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

Mariassunta Giannetti    Chotibhak Jotikasthira
Andreas C. Rapp          Martin Waibel

Jane (Jian) Li
Columbia University

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Motivation

- 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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- Important work on how market participants are adapting to a new regulatory environment
  - Comprehensive analysis from multiple angles (returns, fund performance, flows...)
Comment 1: LS-funds

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- Consider two funds with demand

  \[ x_i = \alpha_i(\mu - p) + \epsilon_i \quad i \in \{1, 2\} \]

  Consider a dealer-sector with demand

  \[ x_d = \gamma(\mu - p) \]
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Apply market clearing, the dealer’s inventory depends on the total demand shock \( \epsilon_1 + \epsilon_2 \)

\[ x_d = -\gamma \frac{\epsilon_1 + \epsilon_2}{\alpha_1 + \alpha_2 + \gamma} \]
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: \( \epsilon_1 \) 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?
The paper suggests that regulation may have increased volatility:

\[ \gamma \downarrow \Rightarrow vol(p) \uparrow \]

How does the existence of LS-funds fit into this?

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)
Comment 3: Constrained Bonds

- Many interesting results on the comparison between constrained and unconstrained bonds
  - Bonds have different exposure to the leverage ratio regulation
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- Use intermediation activity in earlier periods to approximate exposure
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