VIDEO

February 9, 2018

Focus on Funds: Bond Fund Flows Remain Strong Despite Rising Interest Rates

Focus on Funds

Bond Fund Flows Remain Strong Despite Rising Interest Rates

Rising interest rates often lead to bond fund outflows—but over the past year, bond funds have actually seen inflows. In the February 9, 2018, edition of *Focus on Funds*, ICI Chief Economist Sean Collins analyzes what's going on.

Transcript

Stephanie Ortbals-Tibbs, ICI director, media relations: The US is now in a rising interest rate environment. So what will that mean to bond funds and their investors? Recently, ICI Chief Economist Sean Collins walked us through the data and what it means.

Sean Collins, ICI chief economist: It looks like this time, it's for real. The Fed has raised short-term interest rates 1.5 percent since September of 2016 and, judging from Fed fund's future markets, it looks like they'll probably go about another 1.5 percent in the rest of 2018. That's likely to put upward pressure on longer-term interest rates, and downward pressure on bond prices—and, in return, downward pressure on bond fund returns.

Ortbals-Tibbs: Yes, because that's a pretty big uptick, so one would then begin to turn toward bond funds, and then think about what that is going to mean for flows. Are people going to pull out, or what's going to happen?

Collins: Historically, what we've seen as interest rates rise, investors in bond funds tend to respond very modestly, pulling some money out—but it's very modest. What we saw in 2017 was a little bit of a disconnect. We saw a *very* sharp rise in the stock market—about 20 percent. Bond returns were about flat. And you would think that, in that environment, people wouldn't be putting money into the bond funds—but just the reverse happened. We saw *very* strong inflows into bond funds, and that pretty much continued throughout the year. So it's a bit of a disconnect.

Ortbals-Tibbs: And there are some drivers behind that, that people need to understand.

Collins: Probably at least two things are behind that. One is that, with the stock market rising so much in 2017, if you want to keep your portfolio in balance, you're going to have to buy a lot of bonds, if you've also got stocks. That's one factor.

Another factor is demographics. Generally, as people age toward retirement age, they tend to move more of their portfolio toward bonds or bond funds. So what we're seeing now is the Baby Boomers hitting full retirement age, and that's going to continue for about another 10 to 15 years. As that happens and those Baby Boomers move toward bond funds, that creates a natural demand for bond funds. Both of those factors together probably help explain what happened in 2017.

Ortbals-Tibbs: So for policymakers who are then looking at 2018 and beyond, trying to understand what could happen with bond funds in a rising interest rate environment, what is the takeaway?

Collins: We've been in an interest rate environment where interest rates haven't changed for a long time. There's been a lot of talk about what could happen when interest rates begin to rise—speculation that certain investors in bond funds, that are new to bond funds, have never seen an interest rate cycle and they might react more strongly than other investors have in the past.

In fact, it could be just the reverse, because we've got strong inflows from Baby Boomers that are going to provide natural demand for bond funds going off into the future. Even as interest rates rise, we could have a very strong demand for bond funds, which will offset any effect of yields rising or of bond fund returns falling.

Additional Resources

- Weekly Estimated Flow Report
- Monthly Exchange-Traded Fund Assets
- Investment Company Fact Book: Recent Mutual Fund Trends
- Chart: Federal Funds Rate: This Time It's for Real (pdf)
- Chart: Flows to US-Regulated Bond Mutual Funds Are Related to Bond Returns (Usually) (pdf)
