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The portfolio of euro area fund investors and ECB monetary policy announcements [☆]



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ABSTRACT

This paper studies the impact of major ECB monetary policy announcements on the portfolio allocation of euro area fund investors, using daily data between 2012 and mid-2016, a period that includes a variety of unconventional measures. We distinguish between *active* portfolio reallocation, driven by redemptions or injections of investors, and *passive* portfolio rebalancing, triggered by valuation effects related to changes in asset prices and exchange rates. We find that, for this class of fund investors, policy announcements work mainly through valuation effects (the *signalling* channel), rather than via active reallocation (the *portfolio balance* channel). Notably, since the autumn of 2014, monetary policy shocks triggered large asset price and exchange rate effects and prompted a *passive* shift of euro area investors into riskier assets, in particular European and Emerging Market equity funds and out of bond funds.

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1. Introduction

Since the start of the global financial crisis in 2008, central banks around the world have stimulated the economy by aggressively cutting interest rates and implementing unconventional monetary policies. This paper studies the impact that ECB monetary policy surprises between 2012 and mid-2016 have on the portfolio allocation of euro area fund investors. Our main finding is that these investors are only indirectly affected by monetary policy actions via their impact on asset prices and exchange rates. We find little evidence of investors actively reallocating their portfolios, following significant monetary policy announcements.

Most studies have analysed the transmission of monetary policy via the banking system and financial markets. We want to study whether there is a channel of transmission which goes through the asset allocation behaviour of institutional and retail investors. In particular we look into the class of investment fund investors. From an asset pricing perspective, monetary

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policy shocks affect investors' behaviour only insofar as they affect the stochastic discount factor and therefore risk premia. A formal analysis of the links between monetary policy and asset allocation would first try to assess how monetary policy shocks affect the statistical joint distribution of the returns of the portfolio asset classes and then derive its implications for the allocation. We bypass altogether the intermediate step of studying the statistical properties of the asset returns and look instead directly at the impact that monetary policy shocks have on allocations.

Central banks can affect investors' behaviour via several channels. One main channel can be referred to as the *signalling channel*. Changes in monetary policy stance usually affect expectations about future rates, that is the risk neutral components of interest rates. In frictionless finance models, central banks' actions provide new information to investors and affect the forward rates and bond prices, without affecting the positions that arbitrageurs hold in equilibrium and therefore they do not affect risk premia (see, for instance, [Bauer and Rudebusch \(2014\)](#)). As a consequence, in the short run, the signalling channel should not have an impact on active reallocation (due to actual changes in portfolio shares), but should have an impact on passive reallocation (due to the effects on prices).

A second important channel, which typically goes under the name of *portfolio balance channel*, works through the effect that monetary policy operations have on risk premia. The idea of the *portfolio balance channel* goes back to [Tobin \(1965\)](#) and rests on the key assumption that investors have specific preferences for certain types of financial assets. This may be due to differences in preferences, transaction costs or regulatory restrictions. The theoretical implication of this assumption is that changes in the supply of government bonds to private investors via central bank purchases will affect their prices and yields. For instance, according to preferred habitat models à la [Vayanos and Vila \(2009\)](#) and [Greenwood and Vayanos \(2014\)](#), following surprises in purchases of long term treasury bonds by the central bank, investors will be forced to hold smaller positions in long term bonds and bear less duration risk, which in turn will lead to a decrease in risk premia and an increase in bond prices. Because of their effect on the stochastic discount factor, monetary policy shocks associated with the portfolio balance channel should have an impact both on the active and on the passive reallocation of investors.¹

In order to study the impact of ECB policies on the portfolio of euro area investors, we track the evolution of an aggregate portfolio of investment funds that are based in Luxembourg, the largest financial centre for the euro area investment fund industry, which mainly attracts euro area investors. We study how investors, on aggregate, choose investment funds at the fund category level, e.g. bond funds versus equity funds, *not* the portfolio allocation of fund managers. To identify the relevance of the different channels of transmission, we construct measures of *active* portfolio reallocation, driven by the redemptions or injections of underlying investors, and of *passive* portfolio reallocation, triggered by valuation effects related to changes in asset prices and exchange rates, as proposed by [Ahmed et al. \(2016\)](#) and previous work. As common in the literature on the impact of central banks' monetary policy decisions, we identify the announcement effects of traditional and unconventional policies looking at the intraday change in key euro area interest rates around major events, such as ECB Governing Council meetings.

Our main findings show that ECB monetary policy affected investment fund investors mainly via its impact on asset prices and exchange rates. The significant valuation effects associated with these price movements *passively* shifted the asset allocation of euro area investors towards riskier securities, like funds investing in European and Emerging Market equity, and away from European bond funds. These effects are more pronounced for unconventional measures, such as the Asset Purchase Programme (APP). Once we exclude equity funds from the portfolio, we find some evidence of a relative shift in the portfolio of euro area investors towards US and Global corporate bonds, following the APP. Some *active* reallocation into emerging equity markets following ECB actions is observed for institutional investors. Overall, our daily reallocation measures capture reallocation mostly at the margin – with daily standard deviations between 0.02 and 0.1 percentage points. The lack of active reaction of retail investors is consistent with [Calvet et al. \(2009\)](#) and [Ivkovi and Weisbenner \(2009\)](#) who find little evidence of a *disposition effect* of past winners for mutual funds. Our findings are also consistent with the growing literature on rational inattention of informationally constrained investors (see for instance [Gabaix and Laibson \(2001\)](#) and [Alvarez et al. \(2012\)](#)). If information is costly to acquire and process, it is optimal to alternate long periods of inaction with brief periods in which information is processed and portfolios are rebalanced.

The paper is structured as follows. In the next section we provide a review of the related literature. Section 3 presents the investment funds data and explains the construction of our measures of active and passive portfolio rebalancing. Furthermore, we introduce the identification strategy for the impact of ECB monetary policy announcements, with a particular focus on major unconventional measures. Section 4 describes the empirical methodology and summarizes our joint estimation approach. Section 5 discusses the main results and Section 6 presents further robustness checks and extensions of the main model. Finally, Section 7 concludes.

2. Related literature

Our paper is related to many studies about the impact of standard and non-standard monetary policy measures. [Borio and Zabai \(2016\)](#) provide a review of the flourishing literature on this topic and introduce a useful taxonomy to distinguish *balance sheet policies* aimed at influencing financial conditions beyond the short-term rate, from *forward guidance* that manages

¹ [Haldane et al. \(2016\)](#) provide a broader list of the various channels through which unconventional monetary policies are expected to work, including those channels that are more relevant to our study: policy signalling, portfolio balance, as well as confidence, exchange rate, bank lending and market liquidity premia.

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