‘Intoxicated’ institutional investors: how the financial crisis infected the real economy

In this short article, republished for Criticaleye courtesy of INSEAD Knowledge, **INSEAD** explains that one of the least understood aspects of the financial crisis is how it spread from the financial sector to the general economy, where it nearly caused a global financial meltdown.

“We could look at the onset of the crisis as a shock to the liquidity of one market sector -- asset-backed securities” says INSEAD PhD candidate Alberto Manconi. “In August 2007, all of a sudden we realised that we didn’t really know how to price these securities. For this reason, very few investors were willing to trade them.”

How the financial crisis moved from this one specialised sector to the general economy is addressed by Manconi in his paper *The Behaviour of Intoxicated Investors: the Role of Institutional Investors in Propagating the Financial Crisis of 2007-2008*, which he researched with Massimo Massa, Professor of Finance at INSEAD, and Ayako Yasuda, Assistant Professor of Management at the Graduate School of Management UC Davis.

Manconi’s PhD dissertation research looks at the role of institutional investors in the market and their impact on firm policies. In *The Behaviour of Intoxicated Investors*, Manconi, Massa and Yasuda investigate the role of institutional bond investors (in particular, mutual funds and insurance companies) in propagating financial market instability. ‘Intoxicated’ investors are investors who buy into the market mainly because everyone else is doing it, in effect following the herd.

These institutional bond investors are thought to hold significant amounts of asset-backed securities, including collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and collateralised mortgage obligations (CMOs), as part of their debt portfolios. By some estimates, their collective exposure in mid-2007 exceeded even that of banks.

“This suggests that studying the determinants of their actions, both in the pre-crisis period where they made initial purchase decisions, and in the crisis period where they faced decisions whether - and when - to dispose of these securitised debt instruments, could shed light on the causes and effects of the credit crisis that we are in today,” the authors say in the abstract on their research.

So how did the crisis break out of the confines of the financial sector and infect the general economy?

“We suggest the following mechanism,” Manconi explains. “Suppose that an institutional investor, such as a mutual fund, simultaneously holds one part of its portfolio in structured products, mortgage-backed securities for instance, and holds another part in corporate bonds.”

Corporate bonds are an essential source of financing for companies and account for almost half of the overall outstanding US corporate debt. Companies use the funds they raise by issuing these bonds to build new factories, expand existing ones, conduct product research and development, and so on. So when the crisis moved from mortgage-backed securities in the financial sector to corporate bonds, this negatively affected the ability of firms to finance their operations. This in turn would have an impact on the economy. In other words, the corporate bond market was one channel through which the financial crisis could reach the real economy.

The authors suggest the financial crisis made the jump to the corporate bond market, and thus to the general economy, as follows. As the crisis unfolded, more and more institutional investors in need of cash (for example, mutual funds needing to meet redemptions) faced a liquidation problem. That is to say, they needed to liquidate part of their portfolio. However, they could not sell the asset-backed securities in their portfolios due to the low liquidity levels in the market. As a result, they turned to their more liquid holdings: corporate bonds.

But with several mutual funds and other institutional bond investors also trying to liquidate their corporate bond holdings, the market for these, too, was flooded and so prices plunged. As a result, the cost to companies of obtaining financing by issuing corporate bonds increased. And, as a result of that, their ability to finance their operations was crippled, thus spreading the financial crisis to the real economy.

“The particular form of financing we are looking at in this paper is corporate bonds. We don’t directly look at other forms of financing, such as equity and bank loans, which may offer additional explanations of how the crisis moved from the financial sector of the economy to the real sector,” Manconi acknowledges. “But this is one explanation that has been overlooked so far.”

But if correct, his analysis could point to a way of keeping future financial crises contained.

“Our results indicate that this transmission channel is created primarily by institutional investors with a short horizon,” argues Manconi. “These are the ones facing a more urgent liquidation problem, whereas the ones with a longer horizon could potentially wait until the market turmoil has subsided.”

This points to an immediate policy implication. Lock-up clauses, or indeed any form of regulation that has the effect of lengthening the horizon of institutional investors, could limit, or even completely shut down, this form of transmission of financial shock to the corporate bond market.

“We are highlighting the channel through which the crisis could spread and we are saying this is an important channel that we should address if we want to avoid another crisis,” Manconi says. “As the part of the economy that is made up of institutional investors such as mutual funds is becoming more relevant, this channel will be even more relevant in the future.”