Issued: 25 July 2014

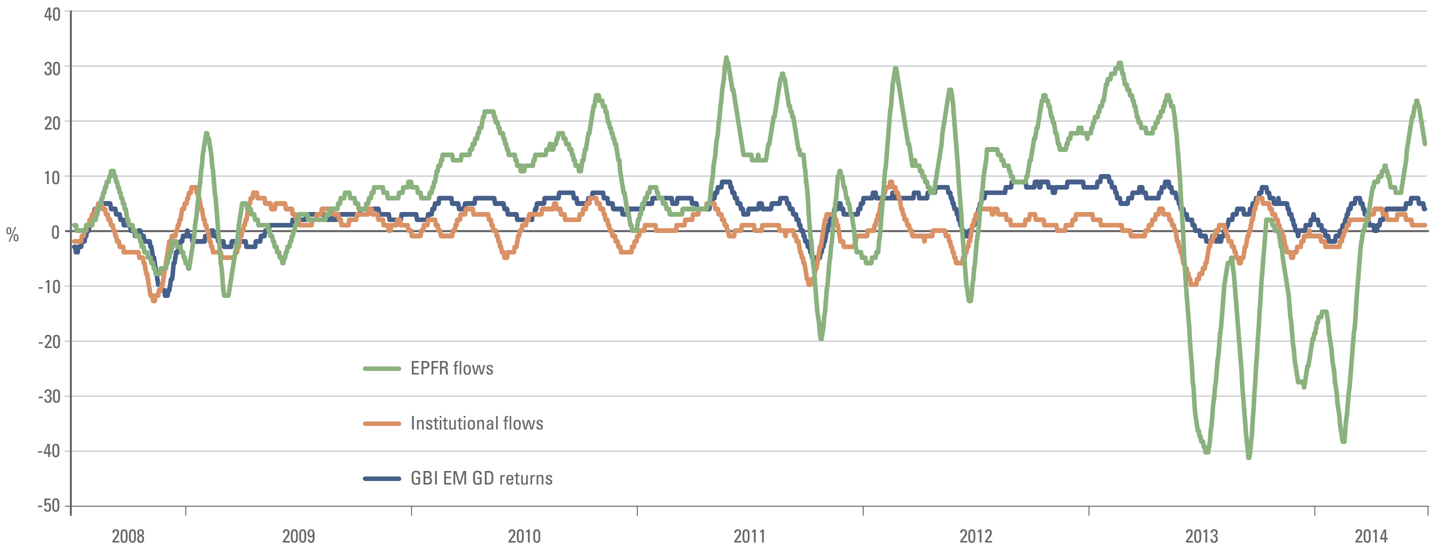
OCCASIONAL VIEW

The illusion of weekly flow data

By Jan Dehn

We believe, the market obsession with analysing weekly flows of US mutual fund investors is understandable but flawed. These flows are not representative of the market as a whole, and they ignore the reality of where the real investor base lies. They do illustrate a number of points well – such as how pro-cyclical the flows are and how violent the response to the 'taper tantrum' of last year was – but need to be viewed in context.

Fig 1: **US mutual fund flows, institutional flows, and EM local currency bond returns**



Source: JP Morgan, Ashmore, Standard Chartered Bank.

The market obsesses about the weekly flows of US mutual fund investors in and out of Emerging Markets (EM) as published by EPFR Global.[1] On the one hand, this is understandable, because EPFR Global's data is the only widely distributed source of EM flow data available on a weekly basis.

Unfortunately, the EPFR Global data is anything but representative of the behaviour of foreign investors in EM. Indeed, it is difficult to overstate just how unrepresentative the behaviour of US mutual fund investors is relative not just to the vast majority of foreign (mainly institutional) investors in EM, but also in relation to the actual market moves in the local currency asset class.

The chart above is based on total foreign holdings in EM local bond markets between May 2008 and July 2014.[2] We show simple monthly moving averages of monthly changes in holdings of EM local currency government debt by US mutual fund investors (measured by EPRF) and other foreign (institutional) investors. We also show the moving average of monthly returns in the GBI-EM-GD index.

What is immediately evident from this chart is that both institutional and US mutual fund investors to some degree behave pro-cyclically, meaning that they tend to buy near the top and sell near the bottom.

But what is more striking is just how pronounced this pro-cyclical behaviour is among US mutual fund investors relative to other foreign investors, as well as in relation to the actual realised volatility in the market itself.

And what is most striking of all is the scale of US mutual fund flows – first in and then out of the market - around the announcement of tapering by the Fed in May last year. The inflows prior to the announcement and the subsequent outflows simply dwarf anything observed in any other episode of volatility, including the sub-prime crisis in 2008/2009, which was arguably a slightly bigger deal, even for EM.

US mutual funds pulled no less than 30% of their exposure in EM local markets after the taper announcement, most of it during

[1] EPFR Global – www.epfr.com

[2] Based on data collected by Standard Chartered Bank, which, in our understanding, is the only institution in the world to compile a near complete picture of foreign flows into EM local markets. We show simple monthly moving averages of monthly changes in holdings of EM local currency government debt by US mutual fund investors (measured by EPRF Global) and other foreign (institutional) investors. We also show the moving average of monthly returns in the GBI-EM-GD index.

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the period of maximum weakness in the market, having added a full 50% to their positions during the bull market that followed the Greek default in Q3 2011, particularly during the latter stages of the rally in late 2012 and early 2013.

We think the market pays too much attention to the very volatile segment of US mutual fund investors in terms of their representativeness of foreign interest in EM as well as their impact on EM markets. The flows reported by EPFR represent less than 15% of total foreign holdings in EM local markets. Moreover, as the chart shows, the other 85% of the investor base behaves radically differently from US mutual fund investors. Institutional investors have generally continued to add to positions in EM local markets, including adding into the weakness last year. The stability of these flows suggests that they are the result of steady programs of allocating to EM as total savings pools gradually increase over time.

Finally, it is important to point out that the size of EM local currency government bond markets today is in the region of USD 6.6trn. This means that foreigners only own about 12% of the total outstanding debt (and US mutual fund investors only 2%). Local institutional investors from within EM today own 88% of EM local bonds. This backstop of local institutional buyers is, ultimately, why the febrile behaviour of foreigners, especially US mutual fund investors, has no lasting impact on markets and no material impact on EM fundamentals. The days of 'Soros reflexivity' – meaning the condition where the departure of foreign investors toppled entire countries – are long gone. Of course, EM countries can and do default and have crises, but such events are country specific.

The bigger – global – systemic risk today is actually that EM investors sell their holdings of local currency bonds from developed economies. After all, EM central banks hold ten times more developed market debt than all foreign investments in EM combined.

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