Insight

Pimco Provides a Real World Test of FSOC's Systemic Risk Hypothesis

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When superstar bond investor Bill Gross left Pacific Investment Management Company (Pimco) last year it "stunned the investment world," according to the *Wall Street Journal*. "The nation's most prominent bond investor" in the words of the *New York Times*, Gross had directly managed for almost three decades what became the largest bond fund in the world, reaching a size of almost $300 billion in assets. For the asset management industry, this was a watershed event.

For the Financial Stability Oversight Council (FSOC), it was a test of a hypothesis. All through 2014, FSOC – charged with identifying systemic risks among the nation's financial firms – had been attempting to make the case that asset managers (i.e., mutual funds like Pimco) posed a systemic risk. What FSOC got in the Pimco debacle was as good example of a real life shock hitting a major fund. It was a real time test of their theory.

In public policy, we rarely get clean experiments in which to test theories. Looking at the before and after of an event never allows us to control for all the innumerable variables. And we don't get to run side-by-side comparisons of identical worlds: one with our treatment and the other as a control. So we look to real life events as an imperfect test of our theories – not as dispositive, but instructive nonetheless.

Fortunately Pimco gave us some extremes that can help drive a conclusion: (1) it is/was the largest fund in the world; (2) the news which sent investors running for the exits was as close to a surprise twist as exists in today's hyper-connected world. On the latter, even Gross was surprised by the decision. When news broke, the extant stream of redemptions immediately turned into a tsunami. Wall-to-wall financial press coverage of the story only added to the natural disaster feel of things.

The uncertainty surrounding his exit, its sudden and unexpected nature, the fund's vast size and influence, and its massive exposure to sovereign debt including Treasuries, meant this should have been a fairly destabilizing event. And for Pimco it looked like it very well may have become one. Investor redemptions increased to almost $8 billion a day. The fund eventually stabilized after losing 45 percent in assets.

But what happened in the end to Pimco and its Total Return Fund are ultimately side issues. Systemic risk entails the contagion that could spread from one firm or market to others throughout the system, resulting in 2008 redux. Even if the fund couldn't stanch the bleeding and had to close up shop, FSOC's case has more to do with those other companies and markets the fund had exposure to. They themselves emphasize the unique risks posed by illiquidity in the bond market. Yet what we saw was little to no evidence of a wider disruption in the types of bond markets the fund was heavily exposed to. Even Total Return Fund's massive plays in U.S. Treasuries are really only a small fraction of the daily transactions of this type of instrument – for example, 10-year yields stayed pretty much where they have been for months, in the two percent range.

It's not that surprising this whole thing amounted to more heat than light. Mutual funds are structurally just a bundle of investment risk wrapped in equity. Fund investors are shareholders in the fund, and those investments make up the entirety of the fund's assets (which are incidentally never held on the balance sheet of the fund manager). The fund always faces the possibility that its assets will decline in value, but the worst case scenario is massive losses for investors and the fund closes. With the exception of a few leveraged and inverse funds (which can always be regulated separately), leverage doesn't enter into it, meaning the assets can always be sold at market price to convert shares into cash.

So while it may have amounted to a pretty major media story, Bill Gross' "conscious uncoupling" with Pimco and the free fall of his longtime personally managed fund, showed us what we already kind of knew. Mutual funds are not banks, and they pose no systemic risk.

Fortunately FSOC has in recent months tapped the brakes on its push to designate some asset managers as "systemically important financial institutions" and thus subject them to bank-like capital requirements. What we have now is a test of policymaker humility in the face of available evidence.