Discussion of Reaching for Yield by Corporate Bond Funds

Choi and Kronlund

by Francis A. Longstaff — UCLA Anderson School

November 2015

Overview

- Many recent papers focus on reaching for yield.
  - Acharya and Naqvi (2015)
  - Becker and Ivashina (2014) — Insurance Firms.
  - Di Maggio and Kacperczyk (2014) — Money Market Funds.
  - Hanson and Stein (2015) — Commercial Banks.
- 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.

Comments I

- Paper focuses exclusively on corporate bond funds.
- Why not other types of fixed income funds?
  - Mortgage funds.
  - Agency funds.
  - Fixed income allocation funds.

Comments II

- 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.