WORLD MARKET OF INVESTMENT FUNDS - DEVELOPMENTS AND TRENDS

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ABSTRACT: *Institutional investors - including mutual funds, pension funds, hedge funds, and insurance companies - are a growing force in developed capital markets. We are in an environment in which investors, regulators and legislators have a dramatically reduced tolerance for risk. Rules and regulations can provide additional investor protections, but can also reduce market efficiency at a great cost to borrowers and investors alike. Finding the right balance is the challenge, and is one that necessitates a wide-ranging discussion of proposals on the table. Our role as economists and researchers is to engage in this discussion on behalf of funds and their investors.*

KEY WORDS: *mutual funds, emerging markets, crisis impact, asset volume, development factors*

1. LITERATURE REVIEW

Many recent studies have increased our understanding of mutual fund performance by trying to find some of its determinants. These studies mainly analyse the relation between fund performance and fund properties, such as fund size, fees, trading activity, flows, and past returns. Different data sources are needed to study the role of institutional investors. Unlike the data on capital flows, which the World Bank collects on a regular basis, no agency has complete information on institutional investors. Companies and institutions like the OECD, the Securities and Exchange Commission (SEC), the Investment Company Institute, Morningstar Emerging Market Funds Research, Frank Russell, AMG Data Services, Lipper Analytical Services, and State Street Bank have partial information on institutional investors. One can obtain a

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general picture only by analysing and combining the different pieces of data, coming from various places.

Institutional investors - including mutual funds, pension funds, hedge funds, and insurance companies - are a growing force in developed capital markets. When individual investors choose their portfolio allocation to emerging markets, they typically make their purchase via mutual funds. In actively managed funds, it is the fund manager who ultimately determines the portfolio allocation, by choosing how the fund invests its assets (within the limits of the fund's defined scope). In index funds, the manager's role is passive, aimed at replicating a predetermined index.

Though mutual funds are commonly included among institutional investors, they differ from hedge funds, pension funds, and insurance companies in the degree to which underlying investors control portfolio size. Funds' behaviour is thus determined by the decisions of both managers and investors. This hybrid nature certainly affects mutual funds' flows to countries and regions. Mutual funds have become one of the main instruments for investing in emerging markets. The first funds, in the 1980s, were closed-end funds; they are well suited to invest in illiquid markets, because their shares cannot be redeemed. With increasing liquidity in emerging markets, open-end funds have become the most widely used instrument. It is important to recognize that mutual fund investors include other types of institutions as well. For example, more than half of pension funds invest in emerging markets through existing mutual funds. This is considered better for liquidity reasons and is also less expensive than giving specific mandates to mangers. Therefore, by looking at mutual funds, one is counting much of pension fund investment in emerging markets as well.

International mutual funds are one of the main channels for capital flows to emerging economies. Although mutual funds have become important contributors to financial market integration, little is known about their investment allocation and strategies. Kaminsky, Lyons and Schmukler (2001) provide an overview of mutual fund activity in emerging markets. First, they describe international mutual funds' relative size, asset allocation, and country allocation. Second, they focus on fund behaviour during crises, by analysing data at the level of both investors and fund managers. Among their findings: Equity investment in emerging markets has grown rapidly in the 1990s, much of it flowing through mutual funds. Collectively, these funds hold a sizable share of market capitalization in emerging economies. Asian and Latin American funds achieved the fastest growth, but are smaller than domestic U.S. funds and world funds.

When investing abroad, U.S. mutual funds invest more in equity than in bonds. World funds invest mainly in developed nations (Canada, Europe, Japan, and the United States). Ten percent of their investment is in Asia and Latin America. Mutual funds usually invest in a few countries within each region. Investments in Asian and Latin American mutual funds are volatile. Because redemptions and injections are large relative to total funds under management, funds' flows are not stable. The cash held by managers during injections and redemptions does not fluctuate significantly, so investors' actions are typically reflected in emerging market inflows and outflows.

Mutual funds with a more diversified portfolio perform somewhat better than funds with a less diversified portfolio. (Engstrom, 2004) He finds no evidence to

indicate that investment outside the fund's primary investment universe will enhance performance. Moreover, the effects of cash holdings on performance are explored, and some weak evidence suggests that large cash holdings imply better tactical decisions. However, extending the funds' investment universe and investing in non-listed stocks can achieve diversification. Elton, Gruber, Das and Hlavka (1993) show that funds investing in these types of assets might achieve superior performance simply because these assets are not captured within the benchmark model.

In this paper we'll analyse the concept of mutual funds, their most important development factors and their recent evolutions registered worldwide, especially the case of U.S. and Europe. We will also show how the actual financial crisis is affecting the number of mutual funds and their net cash flows.

2. EMPIRICAL ANALYSIS OF THE WORLD MARKET FOR INVESTMENT FUNDS

2.1. Factors of investment fund's development

The development of investment funds emerged as a result of the growing desire of people to invest on the capital market, phenomenon that was influenced by a number of general factors and market specific factors. Some of the general factors are: economic growth, the evolution of the saving process, the evolution of the capital markets, pension system's problems. The specific factors are: legal framework, fiscal policy, the funds' advantages.

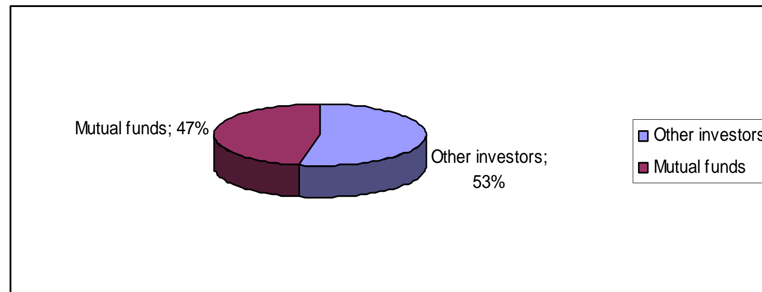
A. *Economic growth.* The development of investment funds has been closely linked with the economy's development, specific situations in various countries pointing out that capital market develops only in a strong and efficient economy. Economic growth helps the development of investment funds, and these, in turn, can be a driver for economic growth, in terms of managed assets and the assets traded. „ Capital is the lifeblood that feeds the economy and whether the channels through which the sap flow is inadequate, missing or incorrectly cut, economic progress are questioned." (Anghelache Gabriela, 2000).

B. *The saving process evolution.* The global saving process is influenced by demographic trends worldwide (rate of aging, fertility, etc.), changes in interest rates, tax regime applied to the saved and placed resources, changes in financial markets, which by enhancing or limitation of imposed restrictions on lending have led to encouraging consumption and reducing of saving, or vice versa.

C. *Capital markets evolution.* Investment funds appear if the existent capital markets are contoured, liquid, transparent and credible. „ A modern economy, competitive, able to adapt to the existing requirements of globalisation is not conceivable without the existence and operation of efficient capital markets." (OCDE, 2002)

D. *The pension system problems.* Traditional pension crisis can be considered a factor of funds' development because the resources saved for retirement will move to private management provided by various specialized intermediaries including mutual funds. Pension reform is a topical issue in almost all economies, given the

demographic trends of falling birth rates, increasing life expectancy, withdrawal from employment before the legal retirement age. These trends are some of the factors leading to imbalances of pension systems.



Source: Mutual Fund Fact Book, ICI, 2009

Figure 1. Pension market in USA at the end of 2008

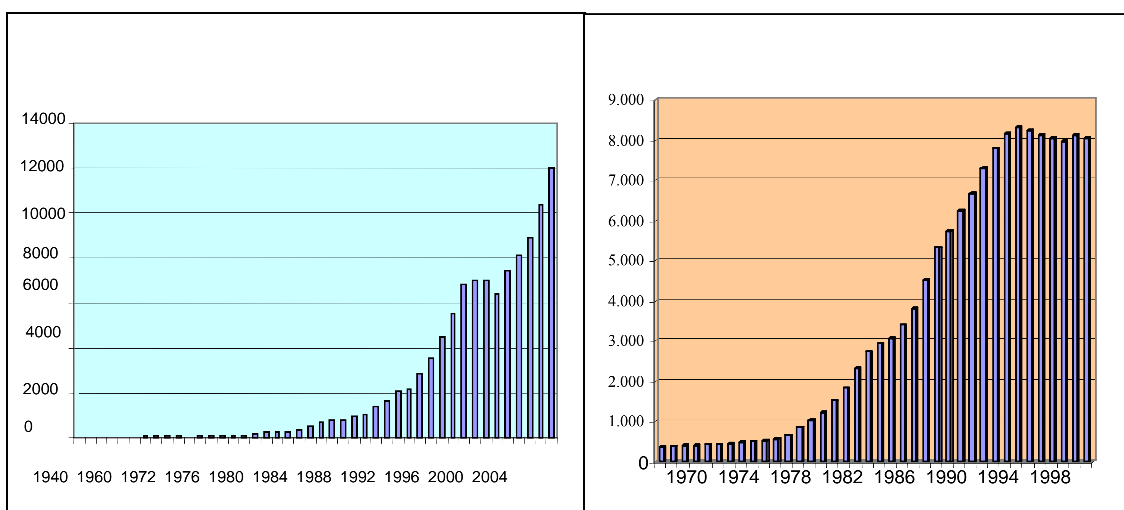
E. *Legal framework.* Investment funds are organized and managed by the management company, which is considered an open society and must fulfil legal requirements. In almost all countries were created supervisory authorities that have the role of issuing regulations regarding the way that financial tools are managed and investors are protected. Evolution of funds has shown that as the regulations are more stringent and the penalties imposed for violations are more severe the greater there is the investors' confidence.

F. *Fiscal policy.* Taxation acts on the structure of assets and reduces the performance of funds; this is why fund managers should include in their asset allocation and title acquisition strategies, the incidence of taxation on the return generated by the issued securities. Application of tax on the funds can be made according to the process of saving and its structure. In Europe, the dominant idea is that taxation is a barrier to unique market development, differences in taxation, unfavourable terms for foreign funds is a question of market fragmentation. To stimulate investment in shares, in France, there are tax reductions (25%) and levels within Defaults (7000-14000 francs) for net long-term investment realized by individuals in SICAV and FCP (Corduneanu, Barna, 2001).

2.2. Analyse of the development of investment funds in U.S.

USA is currently the world leader in the development of managed investment industry, holding 50% of their total. In this context an overview of characteristics and players in this market is a need. American concern today is to secure financial resources for the children's' education and the needed resources after the termination of the active period. This phenomenon is due to two reasons, first is that members of the Baby Boom generation are approaching retirement age and the second is the increase of longevity. To meet these events people must save, phenomenon that contributes to the diversification of investment alternatives. From this perspective it is worth noting the dramatic evolution of U.S. mutual funds, this being a reason why U.S.

is a milestone in this area. The variation of funds' number and managed assets reveal the investors' preference for this form of investment.



Source: Annual Report, ICI, 2007 *Source: Annual Report, ICI, 2007*

Figure 2. The evolution of fund managed assets in USA (billions dollars)

Figure 3. The mutual funds number evolution in USA 1970-2007

Managed investments in U.S. industry are based on four types of investment funds: Mutual Funds; Closed End Funds; Unit Investment Trusts; Exchange Traded Fund - ETF.

Table 1. Assets managed by fund category

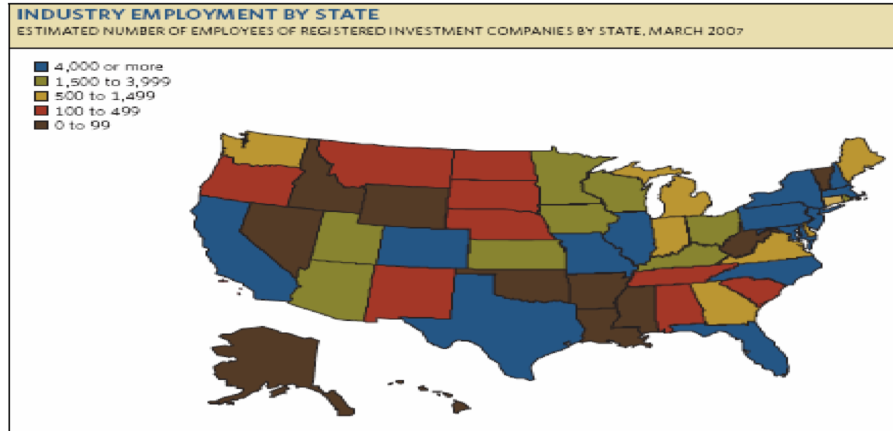
billions of dollars

Year	Mutual funds	Closed End Funds	EFTs	UITs
2000	6965	143	66	74
2001	6975	141	83	49
2002	6390	159	102	36
2003	7414	214	151	36
2004	8107	254	228	37
2005	8905	276	301	41
2006	10412	298	423	50
2007	12021	315	608	53

Source: Total Investment Company Assets, ICI, 2007

For many industries, employment tends to be concentrated in locations of the industry's origins, and investment companies are no exception. Massachusetts and New York served as early hubs of investment company operations, and remained so in 2007, employing nearly one-third of the workers in the fund industry (Figure 4). As the industry has grown from its early roots, other states have become signify cant centres of fund employment. California, Pennsylvania, and Texas also have signified cant

concentrations of fund employees. Fund companies in these states employed about one-quarter of all fund industry employees as of March 2007.



Source: 2009 Investment Company Fact Book, 49th edition

Figure 4. Industry employment by state

The average fees and expenses that investors paid on mutual funds fell in 2008 to their lowest levels in more than 25 years. Investors paid 99 basis points, on average, to invest in stock funds, a 2 basis-point decline from 2007. Average fees and expenses on bond funds dropped 3 basis points to 75 basis points. Fees and expenses on money market funds averaged 38 basis points. The reduction in mutual fund fees and expenses in 2008 continued a downward trend that has been in place since at least 1980. The decline has been most pronounced among stock and bond funds, where the average fees and expenses paid have dropped by more than 50 percent in each category since 1980. The expenses of money market funds, which are lower than those of stock and bond funds, have fallen more than 30 percent since 1980.

Fees and Expenses Dropped for Stock, Bond, and Money Market Funds in 2008
Basis points, 2003–2008

	Stock funds						Bond funds						Money market funds					
	2003	2004	2005	2006	2007	2008	2003	2004	2005	2006	2007	2008	2003	2004	2005	2006	2007	2008
Fees and expenses of which:	122	118	110	106	101	99	95	92	87	82	78	75	44	42	42	41	39	38
Load fees (annualized)	23	23	20	18	16	15	21	20	17	15	13	12	*	*	*	*	*	*
Total expense ratio	99	95	90	88	85	84	74	72	70	67	65	63	44	42	42	41	39	38

Sources: Investment Company Institute; Lipper; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; Data © CRSP University of Chicago, used with permission, all rights reserved (312/263-6400/www.crsp.com); Primary Datasource and Strategic Insight Simfund.

Figure 5. Fees and expenses for stock, bond and money market funds in 2008

Funds of funds are mutual funds that invest in other mutual funds. The market for funds of funds has expanded considerably in recent years. By the end of 2008, there were 865 funds of funds with $490 billion in assets (Figure 6). Over 80 percent of the assets of funds are in hybrid funds of funds, which are funds that invest in a mix of stock, bond, and hybrid mutual funds.

FUNDS OF FUNDS HAVE GROWN RAPIDLY IN RECENT YEARS

Number of funds of funds

					Memo	
	Total	Equity	Hybrid	Bond	Lifestyle[1]	Lifecycle[2]
1996	45	24	19	2	9	0
1997	94	41	48	5	30	3
1998	175	75	91	9	60	7
1999	212	83	115	14	78	8
2000	215	86	119	10	88	9
2001	213	85	123	5	86	15
2002	268	104	159	5	115	15
2003	301	112	184	5	115	26
2004	375	111	259	5	123	64
2005	475	129	334	12	160	91
2006	604	161	430	13	201	154
2007	723	178	533	12	222	222
2008	865	186	663	16	243	289

Total net assets of funds of funds, billions of dollars

					Memo	
	Total	Equity	Hybrid	Bond	Lifestyle[1]	Lifecycle[2]
1996	$13.4	$4.6	$8.7	$0.1	$2.4	0.0
1997	21.5	7.6	13.8	0.1	5.9	0.3
1998	35.4	12.2	23.0	0.1	11.8	2.8
1999	48.3	18.7	29.5	0.2	17.0	5.4
2000	56.9	16.2	40.5	0.2	20.0	7.2
2001	63.4	15.8	47.3	0.3	21.5	10.7
2002	69.0	14.5	53.9	0.6	24.4	13.5
2003	123.1	28.6	93.6	0.9	43.0	23.7
2004	199.6	41.8	156.7	1.1	71.9	40.5
2005	306.0	58.6	246.8	0.7	116.1	66.0
2006	471.0	96.4	372.8	1.8	171.2	108.1
2007	639.8	122.9	513.8	3.1	220.2	175.0
2008	490.1	80.3	406.2	3.6	164.1	153.5

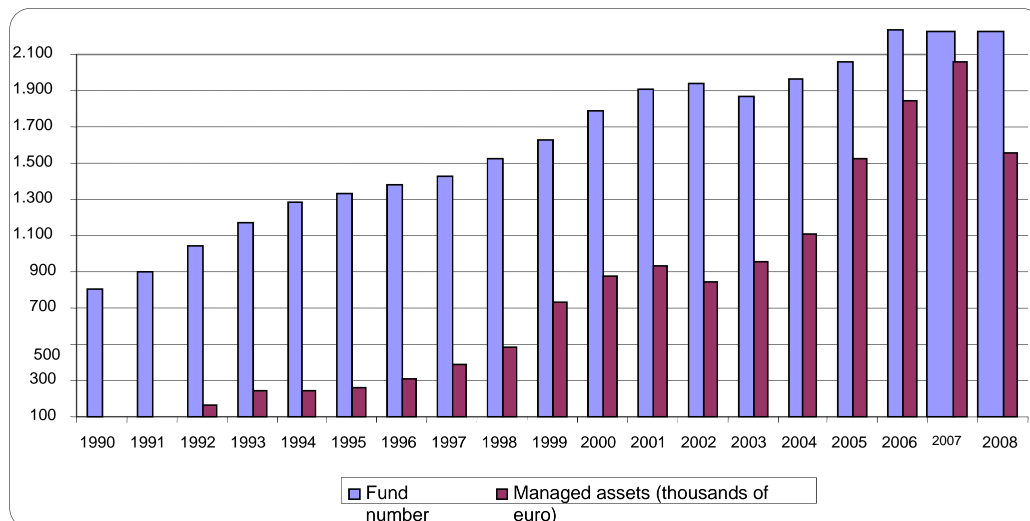
Source: Investment Company Institute

Figure 6. Number and assets of funds of funds

2.3. European investment funds

European investment fund industry has proved in the 1990s one of the components with the highest rate of increase in financial sector. Investment instruments issued by investment funds represent a significant percentage of the public savings in almost all European countries and constitute an important vehicle used by banks and other financial intermediaries, with an increasing role in accumulating assets

for retirement. Luxembourg has recently become the leader in cross-border marketing of investment funds, to accumulation of "savoir-faire over the years due in terms of distribution of funds. The Lipper Analytical Services study made in London reveals that of 20 European investment funds, sold its 18 investment instruments at least to 2 foreign countries, from which one is Luxembourg, and from the 10 funds that sell their securities in more than 5 European countries, 9 are residing in Luxembourg. Since the emergence of the first investment fund in 1959, was reached in 1970 to over 100 funds; in the 8th decade, their number dropped to a third due to a Luxembourg fund scam.



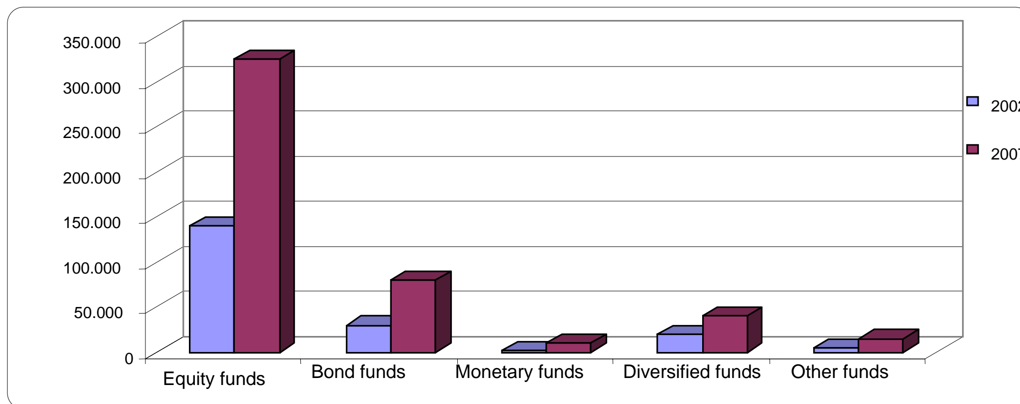
Source: www.alfi.lu/ Evolution des actifs nets et du nombre des OPC, 2008

Figure 7. The number of funds and managed assets

British industry began to expand strongly until after the October 1987 Stock Market Crash, although they were established long after (1931), and the Unit Trusts haven't developed until after the European tax harmonization (Directive 85/CEE, 20 December 1985). Financial Services Act in 1986 set conditions for high investor protection by improving their information, defining the authorities' role of control, establishment of market self-regulatory bodies, defining the rules for calculating the rates etc.

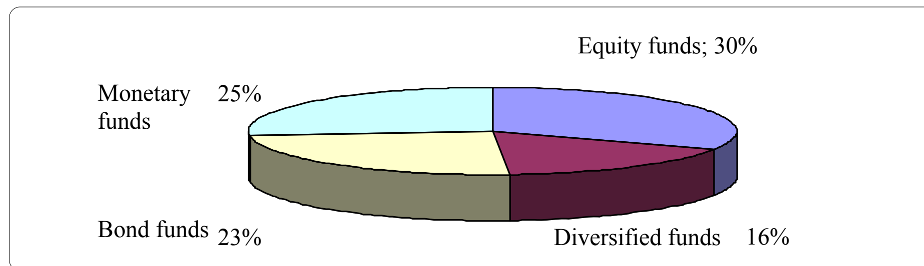
Assets managed funds have evolved dramatically during the analyzed years, so in 1996 the assets managed by investment funds valued 131.762.000 £, and in 2005 the assets managed by funds reached the amount of 347.288.000 £, a 37,94% growth.

Investment fund market in 2008 was dominated by equity funds, which holds 30% market share, followed by money funds 25%, bond funds with 23% and diversified funds with 16%. In absolute terms, 90 percent of total assets in 2008 come from five countries: Luxembourg (106 bil. EUR), Italy (73 bil. EUR), Spain (57 bil. EUR), France (45 bil. EUR) and Germany (19 bil. EUR).



Source: www.investmentuk.org/statistics/funds under management by asset type

Figure 8. The fund's market's evolution



Source: www.BVI.de /statistics

Figure 9. Structure of the funds in 2008

3. IMPACT OF THE CRISIS ON MARKET DEVELOPMENTS OF INVESTMENT FUNDS

The behaviour of mutual funds can be consistent with contagion, either because they generate spillovers or due to their feedback trading. First, international mutual funds can contribute to spreading crises across countries if, for example, investors holding fund shares might decide to sell their Asian funds when Russia devalues its currency. Or fund managers of Latin American funds may sell assets in Brazil when a crisis hits Mexico. These need not be irrational responses: new theories of rational herding explain the transmission of crises through financial links. These models are based on elements like asymmetric information and cross-market hedging. Alternatively, if mutual fund investors or managers follow past or current returns, their behaviour will appear consistent with contagion even though mutual funds are not main force driving the spillovers. On the other hand, it is also possible that institutional investors, like mutual funds, can be a stabilizing force. If investors buy mutual fund shares for long-run gains, they might not withdraw their investments when there is a temporary crisis. For example, Marcis et al. (1995) and Rea (1996) claim that

shareholders did not redeem shares during crisis periods. Rather, they argue that net inflows to emerging markets are usually steady, and crisis-period outflows are small and short-lived (at least during Mexico's crisis). Froot, O'Connell and Seasholes (2000) present a related picture, but without focusing on institutional investors. They analyse, among other things, aggregated net flows into individual emerging markets.

During periods of financial crisis, stock and bond spreads and volume are more volatile and become more highly correlated; moreover, at these times, money supply positively affects financial market liquidity, albeit with a lag of two weeks. During normal times, increases in mutual fund flows enhance stock market liquidity and trading volume, but during financial crises, U.S. government bond funds see higher inflows, resulting in increased bond market liquidity (Chordia, Sarkar, Subrahmanyam, 2001). Liquidity, a fundamental concept in finance, can be defined as the ability to buy or sell large quantities of an asset quickly and at low cost. Equilibrium asset pricing models do not consider trading and thus ignore the time and cost of transforming cash into financial assets or vice versa. Recent financial crises, however, suggest that, at times, market conditions can be severe and liquidity can decline or even disappear.2 Such liquidity shocks are a potential channel through which asset prices are influenced by liquidity. Amihud and Mendelson (1986) and Jacoby, Fowler, and Gottesman (2000) provide theoretical arguments to show how liquidity impacts financial market prices.

Mutual fund assets worldwide decreased 4.0 percent to $18.15 trillion at the end of the first quarter of 2009. Net cash flow to all funds was $45 billion in the first quarter, compared with $95 billion of inflows experienced in the fourth quarter of 2008. Net outflows from long-term funds slowed to $18 billion in the first quarter after an average outflow of $296 billion per quarter in the second half of 2008. Net outflows from equity funds were $41 billion and net outflows from balanced/mixed funds were $22 billion in the first quarter, down from $121 billion and $56 billion of outflows, respectively, in the fourth quarter. Bond funds experienced net inflows of $59 billion in the first quarter compared with net outflows of $157 billion in the fourth quarter. Net flows into money market funds fell to $63 billion in the first quarter of 2009 from $444 billion of net inflows in the fourth quarter of 2008.

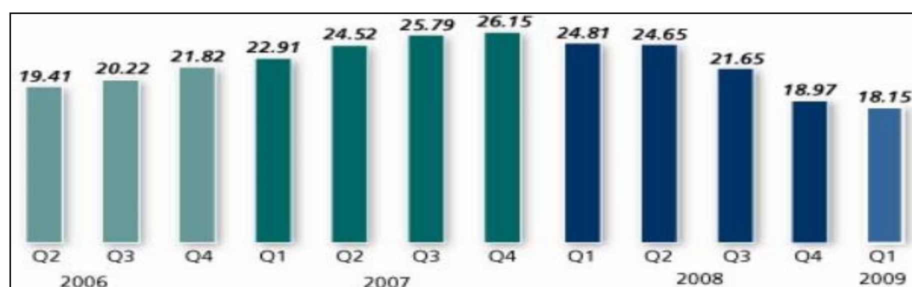


Figure 10. Worldwide Mutual Fund Assets, Trillions of U.S. dollars, end of quarter

Net cash flow into mutual funds worldwide was $45 billion in the first quarter of 2009. Net outflows from equity funds worldwide were $41 billion in the first

quarter, compared with net outflows of $121 billion in the fourth quarter of 2008. The pace of net outflows from American equity funds slowed in the first quarter, with $37 billion of outflows compared with $76 billion of outflows in the fourth quarter. European equity funds experienced $5 billion in outflows compared with $36 billion in outflows in the fourth quarter.

The Asia and Pacific region reported small net inflows of $821 million in the first quarter, compared with $10 billion of net outflows reported in the fourth quarter. Worldwide net outflows from balanced/mixed funds also slowed in the first quarter of 2009. Outflows were $22 billion in the first quarter, compared with $56 billion of net outflows in the fourth quarter of 2008. Net outflows from balanced/mixed funds in Europe fell to $13 billion in the first quarter from $33 billion of net outflows in the fourth quarter. American balanced/mixed funds registered $7 billion of net outflows in the first quarter after reporting $19 billion of net outflows in the fourth quarter.

Bond funds experienced $59 billion in net inflows in the first quarter of 2009, reversing some of the $157 billion of net outflows in the fourth quarter of 2008. American bond funds had net inflows of $72 billion in the first quarter, more than offsetting the $67 billion of net outflows in the fourth quarter. Net outflows from European bond funds slowed to $6 billion in the first quarter from $92 billion of net outflows of in the fourth quarter. Bond funds in the Asia and Pacific region had $7 billion of net outflows in the first quarter compared with net inflows of $1 billion in the fourth quarter. Net flows into worldwide money market funds slowed considerably, with $63 billion of inflows in the first quarter of 2009 compared with $444 billion of inflows in the fourth quarter of 2008. American money market funds experienced net outflows of $9 billion in the first quarter after registering $388 billion of net inflows in the fourth quarter. Inflows into Asian and Pacific money market funds slowed to $2 billion in the first quarter from $58 billion of net inflows in the fourth quarter. In contrast, flows to European money market funds strengthened, with $68 billion in net inflows in the first quarter compared with $3 billion in net outflows in the fourth quarter.

4. CONCLUSIONS

The development of investment funds emerged as a result of the growing desire of people to invest on the capital market, phenomenon that was influenced by several factors, such as: economic growth, development of capital markets, taxation etc. USA is currently the world leader in the development of managed investment industry, holding 50% of their total. Recent developments on the American market were influenced by the negative response of investors to the crisis, which manifests itself in the financial system. The average fees and expenses that investors paid on mutual funds fell in 2008 to their lowest levels in more than 25 years. Investors paid 99 basis points, on average, to invest in stock funds, a 2 basis-point decline from 2007.

In Europe, the investment fund market in 2008 was dominated by equity funds, which holds 30% market share, followed by money funds 25%, bond funds with 23% and diversified funds with 16%. Due to the actual financial crisis, mutual fund assets worldwide decreased 4.0 percent to $18.15 trillion at the end of the first quarter of

2009. Net cash flow to all funds was $45 billion in the first quarter, compared with $95 billion of inflows experienced in the fourth quarter of 2008.

Critical analysis of the investment fund market shows the impact of financial crisis on managed investments and the existing gap between the two poles, the U.S. and Europe, but the process of financial globalisation will lead to bridge this gap and will force the emergent markets to adapt structurally and functionally, so that they wouldn't have to face a migration of foreign and local investors.

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