XXVII ANNUAL CONFERENCE OF MONETARY STUDIES

STRUCTURING COUNTRY INVESTMENT FUNDS

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NOVEMBER 8 - 11, 1995

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I. INTRODUCTION

There is plenty of literature now documenting the recent phenomenal growth of international portfolio investment flows into developing countries. It is estimated that gross portfolio flows to developing countries increased by more than two and a half times between 1989 and 1992, and foreign holdings of emerging market equities totalled US$85.8 billion. This surge in funds flowing to the emerging stock markets accelerated in 1993 and 1994 when total international purchases of developing country equities are estimated to have amounted to over US$25 billion and US$20 billion.

My aim in this presentation is to inform you of the role of closed-end country funds in the private capital flows to developing countries. Closed-end mutual funds are distinguished from open-end funds in that they issue a fixed number of shares at floatation. Because the number of shares is fixed for a closed-end fund, the shares in the fund may trade at a premium, discount or par relative to the net assets value of the fund. This can be contrasted to the structure of the open-ended fund, where the share price always trades at par but the number of shares outstanding may vary daily as stock in the fund is bought or redeemed with the fund manager. A closed-end fund is one that is typically listed on the major stock exchange, like New York or London and invests primarily in listed equities of a particular country or region. Hence a country fund is an investment vehicle that, along with other financial market instruments, helps meet the external financing needs of the recipient country.

While the concept of mutual managed investment in foreign securities had its genesis in the London capital market of the mid-19th century when merchant banking houses led consortium investments in the sovereign bond market, the first modern closed-end country fund dedicated to investments in the securities of a developing country was established in 1981 for Mexico. This fund, the Mexico Fund, mobilized US$112 million in first tranche. A second US$28 million tranche of stock in the Mexico Fund was issued in 1983, and the US$60 million Korea Fund originated in 1984 followed by a US$24 million Taiwan Fund in 1986. Several regional and global emerging market funds that are now regarded as benchmarks within the industry date from 1987 - the Asia Pacific Fund ($87 million), the Scudder New Asia Fund ($84 million), and the Templeton Emerging Markets Fund ($100 million) all came to market in that year. By 1988, developing country closed-end funds had an established market presence as a distinct asset class that began to attract increasing interest from institutional and individual investors alike.

Having provided some background on the emergence of the country funds, I wish to cover in the next section (Section 2) some of the reasons that led to growth in emerging market country funds. In Section 3, I will attempt to identify the particular advantages and disadvantages of country funds from the perspectives of both the industrial country investor and the developing country recipient of the investment capital. Section 4 briefly considers the seminal role of the International Finance Corporation (IFC) in the origination of country funds for emerging market economies.

II. GROWTH IN COUNTRY FUNDS

Closed-end country funds have accounted for a significant although variable share of total portfolio flows to developing countries over the past five years. In 1990, $3.5 billion were channelled to developing countries by way of closed-end funds, equal to over two-thirds of total portfolio flows in that year, but in 1991 and 1992 the total volume of closed-end funds targeting emerging markets was markedly lower at just $1.2 billion and $1.4 billion respectively. In the new investment climate evident in 1993, new issues of closed-end country funds mushroomed to $4.2 billion - making a significant contribution to total portfolio capital flows to developing countries that year which have exceeded $25 billion.

Unlike the mid-80s, when the country fund size tended to be between $25-$50 million, during the late 80s and early 90s, many sizeable new country funds were brought to market with single country funds totalling $200 million or more. These country funds were typically for countries which have a big market capitalization like India, Indonesia, Korea, Malaysia, Philippines, Thailand, Chile and Mexico. After the fall of the Berlin Wall but before the collapse of the USSR, $180 million was raised in two funds for Hungary, and almost $1 billion was issued in regional funds chartered to invest in Eastern Europe. Similar amounts were also raised for regional funds targeted to Asia and Latin America for specific industry or asset class.

Several underlying factors are responsible for both the growth in country funds issuance and the more general increase in portfolio capital flows to developing countries. On the supply side, improvements in developing country capital market infrastructure have coincided with reduced macroeconomic imbalances in several countries and lower assessments of country risk. Large privatization programs in telecommunications, utilities and energy in Latin America have been accompanied by security issues that have increased the size and sophistication of local stock markets, which coupled with tax and regulatory environments more favorable to the foreign investor, have served to expand the investment horizon of industrial country investors.

On the demand side, the preferences of industrial country investors for risk and return, the greater feasibility of international portfolio diversification in a more closely integrated global capital market, flagging investment yields in industrial capital markets and a general assessment that at current prices emerging market equities continue to represent good value and further have good growth prospects, have all added to produce consistently firm demand for developing country portfolio investments.

III. THE ADVANTAGES AND DISADVANTAGES OF CLOSED-END COUNTRY FUNDS

1. ***The Investors' Perspective***

In perfect international capital markets, country funds would offer no advantages over an investment in a portfolio of securities constructed to replicate the holdings of the fund and would

therefore represent a redundant security class. Thus the presence of real world market frictions is the primary economic rationale for the existence of country funds, and indeed, for any mutual investment vehicle. In practice, country funds offer a number of particular advantages to investors over direct equity investments in the underlying securities.

Advantages

* First, country funds allow investors to rapidly attain wide international portfolio diversification at least cost. Subsequent adjustment of actual international portfolio holdings to shifts in desired allocations in the face of exogenous shocks to preferences or incomes may be similarly effected at low cost.

* Second, country funds provide active professional management of investments in developing countries areas that are typically outside the ordinary realms of experience of many industrial country investors and where therefore valuation expertise would otherwise be costly to obtain. In addition, in common with all mutual funds, the investment aggregating function of country funds will typically lead to economies in the form of lower management and administrative costs per unit of investment and the country fund also offers greater divisibility of investments - a feature that increases their attraction to the individual and smaller investor clientele.

* Third, in some instances a country fund may hold an outright monopoly on foreign investor access to a developing country's security markets, or failing this, may enjoy preferential tax or regulatory status relative to other forms of portfolio investment. In these cases, the country fund's shares can be expected to trade at a premium to its net asset value that varies with the value of the monopoly position.

* Finally, the country fund is well suited to the country allocation decision that is typically an integral part of an institutional investor's international investment management process. The country allocation decision, which produces some vector of required portfolio investments in different countries, may be efficiently implemented through purchase of country funds. Empirical evidence suggests that the country allocation decisions dominates the choice of industrial sector in terms of total portfolio returns.

Disadvantages

* From the investor's point of view, the main disadvantages of the country funds have to do with the characteristics of their return distributions and the risk that the market in country fund shares considerably mis-prices the underlying assets. There have been several empirical studies of country fund returns. A common finding is that on account of the observed time-variation in the premium/discount to net assets value of the country fund, country fund returns are somewhat correlated with returns on the market in which they are listed and so are less than perfectly correlated with the returns on their net asset values.

* Consequently, investment in country funds fails to capture all the diversification benefits available to direct investment in the underlying developing market indices. However, one should bear in mind that for many of the emerging markets, there is no indexed vehicle available for investment. There is also some study which suggests that the diversification benefits of country funds are related to the investment horizon - the longer the investment horizon, the greater correlation of U.S. listed country fund returns with the returns on the U.S. market and the less the diversification benefits.

2. ***The Developing Country's Perspective***

Aside from providing an additional source of long-term financial capital for developing countries, closed-end country funds offer several specific advantages as a source of external finance for development.

First, they are a practical investment vehicle in illiquid security markets. Typically, a new closed-end fund represents a commitment of capital for a fixed term of ten years. In contrast to the mechanics of an open-end fund where a sale of shares in the fund by end-investors obliges sales of the underlying assets of the fund once liquidity balances have dropped below pre-determined levels, from a liquidity perspective at least, the markets in the underlying assets of a closed-end fund are independent of the market in the shares of the fund itself. A sale of shares in the closed-end fund on the New York Stock Exchange say, may depress the fund's share price but, provided there is some segmentation between the New York market and the local stock exchange, the sale of fund stock on the NYSE will not necessarily induce selling pressure in the constituent stocks of the fund on the local stock exchange. Where the local market in which the fund is invested is illiquid or even non-existent as in the case of venture investments, this insulating property of the closed-end fund is particularly valuable.

Second, the long-term commitment of capital represented by a closed-end fund will tend to reduce a country's reliance on potentially more volatile sources of private external finance such as short-term bank credit. The lesser the risk of "hot-money" flows in and out of the domestic financial system, the easier the task of macroeconomic and monetary management. Central bank control of the money supply would be facilitated and the risk of inflation reduced. Interest rate and exchange rate volatility would probably moderate as well and this would contribute to a lower cost of capital and increased real investment levels.

Third, the diversified ownership structure of a mutual fund is attractive to those host country governments that are concerned about the loss of control over national corporate assets that might arise if foreign ownership was more heavily concentrated among a few foreign firms or institutions undertaking direct portfolio investment in developing country stock markets.

Fourth, the management of the country funds brings with it considerable investment valuation and operational skills that serve to strengthen the capital market institutions of the developing country. The usual legal requirements that foreign fund managers and promoters team up with local equity partners in the local fund management concern ensures that a minimum transfer of investment

technology takes place. Corporate research is typically encouraged and the pricing efficiency of the local market is enhanced. This in turn contributes to a lower cost of capital. Provided that exchange markets are sufficiently transparent and open to foreign participation, the commercial banking relationships of the country fund managers may also come to serve the external debt financing needs of local companies.

Fifth, the admission of a foreign-listed closed-end mutual fund to a developing country capital market usually results in higher equilibrium stock prices in the local market and a lower cost of equity capital to local firms. This result obtains when the valuable diversification benefits or covariance risk of the fund is priced at the global market price of risk and this factor is not offset by any downward pressure on local market prices that arise from the documented valuation errors in the market in the foreign -listed shares in the fund.

IV. THE ROLE OF INTERNATIONAL FINANCE CORPORATION

IFC's involvement in collective investment fund or country fund business began in 1984 with the first Korea Fund which was sponsored and lead managed by IFC and met with enormous success. The Korea Fund quickly became the model which other countries strove to replicate as they sought to introduce their stock markets to the international investors. Since then, IFC has participated in the floatation of over 94 funds in 36 countries totalling to about $748 million. Of these funds, 26 are country funds, some regional funds, some global funds and some debt-equity conversion funds. Debt-equity conversion funds were mainly associated with the debt crisis and the large external debt restructurings pursuant to the Brady-plan. They were used as ancillary financing vehicles to channel additional funds into secondary market purchases of LDC debt for later conversion into equity holdings in companies in developing countries. With the exception of a couple of unit trusts that were issued in domestic capital markets, all of the funds that IFC has been involved in have been cross-border closed-end funds.

IFC has also been involved in a variety of specialized funds such as venture capital funds, index funds and corporate debt funds. Although the last two i.e. the index and corporate debt funds are a recent addition, IFC's involvement with the venture funds is as old as its involvement with the country funds. Venture funds invest in unlisted, risky new business ventures that typically aim at an eventual stock exchange listing upon creation of a viable business in order to return capital to investors. While the venture capital market occupies a small niche in most industrial country capital markets, the venture capital concept is well suited to a large cross-section of private sector investment activity in developing countries.

Country funds have become a very successful vehicle for international institutional investors to have an exposure to the emerging markets. Huge amounts have been mobilized and invested in emerging markets through this vehicle. However, there are still many emerging markets, typically the smaller markets, for which there are no dedicated country funds. Although the general emerging market funds can invest in any emerging market, in reality they tend to focus on a few larger markets and hence very little, if any, investment is channelled to the smaller markets. If smaller emerging markets want to encourage foreign investments in their stocks, then establishing a country fund or a regional fund e.g. a Caribbean fund focussing on specific countries would help.

V. CONCLUSIONS

Closed-end country funds have accounted for a significant although variable share of total portfolio flows to developing countries over the past ten years.

Country funds offer investors situated in industrial countries several advantages over an equivalent investment in the underlying securities of the fund including: least cost access to international portfolio diversification, active professional management of investments in developing countries where investor expertise is limited, access to markets that are otherwise restricted and an investment vehicle that is well suited to the institutional investors' country allocation decision. From the investors' stand-point. the main disadvantage of country funds is the risk that the market in country fund shares mis-prices the underlying assets.

From the perspective of the developing country, closed-end country funds are a practical investment vehicle in illiquid security markets. They represent a commitment of long-term investment capital whose diversified ownership entails little or no loss of national control of corporate assets while offering the possibility of transfers of investment valuation expertise and capital market institution building opportunities.