

The Benefits and Design of Swing Pricing

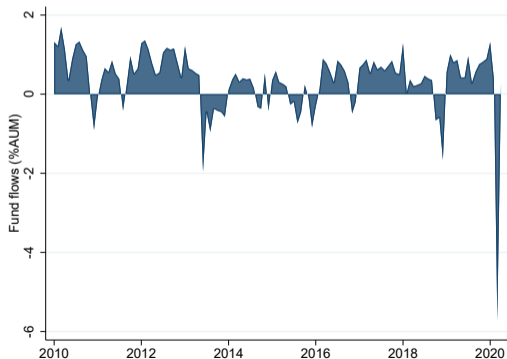
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SEC Investor Advisory Committee Meeting:
Open-End Fund Liquidity Risk Management and Swing Pricing
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Fund Liquidity Transformation is Vulnerable to Runs

- ▶ U.S. fixed-income mutual funds experienced unprecedented run-like outflows during Covid, straining asset markets
- ▶ Outflows at equity funds were much smaller → illiquidity

Figure: Outflows from Bond Funds during the Covid-19 Crisis



1. Swing Pricing can Prevent Fund Runs

- ▶ Liquidity transformation **without swing pricing**
 - ▶ Fund NAV does not reflect the full cost of investor redemptions
 - ▶ Investors want to “run” before others do
- ▶ Liquidity transformation **with swing pricing**
 - ▶ Fund NAV is adjusted to proportionally distribute the costs from investor redemptions
 - ▶ Incurred and anticipated discounts from flow-induced sales (Capponi, Glasserman, and Weber 20, Ma, Xiao, and Zeng 22b)
 - ▶ Costs from dynamic portfolio rebalancing (Zeng 17)
 - ▶ Investors do not need to “run” before others do

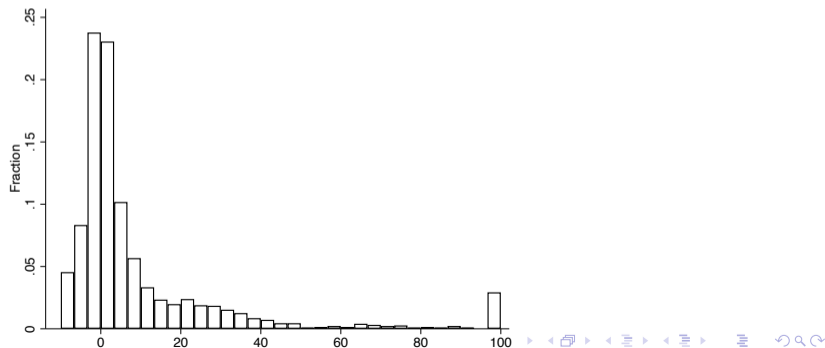
2. Swing Pricing and Liquidity Provision to Investors

- ▶ Concern: investors are hurt because those redeeming funds receive less than their NAVs during outflows
- ▶ However: this argument neglects the equilibrium effect of swing pricing on fund asset holdings
 - ▶ Without swing pricing, bond funds hold cash buffers to meet large outflows
 - ▶ Cash is a drag on fund performance
 - ▶ Swing pricing prevents fund runs and reduces funds' need of holding cash (Jin et al. 2022, Ma, Xiao, and Zeng 2022b)
 - ▶ Fund performance is improved, benefitting investors
- ▶ Therefore, swing pricing could enhance rather than constrain the capacity for liquidity provision

2. Swing Pricing Improves Liquidity Provision to Investors!

- ▶ Ma, Xiao, and Zeng 22b: swing pricing **enhances** liquidity provision for the majority of corporate bond funds
- ▶ On average, fund liquidity provision is **increased** by 6.7%.

Figure: Change in Liquidity Provision with Swing Pricing



3. Swing Pricing versus Swing Pricing Constraints

- ▶ Concern: swing pricing cannot prevent runs and may even trigger runs
- ▶ However: this argument confuses the effect of swing pricing with the effect of constraints on swing pricing
- ▶ Constraints:
 1. Maximum swing factor (cap)
 2. Minimum Swing Threshold

3.1 Maximum Swing Factor

- ▶ A cap on the swing factor essentially makes swing pricing ineffective after that cap is reached
- ▶ This is precisely when we need swing pricing the most, i.e. during crisis times with high illiquidity and large outflows
 - ▶ In several EU Jurisdictions, caps were lifted and funds applied higher swing factors during Covid-19

→ Support removal of the maximum swing factor

3.2 Minimum Swing Threshold

- ▶ Outflows/inflows have to reach a certain threshold before swing the swing factor is applied
- ▶ The presence of a threshold may trigger investors to redeem in order to avoid hitting the threshold in the first place
 - ▶ Evidence from MMFs (Li, Li, Machiavelli, and Zhou 21)
- ▶ Current proposal: 1% threshold for outflows and 2% threshold for inflows for proper swing pricing with market impact

→ Suggest to rethink the market impact swing threshold and/or better justify its choice

Conclusion

Strongly support the implementation of swing pricing for open-end funds but suggest to carefully design the specifics

1. Swing pricing prevents panic runs
 - ▶ Key for the stability of the fund sector and the financial system
2. Swing pricing enhances liquidity provision to investors
 - ▶ Funds can hold less cash and more assets without fire sales
3. Swing pricing \neq constraints on swing pricing
 - ▶ Support the removal of the maximum swing threshold
 - ▶ Suggest to rethink the market impact swing threshold
4. Communicate all the above to investors to remove stigma

References

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