Asset Management and Financial Stability: Implications for Brazil and Emerging Markets

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What Is Systemic Risk?

» The risk that a firm or group of firms will fail and disrupt the financial system’s ability to funnel capital from investors to borrowers, thus causing damage to the broader economy

» Policymakers initially focused on the banking sector, but now are focusing on asset managers and their products
What’s the Banking Process?

**INVESTMENTS**
- Loans
- Government Bonds

**INSURED DEPOSITS**
- Individuals
- Corporations
- Financial Institutions
- Money Market Funds

**UNINSURED LENDING**
- 90% of deposits

**INVESTMENT RISK**
- 10% of capital
- Stock
- Retained earnings
Asset Management: Who Are the Investors?

» Individual investors, high-net-worth households, trusts
  » 93 million Americans invest about $18 trillion in mutual funds, ETFs, and closed-end funds

» Pensions, including 401(k)s, defined benefit plans
  » Most of the nearly $25 trillion in US retirement assets is invested in an asset-managed product

» Endowments, foundations

» Corporations, state and local governments, sovereign wealth funds
  » 20% of corporate cash held in money market funds
  » Sovereign wealth funds hold $5 trillion
How Do Asset Managers Deliver Services?

» Publicly offered funds (mutual funds, ETFs, closed-end funds) issue shares that give pro rata interest in the fund’s pool of assets

» Privately offered funds (hedge funds, private equity, venture capital, real estate funds) issue pro rata interests in the fund’s pool of assets

» Collective investment funds issue pro rata interests in the fund’s assets

» Separate accounts engage an asset manager to oversee securities owned directly by an investor
What’s the Asset Management Process?

INVESTMENT
» Publicly offered funds
» Privately offered funds
» Collective investment funds
» Separate accounts

INVESTMENT MANAGERS

MANAGEMENT

INVESTMENT MANDATE

OWNERSHIP/INVESTMENT RISK

INVESTORS
» Individual investors
» Endowments, foundations
» Pensions, including 401(k)s, defined benefit plans
» Corporations, state and local governments, sovereign wealth funds

CAPITAL
What Are the Structural Implications of This Analysis?

» Asset managers agents, investing at the direction of their clients
» Asset managers generally do not take on investment risk with their own balance sheets
  » Investment risk remains with clients
  » Asset managers do not guarantee or promise a return of capital or a rate of return on investments
  » Asset managers have no government safety net
» Publicly offered funds, such as mutual funds and ETFs, use little or no leverage
» Asset managers are not banks
How Does Regulation of Publicly Offered US Funds Limit Risk?

» Funds are regulated under all four major securities laws—in particular, Investment Company Act

» Fund regulation protects shareholders—and reduces potential for systemic risk

» Funds’ borrowing and leverage are strictly limited

» Funds are required to have a simple capital structure

» Liquidity, daily mark-to-market valuation, diversification help funds meet redemptions in orderly and fair manner
Total Net Bond Fund Flows Are Modest in All Markets—Calm or Troubled

Flows as a percentage of assets; monthly, January 1990–August 2014

In Oct. 2008, 10% of bond funds had inflows of 4% or more.

In Oct. 2008, 10% of bond funds had outflows of 8% or more.

Source: Investment Company Institute
US Equity and Bond Mutual Fund Investors Are Households, Retirement Savers

Household and institutional ownership of US stock and bond mutual funds

- Households: 95%
- Institutional investors: 5%

Retirement account holdings of US stock and bond mutual funds

- Retirement accounts*: 53%
- Other investors: 47%

US stock and bond mutual fund assets: $13.1 trillion

*Retirement accounts includes defined contribution plans, e.g., 401(k) plans, as well as IRAs.

Note: Figures report percentage of assets. Data are for December 2014 and exclude assets in exchange-traded funds.

Source: Investment Company Institute
How Do Funds Manage Liquidity and Redemptions?

» Funds have many tools to counter first-movers:
   » Mark-to-market pricing and fair valuation requirements
   » Bid-pricing—used by 50% to 60% of mutual funds
   » Redemption fees
   » Offsetting redemptions with new sales
   » Managing market exposure through derivatives
   » Redemptions in kind—standard for ETFs and can be used by mutual funds

» And selling fund shares is not risk-free for investors
Regulated Funds Are Unlikely to Pose Systemic Risk to Emerging Markets

» Regulated funds’ share of the total value of emerging market securities is relatively small
» Regulated funds provide a stable investor base
» Their holdings are diversified across a wide number of emerging economies
Regulated Funds’ Share of the Total Value of Emerging Market Bonds Is Relatively Small

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

- Other investors
- Regulated funds

Sources: EPFR Global and International Monetary Fund (IMF)
Regulated Funds Represent a Small and Stable Investor Base for Brazilian Bonds

Billions of US dollars; quarterly, 2005–2013

- Other foreign investor portfolio capital flows to Brazilian bonds
- Net purchases of Brazilian bonds

Sources: EPFR Global and International Monetary Fund (IMF)
Regulated Fund Holdings Are Diversified Across a Wide Number of Emerging Economies

» US and European regulated funds held $1.7 trillion in emerging market securities as of December 2014
  » $1.3 trillion was in emerging market equities
  » $431 billion was in emerging market bonds

» These holdings were spread across more than 85 different emerging market countries

Source: EPFR Global