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The Behavior of Fixed-income Funds during COVID-19 Market Turmoil

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The Behavior of Fixed-income Funds during COVID-19 Market Turmoil

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This note analyzes the stress experienced (and caused) by open-end mutual funds during the March COVID-19 stress episode, with a focus on global fixed-income funds. In light of increased valuation uncertainty, funds experienced a short period of intense withdrawals while the market liquidity of their holdings deteriorated substantially. To cover redemptions, afflicted funds predominantly shed liquid assets first—for example, cash, cash equivalents, and US Treasury securities. But forced asset sales amplified price pressures in markets and contributed to liquidity falling across fixed-income markets. This drop in market liquidity, as well as the general stress in financial markets, may have led to fund investors becoming even more sensitive to challenging portfolio performance and encouraged further withdrawals. Only after central banks intervened, directly and indirectly supporting asset managers, did liquidity and redemption stress subside. Overall, the March episode validated the financial-stability concerns about liquidity vulnerabilities in the fund industry and calls for further action to address them.

EVOLUTION OF FUND FLOWS DURING COVID-19[1]

In March 2020 the COVID-19 crisis led to an unexpected increase in uncertainty and rapidly falling asset prices in equity and credit markets. Some market participants "dashed for cash" by selling off relatively safe and liquid assets, while central banks and certain types of money market funds stepped in, as was seen in US Treasury securities markets (Figure 1, panel 1). Funds experienced a period of rapidly intensifying daily outflows in March 2020 (Figure 1, panel 2, left side), which—according to monthly Morningstar data—amounted to outflows from the global fixed-income fund sector of $481 billion in March 2020. Even money market funds, which are generally less exposed to credit risk, were affected: in particular, US prime money market funds faced several weeks of large redemptions, while government money market funds saw inflows as investors sought the safety and liquidity of government securities (Figure 1, panel 2, right side).

[1] The analysis in this note is based on three separate samples of fixed-income funds representing up to 2,877 funds or up to about 65 percent of global fixed-income funds (see Appendix Table1).