IM Guidance Update

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RISK MANAGEMENT IN CHANGING FIXED INCOME MARKET CONDITIONS

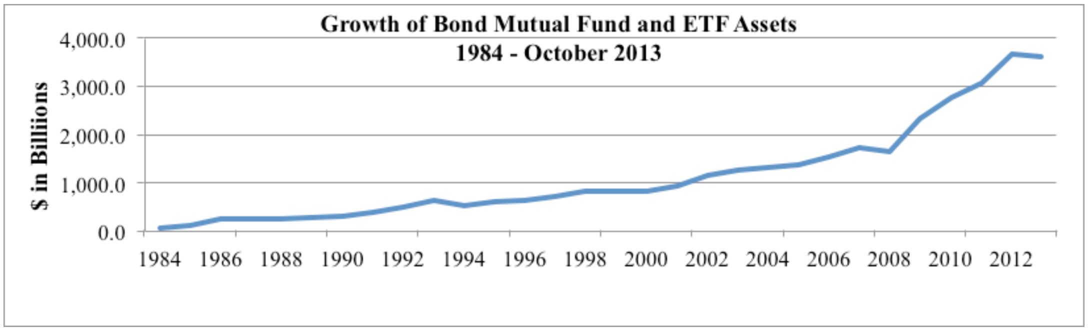
I. *Introduction*

Fixed income markets experienced increased volatility during June 2013 as investors considered the prospect of a tapering of the Federal Reserve Board's quantitative easing program and a general rise in interest rates. While the June 2013 fixed income market volatility subsided by early July, the June volatility—together with changes in bond market size and structure—are a timely reminder of the importance of sound risk management and disclosure practices by fixed income mutual funds and exchange traded funds (ETFs), in particular as the Federal Reserve Board contemplates the possible end of both quantitative easing and the period of near zero interest rates that has persisted for the last five years.

After a brief examination of the developing trends in the fixed income market, this IM Guidance Update suggests certain steps that fund advisers may consider with respect to risk management and disclosure matters relating to changing market conditions. To assist fund boards in providing appropriate oversight of the funds, fund boards may want to consider discussing with fund advisers the steps these advisers are taking in this area. Below, this IM Guidance Update discusses the types of information fund advisers may want to consider providing boards to facilitate this oversight function.

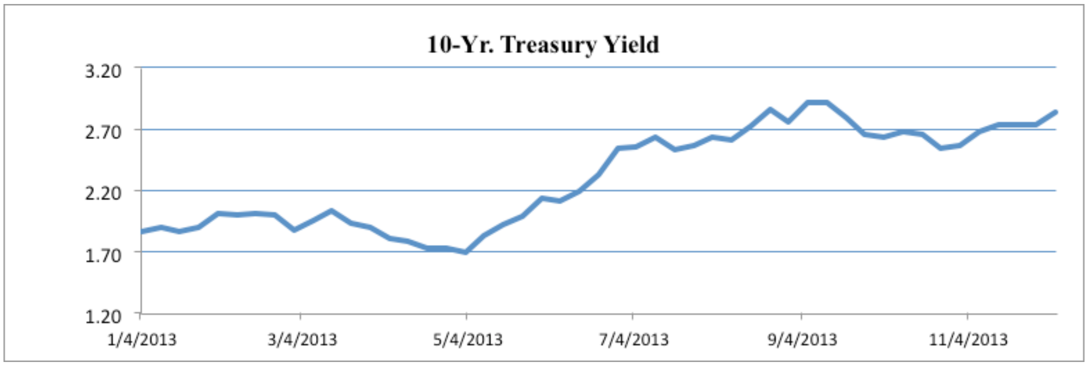
II. *Background*

After nearly three decades of bond market growth, the net assets of bond mutual funds and ETFs are at near-historic highs of $3.6 trillion,[1] with much of this growth coming recently—bond fund and ETF assets have increased by over $2 trillion since the end of 2008.[2]

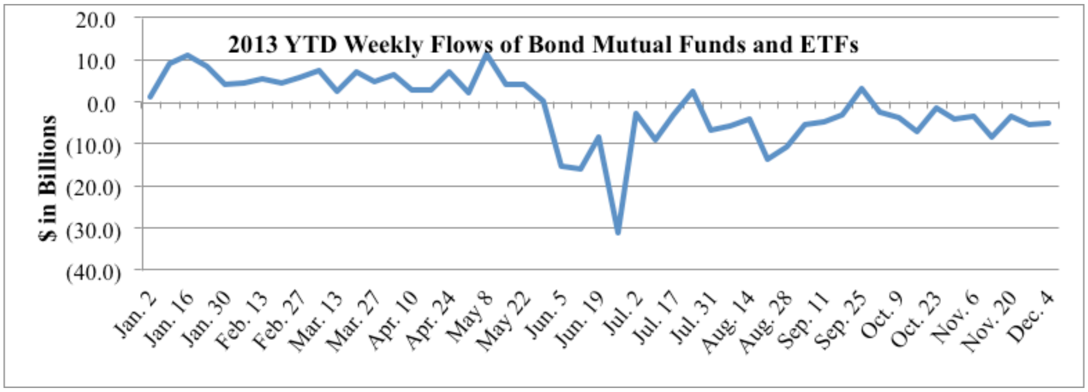


Source: Investment Company Institute

In June, however, the 10-year Treasury note yield rose by almost 50 bps, bond fund prices fell, and bond mutual funds and ETFs experienced net outflows of $68 billion (approximately 1.8% of aggregate assets).[3]

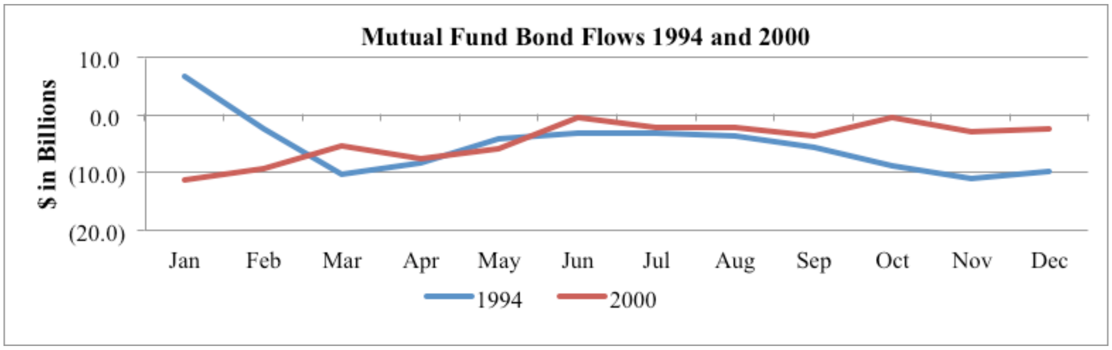


Source: Federal Reserve



Source: Investment Company Institute, Morningstar Direct

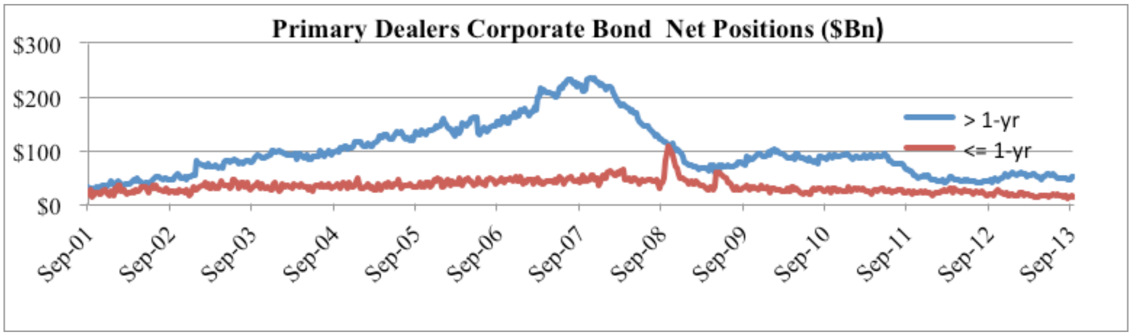
Net outflows from bond mutual funds in periods of rising interest rates is not a new phenomenon. For example, in each of 1994 and 2000, rising interest rates led to several months with bond mutual fund outflows of 1 to 2 percent of aggregate assets.



Source: Morningstar Direct

However, recent outflows are occurring in a somewhat different environment. Prior periods of rising interest rates and fixed income market volatility occurred when the market for bond funds was much smaller and dealer inventories, which are a core indication of their capacity to intermediate (or "make a market") in the fixed income market, were much greater.[4] Bond mutual fund assets stood at $619 billion at the end of 1993 and $812 billion at the end of 1999, or about one-fifth the size of today's market.[5]

While assets in bond mutual funds and ETFs have grown rapidly in recent years, dealer capacity in the fixed income markets appears to have undergone fundamental changes. Today, primary dealer capacity is at similar levels to 2001, while bond mutual fund and ETF assets have grown by a factor of four since that time.[6] Primary dealer inventories of corporate bonds appear to be at an all-time low, relative to the market size, with holdings of approximately $50 billion (0.5% of market size) compared to a peak of approximately $250 billion (4% of market size) before the financial crisis.[7]



Source: Federal Reserve Bank of New York[8]

This apparent reduction in market-making capacity may be a persistent change, to the extent it is resulting from broader structural changes such as fewer proprietary trading desks at broker-dealers and increased regulatory capital requirements at the holding company level.[9] A significant reduction in dealer market-making capacity has the potential to decrease liquidity and increase volatility in the fixed income markets.[10] These (and other) issues relating to the fixed income market were discussed at the SEC's April 16, 2013 Roundtable on Fixed Income Markets.[11]

III. *Risk Management and Disclosure*

Given the potential fixed income market volatility, which may be exacerbated by changes in bond market size and structure discussed above, the Division of Investment Management staff notes the following steps that fund advisers may consider taking:

Assess and Stress Test Liquidity

Consistent with Section 22(e) of the Investment Company Act of 1940, fund advisers generally assess overall fund liquidity and funds' ability to meet potential redemptions over a number of periods.[12] In light of potential market volatility, fund advisers may consider assessing fund liquidity needs during both normal and stressed environments, including assessing their sources of liquidity (such as cash holdings and other assets that would not require selling into declining or dislocated markets if volatility or market stress increases). The assessments may include, for example, needs and sources of fund liquidity over 1 day, 5 days, 30 days, and potentially longer periods.

Conduct More General Stress-Tests/Scenario Analyses

Fund advisers may consider assessing the impact (beyond just liquidity) of various stress-tests and/or other scenarios on funds. For example, they may consider stress-tests involving interest rate hikes, widening spreads, price shocks to fixed income products, increased volatility and reduced liquidity, among other factors.

Risk Management Evaluation

Fund advisers may want to consider using the outcomes of any assessments, analyses, and conversations to evaluate what risk management strategies and actions are most appropriate, if any, in response to changing fixed income market conditions at a fund and/or the complex level. These may include decisions around portfolio composition, concentrations, diversification and liquidity, among other factors.

Communication with Fund Boards

Fund advisers may consider what information should be provided to fund directors so that they are informed of the risk exposures and liquidity position of the fund, and the fund's ability to manage through changing interest rate conditions and potentially increased fixed income market volatility.

Shareholder Communications

Funds should also assess the adequacy of their disclosures to shareholders in light of any additional risks due to recent events in the fixed income markets and the potential impact of tapering quantitative easing and/or rising interest rates, including the potential for periods of volatility and increased redemptions. If a fund determines that its risk disclosure to shareholders is not sufficient in light of these recent events, the fund should consider the appropriate manner of communicating risks to shareholders (e.g., prospectus, shareholder reports).

Endnotes

1 Data based on Investment Company Institute, Exchange-Traded Funds June 2013 (July 26, 2013); Investment Company Institute, Trends in Mutual Fund Investing June 2013 (July 30, 2013).

2 Data based on Investment Company Institute 2013 Factbook, table 3.

3 Based on Investment Company Institute data.

4 As noted in the text, the size of dealer inventories is a proxy for their appetite and capacity to make markets by committing their own capital, as principal, to intermediate for time and size differences in demand between buyers and sellers in the fixed income market. Dealers may also provide market liquidity by acting in an agency or "riskless principal" capacity. However, the amount of agency or riskless principal trading in the fixed income market by institutional investors generally accounts for only a small fraction of market volume.

5 Data based on Investment Company Institute 2013 Factbook, table 3. Fixed income ETFs did not hold enough assets to be tracked in 1993 and 1999.

6 Based on data from the Investment Company Institute 2013 Factbook, table 3 and Federal Reserve Bank of New York Primary Dealer Statistics, which began collecting statistics on corporate debt positions in 2001.

7 Based on Federal Reserve Bank of New York Primary Dealer Statistics.

8 Data includes certain asset-backed securities (such as credit card, student loan and automobile loan-backed securities), but excludes mortgage-backed securities.

9 Many bank holding companies increased their capital ratios after the financial crisis. The Federal Reserve Board also recently adopted increased bank capital requirements to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision, which will be phased in starting January 1, 2014. See Federal Reserve System, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule (July 2, 2013).

10 While other trading venues in the fixed income market may be available, such as centralized, electronic trading platforms, there is no indication that these platforms

have expanded overall liquidity, nor do they appear to be widely used by institutional investors. See Danielle Robinson, Bonds Struggle in Transition to E-Trading, Reuters (August 9, 2013), available at http://www.reuters.com/article/2013/08/09/etrading-bonds-idUSL1N0GA13R20130809.

11 A transcript of the Roundtable, along with other information on fixed income markets, is available at: http://www.sec.gov/spotlight/fixed-income-markets.shtml.

12 Section 22(e) of the Investment Company Act of 1940 requires a registered investment company to pay shareholders for securities tendered for redemption within seven days of tender. Current SEC guidance provides that open-end funds (other than money market funds) should limit their investments in illiquid assets to 15% of the fund's net portfolio assets, with an illiquid asset defined for these purposes as one that cannot be sold at or near its carrying value within seven days. Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992); ASR 113. See also Exchange-Traded Funds, Investment Company Act Release No. 28193 at n.34 (Mar. 11, 2008) [73 FR 14618 (Mar. 18, 2008)] (proposing release). The Guidelines to Form N-1A were prepared by the Division of Investment Management and published by the Commission when it adopted Form N-1A in 1983. Although the Commission in 1998 rescinded the Guidelines to Form N-1A, it has not withdrawn the 1992 release modifying the liquidity guidelines for open-end funds. Those guidelines are Commission guidance and remain in effect.

The Investment Management Division works to:

- protect investors
- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

If you have any questions about this IM Guidance Update, please contact:
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