**MONETARY POLICY AND CORPORATE BOND MUTUAL FUND FRAGILITY**

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**QUESTION**

How does monetary policy (level and uncertainty) affect corporate bond mutual fund fragility?

- In a liquid market, loose monetary policy or high monetary policy uncertainty exacerbates the fragility of corporate bond mutual funds.

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**MOTIVATING EVIDENCE**

Federal Fund Rate and Corporate Bond Mutual Fund Fragility

- Fund fragility is approximated by fund flow-to-past-performance sensitivity.

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**KEY INTUITION**

- Fund fragility arises from first-mover-advantage of early-withdrawal investors.
- Fund investors tradeoff 1) complementarity discounted fund return for 2) bank return.
- When market is liquid, complementarity discount is weak $\Rightarrow (1) > (2)$.
- Loose monetary policy reduces positive gap between (1) and (2), incentivising investors' withdrawal (high fund fragility).
- High monetary policy uncertainty raises the likelihood that (2) bypasses (1), incentivising investors' withdrawal (high fund fragility).

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**CONTRIBUTIONS**

- New evidence on the impacts of monetary policies on non-banking financial intermediary's stability.
- Highlight the interaction effects between monetary policy and market liquidity on the mutual fund industry through asset allocations.

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**ALTERNATIVE EXPLANATION**

- Because fund fundamental performance is worse under loose monetary policy such that flow-performance sensitivity is higher?
- **NO!** Fund performances are better in the cases with higher fund fragility?

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**MODEL**

- $T_0$: Atomic investors with measure $W$, each has 1 unit of capital to invest in fund or bank.
- Fund manages a long-term asset with expected yield $r_2(L)$ over $T_0$ to $T_2$.
- Bank offers a short-term asset with a known return $F$ over $T_0$ to $T_1$, and an uncertain return $F + \sigma R$ over $T_1$ to $T_2$, where $R \sim F()$.

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**DATA**

- Corporate bond mutual funds in CRSP survivor-bias-free US mutual fund database.
- Monetary policy uncertainty: MPU (Husted, Rogers, and Sun 2017).
- Fund performance: $\alpha_{t+1}$ (Chen, Goldstein, and Jiang 2010).

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**RESULT – H1**

$\alpha_{t+1} \sim \alpha_{t+1} + 1(\text{High FF}) + \text{Controls}$

- **Iliquidity**
  - VIX: $-0.996^{**}$
  - TED: $-5.345^{***}$
  - DFL: $0.281^{*}$, $0.031^{*}$, $0.392^{***}$

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**RESULT – H2**

$\alpha_{t+1} \sim \alpha_{t+1} + 1(\text{High MPU}) + \text{Controls}$

- **Iliquidity**
  - VIX: $-0.978^{**}$
  - TED: $7.044^{***}$
  - DFL: $-1.473$, $-1.082$, $-0.766^{***}$

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**PREDICTIONS**

- **H1**: The more liquid the market is, the *looser* monetary policy exacerbates the fund fragility.
- **H2**: The more liquid the market is, the *higher* monetary uncertainty exacerbates the fund fragility.