of overall stock fund asset stability by measuring the pattern of transferring money out of equity (or balanced) funds. It combines two types of outflows reported by the ICI -- redemption activity out of the fund family and intra-family fund exchange redemptions. As shown below, constant asset attrition and periodic spikes are inherent traits of the asset management business. Industry-wide, monthly turnover ratios typically fluctuate within a narrow range, around 2-3% of assets, and only rarely exceed these ranges, including during periods of market volatility and uncertainty. Even when they do, redemption spikes are modest, short-lived, and non-recurring.

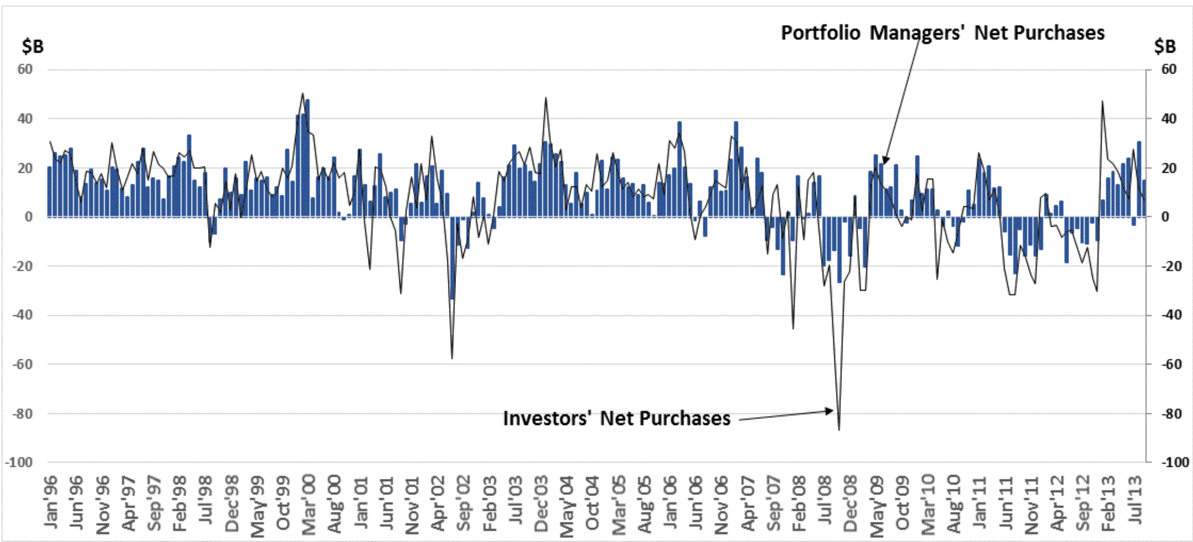


Sources: ICI, Strategic Insight Simfund; data for stock and balanced/hybrid funds
Monthly outflow rates= redemptions and intra-family exchanges, as a percentage of fund assets

- **Naturally, purchases by investors counterbalance redemption each month. As suggested above, equity fund investors increase their redemption activity only modestly even during periods of extreme market stress.**

- Even during the darkest days of financial crisis, portfolio managers of equity funds net redeemed only modest amounts. For example, during October 2008, fund investors redeemed under 2% of aggregate stock fund assets (ICI reported $87 billion of such net redemptions out of about $5 trillion of assets). During the same month, stock fund portfolio managers net redeemed just $26 billion, an amount equal to only 0.4% of assets held in stock funds, and under one-third of the net redemptions by stock fund shareholders, as illustrated in the chart below.

Equity* Fund Net Purchases:
Portfolio Managers vs. Investors 1/96 – 1/13



*Source: ICI, Strategic Insight Simfund; * equity and balanced/hybrid funds*

- Industrywide today, PMs of stock funds have over $400 billion in cash, liquid ETF holdings, and other liquidity facilities. In aggregate, the industry average of over 5% cash held by equity funds and additional liquidity facilities are well above the maximum range of the monthly outflows the mutual fund industry has experienced during the most volatile periods.

- Funds' cash holdings serve not only as a buffer against excessive short-term liquidations in a bear market, but also support price levels through opportunistic buying of cheaper stocks by portfolio managers. The chart above captures such activity. The structure of the mutual fund business drives the reality that portfolio managers always act as a buffer; their purchasing patterns lag investor buying activity, and their redemptions also lag and mitigate short-term emotional redemptions by investors.

- **Most important, heighted above, is the significantly smaller net redemptions by PMs, along with examples of positive net purchases, during months of elevated net redemptions by fund shareholders.** The evidence suggests that on a short-term basis, mutual fund portfolio managers provide positive liquidity to the stock markets, often counterbalancing downward price movements.

- **In summation: stock fund investors have never redeemed en-masse. And their portfolio managers have net liquidated little even in times of large stock market price declines. Mutual funds and mutual fund management firms have not in the past, and I believe will not in the future, trigger systematic risks to the financial market.**

- The Investment Company Institute published over the years a number of studies of shareholder redemption activity. One such study was published 17 years ago (in early 1996, http://www.ici.org/pdf/per02-02.pdf). It reviewed redemption activity during 50 years, 1945 – 1995, and concluded, "In none of stock market breaks and sharp declines in equity prices, have stock fund owners liquidated shares en masse". In the 17 years since the publication of this report, each market correction – and each subsequent crisis – witnessed a repeat of the important and reassuring observation of this ICI study. Another truism of the mutual fund industry is that most fund investors are inactive even during periods of great financial uncertainty. This was exemplified by the ICI's Fundamental review, "Redemption Activity of Mutual fund Owners" March 2001 (**http://www.ici.org/pdf/fm-v10n1.pdf**), which contrasted the multiple redemption actions each year by a small number of shareholders with redemptions or rebalancing actions taken by over 80% of the other investors. Subsequent studies reaffirmed such general observations.

- This commentary is focused on the patterns of stock and balanced fund redemptions. A number of Strategic Insight past studies observed redemption patterns among bond funds. In general, our observations and conclusions for bond funds were similar regarding the magnitude and durations of bond fund net redemptions during periods of bond investor concerns.

- Further analysis and data about bond fund and equity fund redemption patterns is available in the studies referenced on page 1 to this report.

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This study's principal author is Avi Nachmany, Executive Vice President, Research Director, and Co-Founder, in 1986, of Strategic Insight (a research and business intelligence firm for the U.S. and global mutual fund industry).