Press points for Chapter 2: *Changes in International Investor Base and Implications for Financial Stability*

Global Financial Stability Report (GFSR), April 2007

Key points

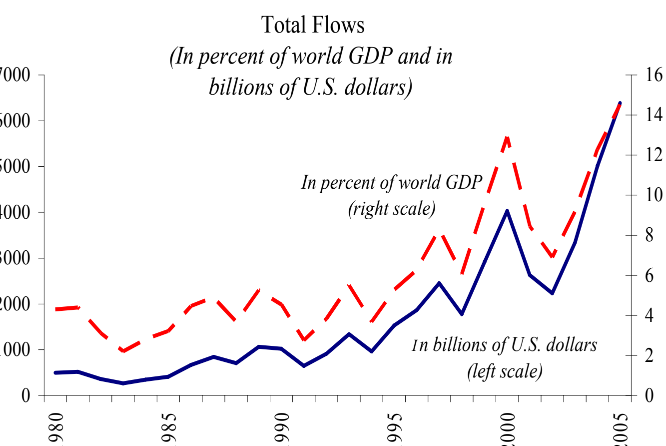
- **There has been an unprecedented growth and deepening in financial markets and internationalization of asset allocation over the last decade..**

- **The increase in assets under management of traditional investors has been accompanied by a decline in home bias and increased investment in internationally oriented hedge funds. The official sector has become a key player in cross-border asset allocation.**

- **The increased diversity of investors should contribute to financial stability, however, the speed that these changes are taking place may temporarily distort prices in financial markets and create pockets of vulnerabilities.**

- **Countries can reduce vulnerabilities by providing an enabling environment for the development of sound markets and instruments.**

Cross-border financial asset accumulation has increased sharply, tripling over the past decade. While some of this growth represents a continuation or resumption of trends that have been evident for some time, recent years have witnessed several new developments, notably the broadening of the investor base eager to hold international assets. Certain classes of investors, such as private institutional investors from mature market economies as well as the official sector of emerging markets, have gained in importance in global financial markets.



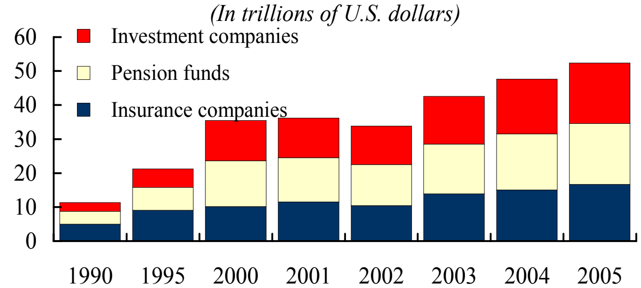
Source: IMF staff calculations based on data from IMF, *International Financial Statistics* and *World Economic Outlook.*

Several factors have affected the level and nature of cross-border financial flows:

- **There has been rapid growth in assets under management of mature market institutional investors.** Their assets under management have more than doubled over the past decade to about US$53 trillion in 2005 with institutional investors in the United States accounting for about half of the share and in continental Europe for more than a quarter, followed by Japan and the U.K. Within conventional investment management, pension fund assets managed by institutional investors have expanded significantly.

Assets Under Management of Institutional Investors in Mature Markets

(In trillions of U.S. dollars)



Sources: International Financial Services, London; OECD; and IMF staff estimates.

- **The asset allocation behavior of institutional investors has changed. There has been a decline in home bias** (portfolio allocations biased towards the home country), evident in portfolio equity and debt holdings. **There has also been an increasing reliance on hedge funds as a vehicle to achieve higher returns.** Pension funds and funds of hedge funds have become increasingly important investors in hedge funds. According to market estimates, assets under management of the hedge fund industry, though small compared to other institutional investors, have grown from US$30 billion in 1990 to more than US$1.4 trillion at the end of 2005. Global institutional investors' capital allocated to hedge funds is estimated at US$360 billion at the end of 2005, representing 30 percent of total hedge fund assets.

- **The official sector in emerging markets, particularly central banks and sovereign wealth funds have become key players in cross-border asset allocation and has contributed to the financing of the global imbalances.** Gross official reserves have more than doubled since 2002 to reach nearly US$5.0 trillion by September 2006. In addition, the governments of commodity producing countries have become large investors in financial instruments, in particular bonds and equities, through sovereign wealth funds. Market estimates indicate that these funds manage more than US$1.4 trillion.

The diversity of assets, source countries, and investor types now involved in cross-border asset accumulation suggests that this form of globalization should support financial stability. Long-time horizons and lower leverage of institutional investors imply greater propensity to ride out market volatility. That said, the speed that these changes are taking place and the sheer size of capital flows may temporarily

distort prices in financial markets and create pockets of vulnerabilities. In some emerging market countries, increased demand has outpaced the availability of domestic financial assets, leading to a sharp increase in asset prices, rapid credit growth, and currency appreciation. Also, investors have been venturing down the "credit ladder" into investments in which they have little experience. The growing role of leveraged investors, such as hedge funds, may have introduced a propensity for asset prices to overshoot during good times, increasing the probability of downside risks when financial conditions worsen.

The focus of prudential regulation and supervision needs to shift towards international risks conveyed through financial market instruments. Countries can reduce vulnerabilities by developing sound markets and instruments and by providing the enabling environment for market participants to share and transfer risks to those most able and willing to bear them. Last but not least, mechanisms to deal with considerable gaps in global financial information flows can facilitate a more effective oversight.