MEMO# 8557

January 16, 1997

INSTITUTE PAPER ON US EMERGING MARKET FUNDS

January 16, 1997 TO: INTERNATIONAL COMMITTEE No. 4-97 RE: INSTITUTE PAPER ON US EMERGING MARKET FUNDS ____ We are pleased to send you a copy of a research paper just published by the Institute titled "US Emerging Market Funds: Hot Money or Stable Source of Investment Capital?" The paper examines the behavior of shareholders and portfolio managers of emerging market funds in response to market downturns. This research initiative examines the extent to which mutual funds provide a stable and consistent source of finance in emerging markets. The results would appear to allay concerns sometimes expressed by emerging market representatives that investments in their markets by foreign investors generally, and US mutual funds specifically, might be "hot money" -- that is, fund shareholders and portfolio managers likely would run during times of financial stress and thus exacerbate market instability. The paper examines the net flow of new cash into emerging market equity funds from 1991 to early 1996 and the portfolio investments in twenty-three emerging market countries by thirteen large equity funds from 1993 to 1995, the periods for which data were available. This is the first time the Institute has analyzed this issue and, to our knowledge, the first time the topic has been addressed in a research study. The principal findings of the study are: During 1991 to 1996, shareholders in US emerging market equity funds did not redeem shares in large volume during periods of foreign market weakness. The net inflow of new cash continued during some periods in which equity prices in emerging markets moved sharply lower. In other periods of market downturns, such as the Mexican peso crisis in late 1994, outflows were relatively small and short-lived, and inflows resumed even as equity prices declined further. During the 1993-1995 period of high volatility in emerging markets, portfolio managers generally did not shift investments between countries in a manner that would exacerbate price swings. For the period examined, managers quite frequently did the opposite, buying shares at times when share prices were falling or selling in rising markets. When portfolio liquidations of securities in falling markets did occur, they typically were small relative to the size of the positions taken. We have provided copies of the paper to emerging market representatives, international organizations and government officials. We hope the research results will be useful to countries considering the role US mutual funds can play in meeting the capital needs of emerging market countries and the need or justification for policies restricting access to their securities markets by US mutual funds and other foreign institutional investors. Mary S. Podesta Associate Counsel - International Enclosure