Press Points for Chapter 2:

LONG-TERM INVESTORS AND THEIR ASSET ALLOCATION: WHERE ARE THEY NOW?

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Prepared by S. Erik Oppers (team leader), Ruchir Agarwal, Serkan Arslanalp, Ken Chikada, Pascal Farahmand, Gregorio Impavido, Peter Lindner, Yinqiu Lu, Tao Sun, and Han van der Hoorn

Key Points

- Asset allocation strategies of private and official institutional investors have changed since the crisis. Most importantly, these investors are more risk conscious, including with respect to liquidity and sovereign credit risk.
- So far, in the low interest rate environment, most long-term institutional investors are choosing to accept lower returns, rather than take on more risk. Given their fixed future payments or liabilities with guaranteed returns, pressure will build for them to move into riskier assets the longer the low interest rate environment lasts.
- As heightened risk awareness and regulatory initiatives push private investors to hold "safer" assets, this may remove a set of "deep pocket" investors that helps to stabilize financial markets. There may be a role for sovereign asset managers to take on some of the longer-term risks that private investors now avoid.
- The main drivers of asset allocation decisions of long-term unleveraged institutional investors are good growth prospects, falling risks in recipient countries and higher global risk appetite. Interest-rate differentials between countries play a lesser role.
- The structural trend of investing in emerging markets has accelerated following the crisis, but the risk of a reversal cannot be discounted if fundamentals (such a growth prospects or country or global risk) change. The magnitude of recent outflows from emerging market equity and bond funds is in line with the chapter's empirical findings on the effects of increases in global risk aversion.

This chapter examines the fundamental drivers of the longer-term asset allocation decisions of longer-term unleveraged private and public institutional investors. It looks at longer-term trends, but also asks whether asset allocation has changed as a result of the global financial crisis and the low interest rate environment.

The chapter takes as its point of departure the individual asset allocation decisions of individual investors. These decisions are at the core of financial flows between markets

currencies and countries. The chapter differs from previous studies by using disaggregated mutual fund data that has information on equity and bond investment flows into individual countries, rather than aggregated balance-of-payments data that are farther removed from the decisions of individual investors.

The analysis shows that private asset allocation is driven most strongly by positive growth prospects and falling risks in the recipient countries; interest rate differentials between countries play a lesser role. This latter finding does, however, *not* imply that capital flows in general do not respond to interest rate differentials, since they may be the result of short-term leveraged investors' decisions (such as those executing carry trades)—which this chapter does not examine.

The global financial crisis and its aftermath expose investors to two opposing forces. On the one hand, the crisis has made long-term investors more risk conscious, especially with respect to liquidity and sovereign credit risks, including those of advanced economies. On the other hand, the low interest rate environment is putting increasing pressure on institutional investors (especially insurance companies that have sold products with minimum guaranteed returns and pension funds that are underfunded) to enhance portfolio returns by investing in riskier assets.

Most institutional investors are so far accepting lower returns rather than taking on more risk. The chapter argues that this may well be evidence that the investment behavior of long-term institutional investors has fundamentally changed. This structural shift can be seen in the data: the regressions in the chapter show significant downward shifts in investment flows for the full period after the start of the crisis in mid-2007, reflecting an adjustment of portfolio flows to the new assessment of risks, and there is so far no evidence that this effect is fading. Nevertheless, if—as expected—interest rates in advanced economies stay low for an extended period, such investors will be under increasing pressure to take on more investment risk, as their financial situation becomes increasingly unfavorable.

The structural trend of investing in emerging markets has accelerated following the crisis. However, with many first-time investors taking advantage of the relatively better economic performance of these countries, there is a risk of a reversal if fundamentals change. For larger shocks, the impact of such reversals could be of the same magnitude as the pullback in flows experienced during the financial crisis. Indeed, the magnitude of recent outflows from emerging market equity and bond funds (which occurred after the chapter was finalized) is in line with the chapter's empirical findings.

The chapter suggests that sovereign asset allocation may provide a counterweight for changing private sector behavior. The chapter suggests that heightened risk awareness and initiatives like Solvency II for European insurance companies may push these institutions away from their traditional role of taking on longer-term risky assets, potentially dampening the positive impact of one class of "deep pocket" investors that are willing to hold illiquid assets through market downturns. As private investors are pushed to hold "safer" assets, there may be a role for sovereign asset managers to take on some of the longer-term risks that private investors now avoid.