

Discussion: Intermediary Balance Sheet Constraints, Bond Mutual Funds' Strategies, and Bond Returns

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- **Bank-affiliated dealers decreased liquidity supply in the bond market due to regulation** (Adrian et al. 2017; Bessembinder et al. 2018; Bao et al. 2018; Dick-Nielsen and Rossi 2019...)
- **Who is stepping in as alternative liquidity providers?** (Choi et al. 2021; O'Hara et al. 2022; Kruttli et al. 2024)
- **Mutual funds have become increasingly important in the corporate bond market** (Feroli et al. 2014; Goldstein et al. 2017...)

- Mutual funds supply more liquidity in the IG market after the introduction of leverage ratio constraint
 - Liquidity-supplying (LS) funds have better performance
 - Funds are more likely to adopt LS-strategy when past performance has been good
- Liquidity and returns of constrained bonds are more sensitive to mutual funds' funding condition post-regulation (Falato et al. 2021; Haddad et al. 2021; Ma et al. 2022...)

This Paper

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- Liquidity and returns of constrained bonds are more sensitive to mutual funds' funding condition post-regulation (Falato et al. 2021; Haddad et al. 2021; Ma et al. 2022...)
- Important work on how market participants are adapting to a new regulatory environment
 - Comprehensive analysis from multiple angles (returns, fund performance, flows...)

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Consider a dealer-sector with demand

$$x_d = \gamma(\mu - p)$$

- Apply market clearing, the dealer's inventory depends on the total demand shock $\epsilon_1 + \epsilon_2$

$$x_d = -\gamma \frac{\epsilon_1 + \epsilon_2}{\alpha_1 + \alpha_2 + \gamma}$$

Comment 1: LS-funds

- Suppose $\epsilon_1 + \epsilon_2 < 0$ (selling pressure) \Rightarrow the dealer has positive inventory $x_d > 0$
- Fund 1 is a LS-fund if and only if

$$x_1 = \frac{(\alpha_2 + \gamma)\epsilon_1 - \alpha_1\epsilon_2}{\alpha_1 + \alpha_2 + \gamma} > 0$$

- Nature of shocks: ϵ_1 positive (or not too negative)
- Demand elasticity: $\epsilon_1 = \epsilon_2 < 0$, but $\alpha_1 > \alpha_2 + \gamma$
- Tighter regulation $\gamma \downarrow$, $x_d \downarrow$ and $x_1 \uparrow$

Comment 2: Implication on Volatility

- If LS-funds provide liquidity because they are very elastic, they lower return vol and the impact of regulation
 - Comparing demand elasticities of LS and non-LS funds
 - What fund features allow them to be elastic and do these features persist during crisis?

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 - Comparing demand elasticities of LS and non-LS funds
 - What fund features allow them to be elastic and do these features persist during crisis?
- If LS-funds provide liquidity because they happen to have opposite demand shocks, then it depends on whether it is idiosyncratic or systematic
 - How persistent is the LS characteristic?
 - Does the flow of LS-funds load negatively on aggregate flows?

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 $\gamma \downarrow \Rightarrow vol(p) \uparrow$
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- The analysis on fund flows seems to suggest an amplification effect \Rightarrow clarify the mechanism

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 - More elastic demand alleviates the impact of regulation
 - Short-term investors amplify the effect of illiquidity on bond prices (Li and Yu, 2023)

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- Many interesting results on the comparison b/w constrained and unconstrained bonds
 - Bonds have different exposure to the leverage ratio regulation
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 - Is this a consistent interpretation?
- Use intermediation activity in earlier periods to approximate exposure

Conclusion

- Great paper!
- The paper highlights the liquidity provision role of mutual funds in response to the new regulatory landscape
 - May become more and more relevant
 - Important implications for market stability
- Would be great to sharpen the interpretation further
- Really enjoyed reading the paper! Thank you