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MUTUAL FUND SHAREHOLDER BEHAVIOR IN MARKET DECLINES

July 21, 1997 TO: BOARD OF GOVERNORS No. 43-97 RE: MUTUAL FUND SHAREHOLDER BEHAVIOR IN MARKET DECLINES
____ A study published in the July 1997 Economic Policy Review of the Federal Reserve Bank of New York finds that mutual funds do not pose a systemic risk to the financial markets in the event of a market decline. The study, which was conducted by economists at the FRBNY, supports previously published Institute findings with respect to shareholder behavior. A copy of the study is enclosed. The purpose of the study was to test whether a sharp drop in stock or bond prices could set off a cascade of fund redemptions, which in turn would exert further downward pressure on stock and bond prices. As the authors note, economists such as Henry Kaufman and David Hale suggest that such a process could cause a downward spiral in prices. The study examined the monthly correlation between market returns and mutual fund flows from 1986 to 1996. The authors conclude that the short-term effect of market returns on mutual fund flows has been too weak to sustain a spiral. Even during the unusually severe market declines, the study found no evidence of panic on the part of fund shareholders or portfolio managers. In July 1995 and March 1996, the Institute published the results of its research into mutual fund shareholder behavior in volatile markets.* Institute research indicates that mutual fund shareholders have never liquidated shares en masse. Though not insensitive to price movements, shareholder response tends to be spread over time. Like the Institute's own research, the attached study indicates that mutual funds are unlikely to be a destabilizing force in the financial markets. Matthew P. Fink Enclosure _____________________ ; and July 1995 Perspective Mutual Fund Shareholder Response to Market Disruptions March 1996 Perspective, Mutual Fund Shareholder Activity During U.S.Stock Market Cycles 1944-95*See