

## Box 2

### INVESTMENTS IN MIXED FUNDS: NATURE AND MOTIVATIONS

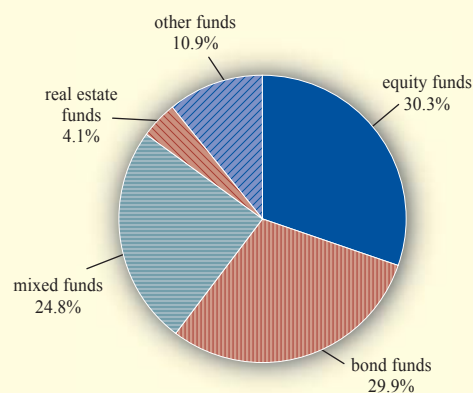
Investment funds are commonly classified according to their investment policy, i.e. the asset classes in which they mainly invest.<sup>1</sup> Some funds follow a “pure” investment strategy, in that they predominantly hold positions in one asset class, such as equity, bonds or real estate.<sup>2</sup> The universe of investment funds also includes funds that diversify their portfolios across multiple asset classes. These are known as mixed, balanced or asset allocation funds. Classification by

<sup>1</sup> Other classification schemes distinguish investment funds according to, for example: their legal form; whether they are open or closed-ended; or whether they accumulate or distribute their earnings.

<sup>2</sup> Money market funds – another major type of fund – invest mainly in money market instruments and short-term bonds. Moreover, financial innovation, globalisation and increased financial market sophistication, as well as the search for higher returns in a context of low levels of interest rates, have prompted the emergence of alternative types of fund, which specialise in investing in, for instance, commodities or in shares/units of other funds (including hedge funds and private equity funds).

**Chart A Investment fund total assets broken down by investment policy**

(percentage points)

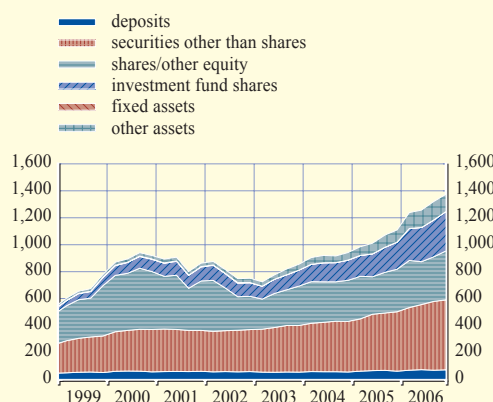


Source: ECB.

Note: The data refer to the fourth quarter of 2006 and exclude money market funds, which are part of the MFI sector.

**Chart B Assets of mixed funds**

(EUR billions)



Source: ECB.

investment policy allows analysts to identify the effect that developments in the realised and expected relative returns of different assets have on investors' portfolio allocation decisions across various investment fund types. As shown in the main text, mixed funds have recently attracted larger amounts of investment capital than bond or equity funds. Against this background, this box looks into the factors that may explain the increased importance of investments in mixed funds over recent quarters. It should be noted that the analysis is based on data that are not completely harmonised across the euro area. In particular, the classification by investment policy follows national rules, in the absence of euro area-wide definitions.

In terms of total assets, the euro area investment fund landscape is dominated by equity and bond funds, which jointly commanded a 60% market share in the fourth quarter of 2006, split evenly between the two types of fund (see Chart A). Mixed funds follow equity and bond funds as the next most important fund type, holding assets that amounted to approximately 25% of the total. It should be borne in mind, however, that the size of funds' portfolios is not only affected by the net investment flows which they attract but also by valuation effects reflecting developments in asset prices. This is more evident in the case of equity and bond funds, the relative size of which is strongly affected by developments in equity prices and bond yields. In the case of mixed funds, however, valuation effects are more muted, reflecting the diversified composition of their portfolios. As a result, the impact – in terms of relative size – of the large net flows into mixed funds over recent quarters has been dampened by the lower valuation effect as compared with equity funds. Consequently, the share of mixed funds' assets in total investment fund assets has remained broadly stable.

Flows into equity and bond funds are normally easier to explain, since demand for the former tends to move in line with stock prices, while flows into the latter are typically related to developments in bond yields. This notwithstanding, the build-up of uncertainty, which on occasion culminates in episodes of market turbulence, can blur these relationships, for example by increasing flows into bond funds as investors "fly to safety". In any case, flows into these types of fund tend to

move in opposite directions.<sup>3</sup> As mixed funds can encompass quite diverse investment strategies, net flows into this category of fund may be driven by a host of heterogeneous considerations. In principle, mixed funds, through their diversified portfolio allocation across asset classes, allow investors to take positions in the equity markets, albeit with more modest overall risk/return features than those typically associated with equity funds. In the current environment, in which equity market valuations are testing their historical highs, while bond markets are affected by uncertainty regarding interest rate developments, the investment strategies proposed by mixed funds have thus become increasingly attractive to investors. Although investors themselves – institutional investors in particular – could arguably replicate the risk/return profiles of mixed funds by taking outright positions, for instance, in equity and bond funds, this would require constant active reallocation of their portfolios to maintain the required profile, which entails increased transaction as well as information costs.

In order to reach definite conclusions regarding the factors that have driven the surge in net flows into mixed funds over recent quarters, it would be necessary to isolate the valuation effects in order to obtain information on net investment flows and, ideally, to have access to information on the sources of these flows. However, official data on these are currently very limited, although efforts are being made to improve this shortcoming. Nevertheless, some relevant insights may be obtained by examining the composition of mixed funds' portfolios and how this has developed over time. A notable feature of mixed funds' portfolios over recent years is the increased tendency to take positions in shares/units of other funds (see Chart B). The size of mixed funds' positions in other funds has grown continuously, from 6% of total assets in the fourth quarter of 1998 to 21% in the fourth quarter of 2006. While the rising importance of investment fund shares in fund portfolios is a development also observed in other fund categories, it is far more prominent in the case of mixed funds. At the same time, although positions in shares and other equity in mixed funds' portfolios have recovered somewhat from the very low levels reached in the aftermath of the bursting of the technology stock bubble, they are still well below their pre-bust peak. This to some extent reflects active investment decisions and not merely valuation effects, since equity prices had recovered most of the lost ground by the end of 2006.

Taken together, these developments point to a possible substitution of outright equity positions in mixed funds' portfolios by shares in other funds, some of which may in turn invest in equity markets. This partial outsourcing of asset management by mixed funds is likely to reflect the increasing sophistication of the investment strategies followed and the financial instruments employed, as well as the broader investment orientation of some of these funds in an effort to diversify their portfolios and enhance their returns. Moreover, the rising importance of investment fund shares in mixed fund portfolios may also reflect increasing positions in funds that are not directly available to retail investors, such as hedge funds and private equity funds, as well as the emergence of specialised funds that mainly invest in such schemes ("funds of hedge funds"), which in some cases are classified as mixed funds.

Overall, the stronger flows into mixed funds in the course of 2006 as compared with any other investment fund type may be a reflection of the specific asset allocation structure of these funds, which offers investors the opportunity to take equity positions with a moderate risk/return profile and also to invest in a diverse range of investment funds, including some types – such as hedge funds – that are not otherwise available to retail investors.

<sup>3</sup> See the box entitled "Recent developments in the net flows into euro area equity and bond funds" in the June 2004 issue of the Monthly Bulletin.