ICI VIEWPOINTS

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2015 Investment Company Fact Book: Letter from the Chief Economist

By Brian Reid

A version of this letter by ICI Chief Economist Brian Reid was released today in our 55th edition of theInvestment Company Fact Book.

This year marks the 75th anniversary of the Investment Company Act and the Investment Advisers Act—the key statutes under which mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts are regulated and governed. In 1940—the same year that Congress enacted these laws—the fund industry formed the National Committee of Investment Companies, the trade group that became the Investment Company Institute (ICI).

Shortly after its formation, ICI began to collect mutual fund asset and flow data, launching a statistical and research program that remains one of the Institute's core activities and central strengths. This data collection program has expanded greatly over time, with ICI currently managing 18 different fund surveys. Our historical data—some extending back nearly three-quarters of a century—provide perspective about funds and their investors across changing market cycles and an evolving investor base.

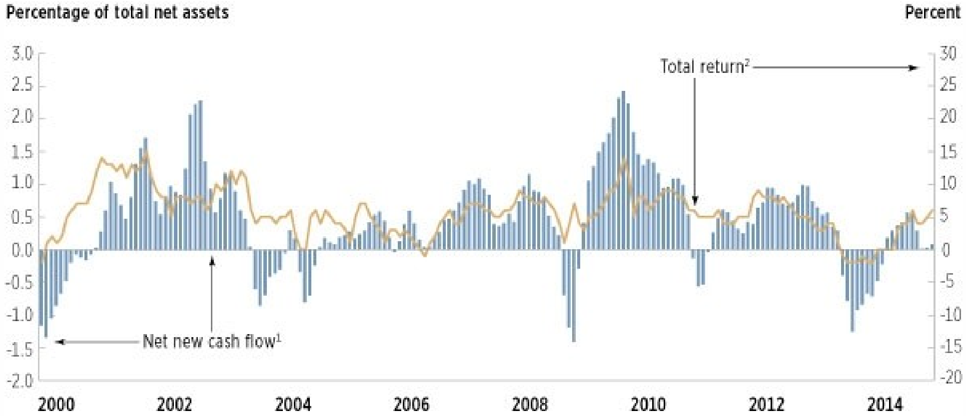
One of the first projects I worked on when I joined ICI in 1996—a study showing how bond fund investors react during bond market downturns—introduced me to this historical record. At the time, there was an ongoing debate about how fund investors would react to market declines, because fund assets had risen from about $1 billion in 1940 to $3.5 trillion in 1996. Commentators and researchers were concerned that fund investors would leave the markets en masse during a downturn, destabilizing a financial system in which funds were playing a larger role.

If this reminds you of today's debates about financial stability and the fund industry, you are right. But as ICI economists Sean Collins and Chris Plantier recently wrote, this debate did not first appear in the 1990s. About once every decade since the 1920s, fears resurface that fund investors will redeem heavily from stock and bond funds, causing markets to crash. These concerns typically appear after a period of rapid fund growth. And so once again—after nearly a decade of strong inflows to bond funds—some regulators, researchers, and commentators are raising concerns about how fund investors will react when interest rates begin to rise and bond funds report losses.

Yet every time I explore this topic I return to the same conclusion: stock and bond funds are a remarkably stable source of capital to the U.S. and global economies. As we discuss in chapter 2 of the *Fact Book*, even at the height of a market downturn, outflows from bond funds amount to only 1 or 2 percent of bond fund assets in a month. And even when bond funds have net outflows, investors do not all move for the exits. As some investors sell shares in bond funds, others continue to buy; a substantial portion of individual funds have net inflows; and fund managers are both buyers and sellers of securities.

All of this means that funds continue to operate on both sides of the markets, rather than engaging in the one-sided trading that is often predicted.

Net New Cash Flow to Bond Funds Is Related to Bond Returns
Monthly, 2000–2014



[1] Net new cash flow is the percentage of previous month-end bond fund assets, plotted as a three-month moving average. Data exclude flows to high-yield bond funds.

[2] The total return on bonds is measured as the year-over-year percent change in the Citigroup Broad Investment Grade Bond Index.

Sources: Investment Company Institute and Citigroup

Yet despite this historical evidence of stability, these concerns regularly resurface—and so ICI Research continues to explore and explain this issue. During the past year, we have written and contributed to white papers, comment letters, and blog posts explaining how fund investors behave during periods of stress. For example, Chris Plantier has examined this for funds investing in emerging markets, while ICI economist Shelly Antoniewicz and our ICI legal colleague Jane Heinrichs have studiedinvestor behavior in ETFs.

The natural question is, why do we see such stable investor behavior? Certainly one aspect is that most fund investors typically invest for the long term. As we discuss in chapter 6 of the *Fact Book*, 91 percent of mutual fund investors indicate that saving for retirement is one of their goals. These investors have embraced the guidance of financial planners, academics, fund companies, and journalists that timing the market is most likely to leave them worse off than remaining invested and continuing to make regular contributions to their funds.

Of course, shareholder stability also depends crucially on the strength of regulations that protect investors. Thecore features of regulated funds—such as limitations on fund leverage, mark-to-market pricing of fund portfolios, portfolio diversity, and liquidity management—have provided important shareholder protections and helped maintain investor confidence during periods of market stress over the past 75 years. These protections help ensure that investors who stay in a fund are shielded from harm caused by investors leaving the fund. The industry leaders, Securities and Exchange Commission staff, and members of Congress who worked to craft the statutes that now serve as the foundation for regulated funds all understood how investor protections are interwoven with investor confidence and capital formation.

Gathering and analyzing data about funds, their investors, and the markets, and using those data to inform and educate regulators, policymakers, and other stakeholders, are critical to ICI's service to funds and their investors. The months of effort that ICI staff dedicate to publishing the Fact Book contribute significantly to that mission. The *Investment Company Fact Boo*k is a continuation of nearly 75 years of effort by ICI and the fund industry to facilitate sound, well-informed public policies affecting investment companies, their investors, and financial markets.

Brian Reid was Chief Economist of the Investment Company Institute.
