The Portfolio Balance Channel of Unconventional Monetary Policy: Evidence from Mutual Funds

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Main Idea

QE and the Portfolio Balance Channel?

- The mechanism by which QE might affect borrowing costs (and aggregate demand) remains controversial

- High-frequency evidence of a (large) yield response to major QE announcements

[Gagnon et al., 2011; Krishnamurthy and Vissing-Jorgensen, 2011; Joyce et al., 2010; Neely, 2012; Swanson, 2011; Bauer and Rudebusch, 2011; Wright, 2012; D'Amico and King, 2013; and many, many others…]

- Reconciliation with limited *empirical* evidence on the mechanics of the "portfolio balance" channel? Plus, important theoretical concerns [Woodford (2012)]

- The literature has been relatively silent on ***how*** investors adjust their portfolios and whether these adjustments can be squared with the observed equilibrium price effects.

[aside: do we learn anything new with negative global yields?]

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Main Idea

QE and the Portfolio Balance Channel?

- This paper explores a subset of the investment management space, <u>bond mutual funds</u>, to potentially provide *micro-level* evidence of a portfolio balance channel
  [I view their paper somewhat differently from how it is pitched]

- The authors document that funds ***<u>reduce</u>*** holdings in the specific Treasury and Agency* bonds purchased by the Fed.

- Affected funds increase holdings in (other) government bonds, as well as corporate and international bonds.

- They document some heterogeneity by mutual fund type as well as some price effects.

* Please provide a little more clarity on what is meant by "Agency" here

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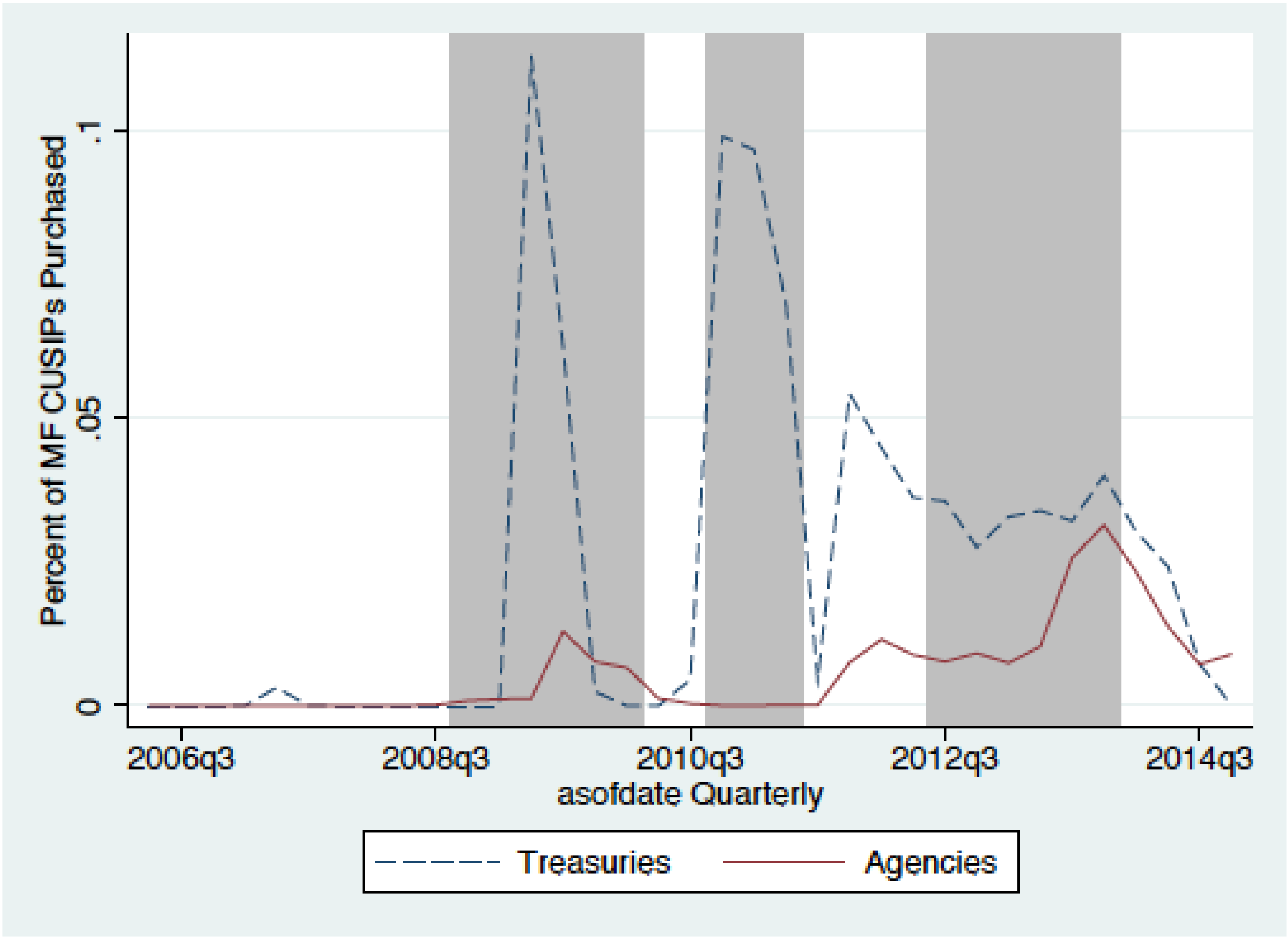
Federal Reserve Activity

Bond purchases as a fraction of MF ownership



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Potential Issues…?

Micro-level research is an undeniably important avenue….

However, before going further, there are some important shortcomings to immediately acknowledge:

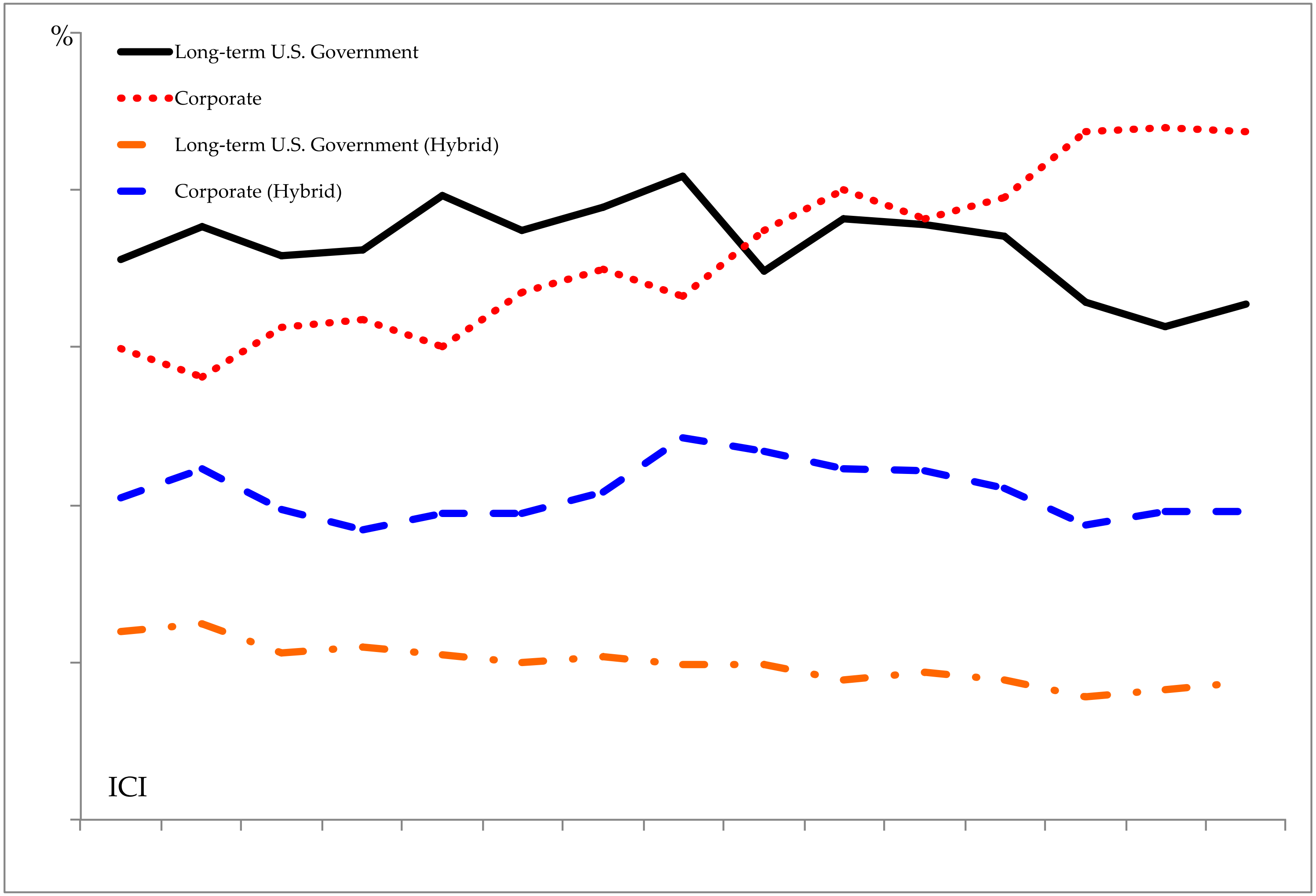
- Why Mutual Funds?
- Quarterly (vs. Transactional) Data
- Implications of instead holding targeted assets?
  [MBS purchases]
  (liquidity, mark-to-market accounting, index effects)

Lingering Issues / Questions

Do we expect to observe "portfolio balance" *within* bond funds or do these funds simply represent "pass-through" to (end-investor) households?

Mutual Fund Aggregates

Fraction of MF Portfolios



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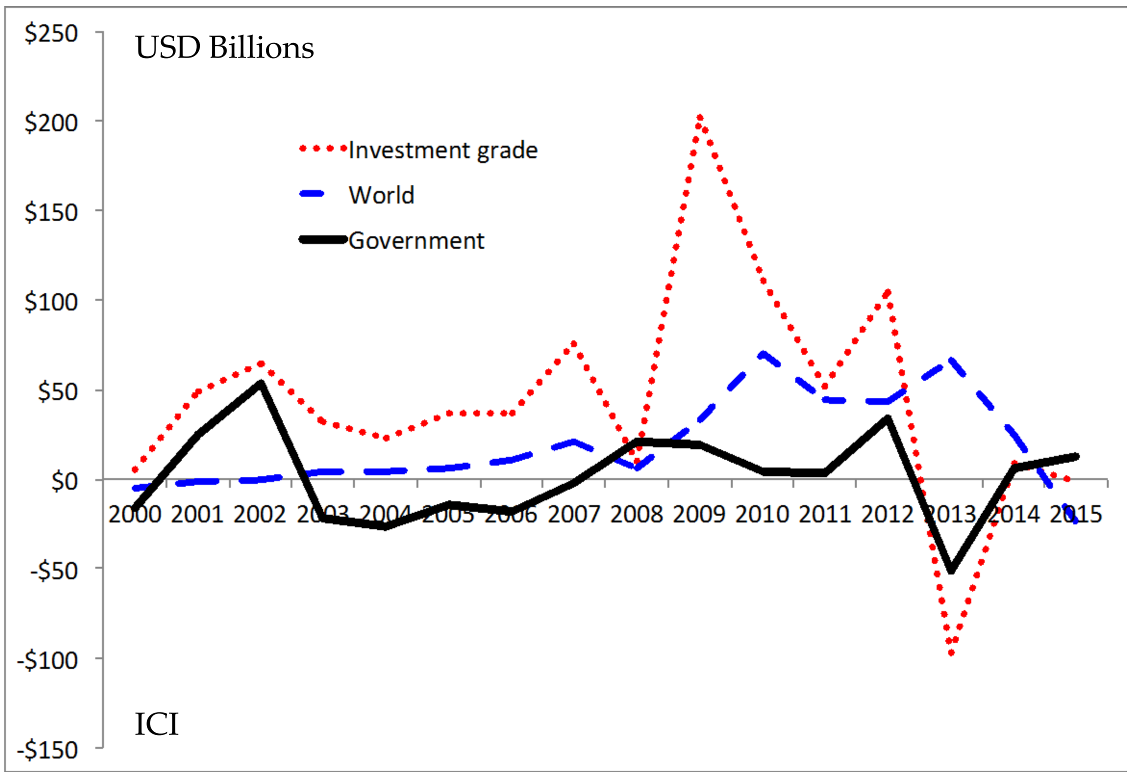
Mutual Fund Flows (Pass-through?)

Net New Cash Flow

Households **directly** own 85 to 90% of mutual fund claims



Fund net new cash (subscriptions less redemptions) represent household portfolio rebalance. Authors need to confront both macro and micro dynamics.

On Funds

Cross-sectional variation #1

While the authors touch the exploration of fund heterogeneity, they are potentially ignoring useful degrees of fund *variation*.

- Active vs. passive funds

[PIMCO Total Return Fund vs. Vanguard Long-Term Treasury Fund]
[Plus, over 300 bond or hybrid ETFs, managing over 450 billion USD]

- Among active funds, measure their *degree* of "activeness"

  [Cremers and Petajisto (2009)]

- Role for financial constraints?

  [Capital adequacy /distress for regulated banks and insurers – analogue here?]

- Certainly, investor flow is central from the perspective of pass-through portfolio rebalance.

  [*FIFA* is used a control, but should it be part of the story?]

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Lingering Issues / Questions

Can we use security-level cross-sectional heterogeneity to help us answer *how* LSAPs work?

- Is this really about the removal of *duration* or *credit* risk? Or distress / market failure?

- Are these market liquidity effects?

[Do we observe *temporary* price effects ("fire purchases") or are these effects permanent?]

- Are there simply highly constrained investors (think of the most extreme versions of preferred habitat).

[Skeptical Aside: might this perversely be adversely affecting financial stability? "reaching for yield" behavior]

Finally, **<u>the</u>** 3.5 Trillion Dollar Question

Does any of this matter?

- The lingering question is whether unconventional monetary policy has an(y) effect on economic activity and/or resource allocation.
- While the aggregate data suggest limited effects, at best – this method could permit a more focused exercise.
- Here, <u>for those firms</u> that experience a reduced interest cost through this MF channel, do you observe (i) new capital raising, (ii) CAPEX or asset growth, or (iii) altered resource allocation?

Conclusion

- An interesting paper, at the intersection of macro/monetary and finance, pushing a logical direction for an important and ongoing literature

- Have some lingering questions about how to interpret the empirical results (portfolio balance within vs. across)

- I think the authors should both confront the aggregate implications as well as go further to exploit micro cross-sectional heterogeneity

- **<u>Definitely worth a read and thanks for having me.</u>**

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