INVESTMENT COMPANY INSTITUTE

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July 28, 2015

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In an appearance on *Nightly Business Report* with hosts Tyler Mathisen and Sue Herera, ICI Chief Economist Brian Reid discusses mutual fund and exchange-traded fund investors' exposure to Chinese markets, as well as the effects of rising interest rates and the Puerto Rican debt crisis on bond funds.

Transcript

Sue Herera, Host of Nightly Business Report: American investors keep roughly a quarter of all their financial assets in mutual funds and ETFs—$18 trillion in all. And those shareholdings are subject to all of the cross currents in play in the markets today, such as China, the potential for rising rates, worries about bond defaults, and a lot more, too.

Here to assess the risks that fund investors face is Brian Reid, chief economist at the mutual fund industry's main trade group, the Investment Company Institute.

Good to see you, Brian. Welcome.

Brian Reid, ICI Chief Economist: Thanks for having me on.

Herera: So, how exposed, in your opinion, do you see mutual fund and ETF holders being to China?

Reid: Very limited exposure directly. Of that $18 trillion that you mentioned that are in mutual funds and ETFs, only about $150 billion is sitting in Chinese stocks. So, that's less than 1 percent. There's a little bit more concentration obviously in an emerging market fund, or a fund that's specializing in the Asia region, but still, that exposure is quite limited for the typical investor.

Mathisen: And where are those stocks held? Are they in Hong Kong, which is the more stable market, or are the stocks mostly in Shanghai — the ones that U.S. funds own?

Reid: That's right. The ones that the U.S. funds own are largely in Hong Kong and some of the ADRs [American depository receipts] that are here on the U.S. exchanges. Because that connection between Shanghai and Hong Kong has been relatively new, there has not been a lot of investment directly in that Shanghai market.

Herera: What about investors who may hold a mainstream U.S. mutual fund, but that mutual fund contains Apple, or Ford, or Boeing, or GM, or Caterpillar—all of whom have large business interests in China, and some of them have been hit by the Chinese crisis? Does that not give them exposure indirectly to the crisis in China?

Reid: Absolutely—there is this indirect exposure. Those companies, though, are largely driven by exports. And so, again, while there is some internal Chinese demand for those products, a lot of that business is exporting back to Europe and the United States. And so, that is where a lot of the demand for that product is coming from.

Mathisen: Let's talk about the possibly of rising rates—however those small those rate rises may be, it will be the first time in a long, long time that American bond fund investors have had to experience what happens when interest rates go up. What does happen to their funds' price?

Reid: Well, the average bond fund has a duration of about 4 to 4.5. And what does that mean? Well, that means when the bond interest rates move up by one percentage point, you can expect your bond fund to fall by about 4 percent to 4-and-a-half percent.

Mathisen: In price?

Reid: In price.

Mathisen: In value.

Reid: In value. Now, at the same time, you continue to get interest income from that. So, that total return is actually going to be somewhat higher than that negative 4 percent, even when bond prices fall, because of that interest income coming to you.

Herera: One of the crises that has been a little bit on the back burner is Puerto Rico, and the bond crisis that's going on there. How concerned are you about that, and how concerned should the average investor be about it?

Reid: You know, when you look at the bond funds that are holding Puerto Rico, there is about 50 percent of the municipal bond funds holding some Puerto Rican bonds. The average exposure in the municipal bond fund is about 2 percent, which is about the share of Puerto Rican bonds in the overall muni market.

Now, there are some bond funds that hold more than that because of the way they specialize, but I think what's important to keep in mind is that the price effects are already built in to the price of that mutual fund. If you get out now, you're locking in those losses.

Herera: All right. Brian, nice to have you here. Thanks for joining us.

Reid: Thanks for having me in.

Herera: Appreciate it. Brian Reid with the Investment Company Institute.

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