# When rates rise, will bond fund owners bolt?

By Editor Test *Wed, Nov 21, 2012*

*History shows that intermediate-term bond funds are likely to see less flight than junk bond funds, a Schwab executive writes in the Journal of Financial Planning.*

**Table 1: Correlation of Monthly Total Returns with Monthly Net Cash Flows**

| Period | High-Yield Bond | Intermediate-Term Bond |
|---|---|---|
| August 1992–July 2012 | 0.53 | 0.10 |
| August 1992–December 1995 | 0.79 | 0.53 |
| January 1996–December 2000 | 0.47 | 0.08 |
| January 2001–December 2005 | 0.65 | 0.35 |
| January 2006–December 2010 | 0.65 | 0.22 |
| January 2011–July 2012 | 0.72 | –0.27 |

Source: Barclays Capital (return data) and Morningstar (cash flow data for mutual funds)

As bond funds continue to absorb assets and the Fed's policy of suppressing long-term interest rates continues, some observers wonder if a bond bubble is building. They fret that if and when interest rates on new bonds begin to rise and depress the prices of existing bonds, bond fund owners might panic and make the problem worse.

In an essay in this month's issue of the *Journal of Financial Planning*, Mark W. Riepe, CFA, president of Charles Schwab Investment Advisory in San Francisco, looked at the historical relationship between changes in interest rates and fund flows for intermediate-term (average maturity, four to 10 years) bond funds and for high-yield or "junk" bond funds from August 1992 to July 2012.

Riepe assumed that high-yield fund shareholders would be "more active and motivated by tactical considerations when deciding to get in or out of a fund" and that "the intermediate bond category is more likely to be populated by shareholders who have a longer-term, strategic mindset and seek diversification from stocks." The correlation between fund outflows during rate hikes would likely be stronger in high-yield bond funds than in intermediate-term bond funds, he hypothesized.

Riepe constructed a series of monthly net asset flows for all mutual funds within the high-yield and intermediate-term categories between the dates listed above, using data from Morningstar. The data on individual funds were aggregated into category totals. The category totals were then correlated with the monthly returns of the Barclays Aggregate Index (for intermediate bond) and the Barclays U.S. Corporate High Yield Index (for high yield).

The data confirmed Riepe's expectations. They showed that the high-yield category had a positive net cash flow in only 8 of the 64 months when there was a negative total return to the high-yield index, for a 0.53 correlation between returns and net cash flows over the 20-year period. For intermediate bond fund flows, the correlation was only 0.10, though it reached 0.53 when rates rose over a three-year period in the early 1990s. (See chart from *Journal of Financial Planning* below.)

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"High-yield investors, I suspect, will be the quickest to pull the trigger and redeem shares if rates rise… On the other hand, high-yield returns are not driven solely by interest rate movements. High-yield returns have been correlated with equity returns in the past. If rising rates are accompanied by rising stock prices, flows may be modest," Riepe wrote.

For intermediate-term bond funds, demographics may dampen flows. "If rates increase month after month, as in 1994, some outflows [from intermediate-term bond funds] appear to be likely," he said. But given boomers' age and conservatism, he expected them to largely stick with their core bond fund choices even if rates rise.