Discussion of Reaching for Yield by Corporate Bond Funds
Choi and Kronlund

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Overview

Many recent papers focus on reaching for yield.

- Acharya and Naqvi (2015)
- Becker and Ivashina (2014) — Insurance Firms.

This paper studies whether corporate bond funds reach for yield.

- Uses fund level holdings and flow data to study this issue—impressive data set.
- Sample covers the 2002–2012 period.
Approach

- Computes measure of reaching for yield:

$$= \sum_j w_{j,i,t}(y_{j,t} - y_t^{AGG})$$

- Since weights sum to one, this is just the yield on fund minus yield on Lehman Agg.

- Reaching for yield is decomposed into three components:
  - Holding lower rated bonds.
  - Holding longer maturity bonds,
  - Holding higher yielding bonds within each rating and maturity bucket.

- Also decomposes changes in the reaching for yield measure into active and passive components – less intuitive decomposition.
Key Findings

- On average, funds hold lower yielding portfolio than Lehman Agg, which they interpret as negative reaching for yield.
- Reaching for yield increases during low rate, flat slope, and tight credit spread environments.
- Younger funds and larger funds tend to reach for yield more.
- Cash flows to funds that actively reach for yields.
- Funds that reach for yield have higher returns.
- Higher returns is due to beta—no alpha.
Paper focuses exclusively on corporate bond funds.

Why not other types of fixed income funds?
  - Mortgage funds.
  - Agency funds.
  - Fixed income allocation funds.
Earlier version focused only on reaching for yield within rating and maturity bucket.

New version also considers changing ratings and maturity.

But there is still an additional dimension that needs to be explored.

Average fund invests only 46.9% of its assets in corporate bonds.

Analysis doesn’t consider what happens to the rest of the portfolio.

How does the fund change its allocation to other asset classes?

What role do the other asset classes play in yields, returns, and liquidity?
Reaching for Carry?

- Many market participants have “carry illusion.”
- For bonds, carry determined by both the yield and the rolldown on the bond.
- Carry is the deterministic component of returns — may seem more real to PMs.
- Analogy of options traders and theta.
- But yield is only one component of carry, which, in turn, is only one component of expected return; slope of term structure is integral determinant of rolldown for a bond.
- Results may be more informative if analysis conducted in carry space rather than yield space.
Reaching for Liquidity?

- In general, lower yielding bonds are less liquid.
- But there are many exceptions to the rule.
- Can we rule out that within ratings and maturity buckets, funds are picking the most liquid bonds with the lowest transaction costs — which may result in their portfolio being different from Lehman Agg?
- Appendix shows that funds tend to underweight AAA, AA, and A ratings.
- Could it be that this is because funds overweight more liquid Treasuries and Agencies?
- Fidelity’s $115 billion Cash Reserve fund to go 100% Treasuries by Dec 1.