ICI GLOBAL
RESEARCH PERSPECTIVE

LONDON | HONG KONG | WASHINGTON, DC APRIL 2015

EXECUTIVE SUMMARY

Regulated Funds, Emerging Markets, and Financial Stability

In the quarter century since the fall of the Berlin Wall, the global economy has become much more open. With this new openness, capital flows to emerging market economies have boomed, and regulated fund holdings of emerging market securities have grown significantly.

From 2000 to 2013, emerging market economies received cumulative gross capital inflows of nearly US$10 trillion. Of this, $1.7 trillion is attributable to portfolio capital flows—flows which arise from foreigners' net purchases of stocks, bonds, and other securities issued by entities in emerging market countries. Even though portfolio capital flows make up only a small fraction of the total capital flows to emerging economies, observers have raised some concerns about their impact on emerging economies. In particular, some economists have suggested that regulated funds—which have contributed to the broad trend of portfolio capital flows to emerging economies—could prove to be a relatively unstable source of capital, perhaps even to the extent of posing systemic risks to emerging markets.

ICI's new research paper, "Regulated Funds, Emerging Markets, and Financial Stability," examines trends in regulated fund holdings of emerging market securities, and puts those trends in context to explain why regulated funds pose limited systemic issues for emerging economies.

The report begins by examining existing research into funds and whether they present systemic risk to emerging markets. It then addresses policymakers' and academics' concerns that certain kinds of fund-level behavior might increase volatility in capital markets of emerging economies. While questions about the role of regulated funds in emerging markets are understandable, suggestions that such funds are likely to disrupt the capital markets of emerging economies seem overstated for three main reasons. Regulated fund holdings of emerging market securities:

- remain a small portion of the total value of the stocks and bonds of emerging market countries;
- are relatively stable; and
- are generally diversified across a wide number of emerging economies, which limits the effects of their portfolio transactions on any particular country.

The report also addresses whether regulated funds may amplify changes in emerging market securities prices. New analysis demonstrates that returns on emerging market stocks and bonds are explained by factors other than funds' net purchases of emerging market stocks and bonds—the most significant being capital flows from other (non-fund) investors to emerging economies. In addition, the new analysis finds that while funds' net purchases of emerging market securities respond to returns on those securities, they do not have a persistent influence on the future returns.

This new analysis has important implications, not only about the role regulated fund holdings play in emerging economies, but also about how regulators study the effects of fund flows on emerging markets. When looking at the effects of regulated fund flows on the financial stability of emerging market economies, it is important that regulators consider all economic factors—as well as the portfolio capital flows from all foreign investors—rather than narrowly focusing on regulated funds and their activities.

KEY FINDINGS

- **Regulated fund holdings of emerging market stocks and bonds have grown significantly in the past decade.** This growth is part of a broader trend of investors seeking greater exposure to emerging markets, and these flows have supported strong growth in emerging economies. From 2010 to 2014, emerging market economies received cumulative gross portfolio capital flows of US$1.4 trillion. A small fraction of those inflows—less than $200 billion—came from regulated funds.
- **While regulated funds have contributed to the broad trend of portfolio capital flows to emerging economies over the past decade, they are unlikely to pose systemic risk to emerging markets.** New empirical results in this report suggest that there are three main reasons for this.
  - **First, regulated fund holdings of emerging market securities remain a small portion of the total value of the stocks and bonds of emerging market countries.** In 2013, regulated funds held just 4.3 percent of outstanding debt and 8.5 percent of the stock market capitalisation of emerging market countries. Other market participants are the dominant investors in emerging market equity and fixed-income markets.
  - **Second, while regulated funds represent a sizeable part of the foreign investor base in emerging market countries, they are a stable investor base.** Regulated funds are not the primary source of the variability of portfolio capital flows to emerging markets. As of 2013, regulated funds held more than half of the emerging market equities held by foreign investors and almost 30 percent of emerging market bonds held by foreign investors. But on average, regulated funds accounted for less than 15 percent of the variance of foreign portfolio capital flows to emerging markets from 2005 to 2013.
  - **Third, regulated fund holdings are diversified across a wide number of emerging economies, which limits the effects of their portfolio transactions on any particular country.** Regulated fund holdings are spread across more than 85 different countries, and if there were investor outflows from US and European regulated funds, funds could accommodate them by selling a small amount of securities from a wide range of those countries.

New Empirical Results

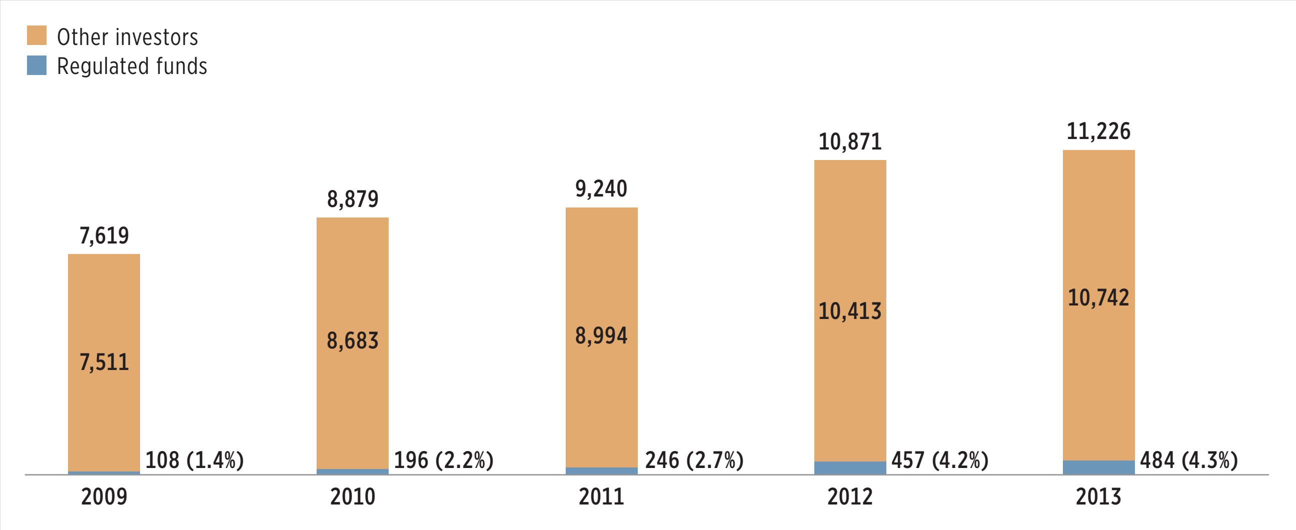
- **Monthly returns on emerging market securities are explained by factors other than funds' net purchases of emerging market stocks and bonds—most significantly by capital flows from other (non-fund) foreign investors.** For example, the returns on US Treasury securities and the S&P 500 index affect the returns on emerging market bonds and equities, respectively. More notably though, statistical analysis demonstrates that a broader measure of all foreign investor flows dominates net purchases by regulated funds. Thus, when this broader measure is included in the analysis, it shows that regulated funds' net purchases have no effect on monthly returns of emerging market securities. This suggests that regulators should focus on portfolio capital flows to emerging market countries from all foreign investors, rather than narrowly focusing on those from regulated funds.
- **Regulated funds' net purchases of emerging market securities do not drive returns.** Weekly data show that while net purchases respond with a lag to returns on emerging market securities, those purchases do not have a persistent effect on future returns. In addition, weekly data demonstrate that the gradual and lagged response of net purchases to returns explains much of the monthly correlation between net purchases and returns.

The full *ICI Global Research Perspective* is available at www.ici.org/pdf/icig_per02-01.pdf.

FIGURE 1

Regulated Funds' Share of Total Emerging Market Bonds Outstanding

Billions of US dollars (percentage of total); year-end, 2009–2013



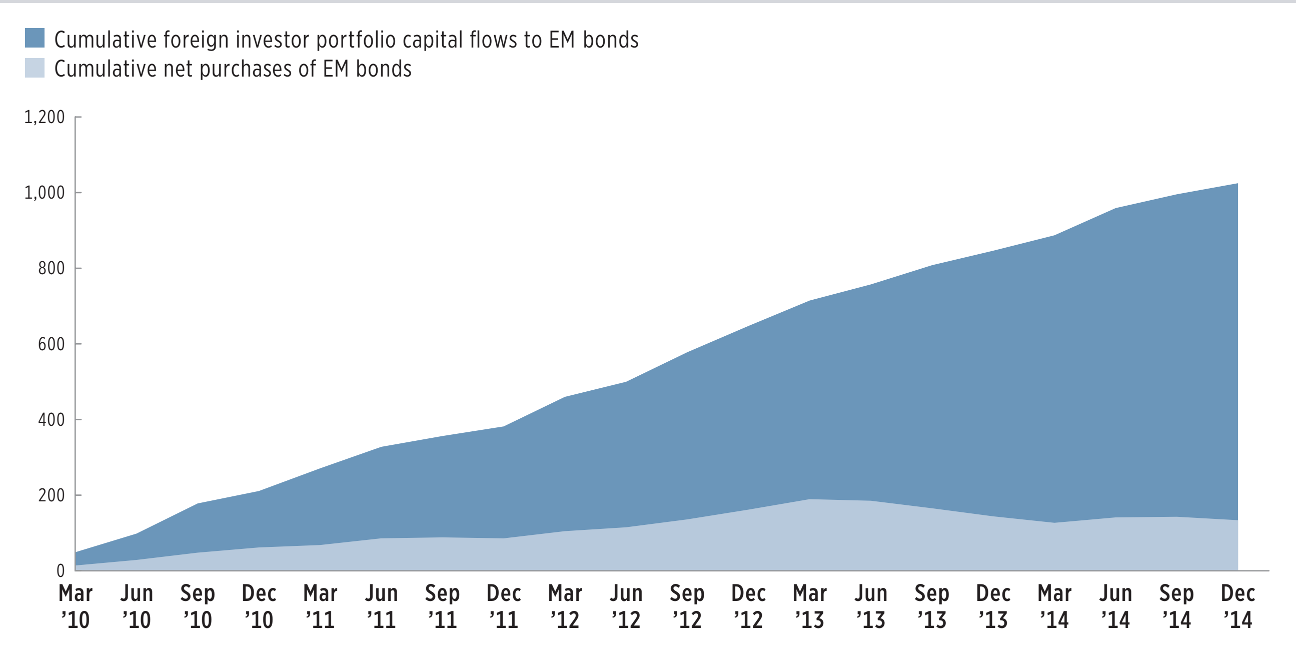
Note: This figure classifies countries as emerging based on the IMF's country classification. Components may not add to the total because of rounding.

Sources: EPFR Global and International Monetary Fund (IMF)

FIGURE 2

Cumulative Net Purchases of Emerging Market Securities Are a Small Share of Total Foreign Investor Portfolio Capital Flows to Emerging Markets

*Billions of US dollars; quarterly, March 2010–December 2014**



* Data for September 2014 and December 2014 are estimated.

Sources: Institute of International Finance and EPFR Global

FIGURE 3

US- and European-Domiciled Regulated Fund Holdings of Asian and Other Emerging Market Securities

31 December 2014

	Total holdings	Equity holdings		Bond holdings	
Region	Millions of US dollars	Millions of US dollars	Percentage of total	Millions of US dollars	Percentage of total
Asia	**$1,007,897.2**	**$899,618.2**	**70.71%**	**$108,279.1**	**25.12%**
China	309,230.2	290,374.3	22.82	18,855.9	4.37
South Korea	143,642.8	128,093.2	10.07	15,549.6	3.61
India	141,629.5	132,370.7	10.40	9,258.8	2.15
Taiwan, Province of China	107,329.5	107,104.8	8.42	224.7	0.05
Hong Kong	97,233.7	90,477.6	7.11	6,756.1	1.57
Indonesia	52,858.4	29,479.4	2.32	23,379.0	5.42
Singapore	44,081.9	39,638.5	3.12	4,443.4	1.03
Thailand	38,689.4	32,733.3	2.57	5,956.1	1.38
Malaysia	33,443.1	21,784.5	1.71	11,658.6	2.70
Phillippines	23,169.2	16,276.3	1.28	6,892.9	1.60
Other Asia	6,362.1	5,573.8	0.44	788.3	0.18
Sri Lanka	5,082.8	1,556.7	0.12	3,526.1	0.82
Vietnam	3,437.2	2,928.9	0.23	508.3	0.12
Bangladesh	1,391.5	1226.3	0.10	165.2	0.04
Mongolia	315.8	N/A	0.00	315.8	0.07
Latin America	**307,589.6**	**162,509.7**	**12.77**	**145,080.0**	**33.65**
Middle East and Africa	**197,553.8**	**130,144.8**	**10.23**	**67,409.0**	**15.64**
Europe	**190,336.0**	**79,994.2**	**6.29**	**110,341.8**	**25.59**
Total	**1,703,376.6**	**1,272,266.9**	**100.00**	**431,109.8**	**100.00**

Note: Equity and bond holdings may not add to the total because of rounding. This table includes the newly industrialised countries of Hong Kong; Singapore; South Korea; and Taiwan, Province of China, for illustrative purposes.

Source: EPFR Global

ICI Global

35 New Broad Street
London, EC2M 1NH
United Kingdom
+44 203 009 3100
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2910 9224

ICI INVESTMENT COMPANY INSTITUTE®

ICI 1940 2015

1401 H Street, NW, Suite 1200
Washington, DC 20005
United States
+001 202 326 5800
www.ici.org

The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.6 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors.