MEMO# 6119

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TWO ARTICLES CONCERNING MUTUAL FUNDS AND FINANCIAL STABILITY

August 8, 1994 TO: BOARD OF GOVERNORS NO. 73-94 RE: TWO ARTICLES CONCERNING MUTUAL FUNDS AND FINANCIAL STABILITY ____ The Federal Reserve Bank of Kansas City recently published two articles concerning the effect that mutual funds have on financial stability. Copies of the articles are attached. In the first article, Henry Kaufman observes that the average mutual fund investor has never experienced a prolonged bear market. He predicts that, "after repeated bouts of volatility" and an increase in interest rates, CDs or other money market instruments "will no longer be looked at contemptuously by many investors, new inflows into mutual funds will dry up, and many individuals may become net sellers." Kaufman argues that these developments will force funds to sell their holdings regardless of the price impact or "whether other buyers of equities and bonds step forward quickly to buy." Expressing concern that "excesses originating in the mutual fund area may be the source of an economic shock should an asset price bubble be suddenly burst," Kaufman concludes that "the time has come when we have to be concerned not only with the issues of fraud and abuse, which is the conventional focus of the SEC, and consider the systemic implications of the explosion of mutual funds." Kaufman proposes that investors be required to give 60 to 90 days' withdrawal notice to increase investor awareness of mutual fund risks and "introduce a useful brake on exaggerated reactions to abrupt price movements." In the second article, Donald P. Morgan, senior economist of the Federal Reserve Bank of Kansas City, argues that concerns of the sort expressed by Kaufman are exaggerated. Morgan presents evidence that individuals have shifted their investments into mutual funds primarily because they have reached the age at which they will save for retirement. Because these households have long- term investment goals, their shift to mutual fund investments should not be destabilizing. Moreover, Morgan demonstrates that previous shifts to stocks and bonds did not destabilize consumption and that households' foreign investments, by diversifying risks abroad, could help stabilize consumption. We will keep you informed of future publications on these issues as they come to our attention. Matthew P. Fink President Attachments