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International Asset Allocations and Capital Flows: The Benchmark Effect

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Abstract

Benchmark indexes have become important in financial markets for portfolio investment. In this paper, we study how international equity and bond market indexes impact asset allocations, capital flows, asset prices, and exchange rates across countries. We use unique monthly micro-level data of benchmark compositions and mutual fund investments during 1996-2014. We find that movements in benchmarks appear to have important effects on equity and bond mutual fund portfolio allocations, including passive and active funds. The effects persist after controlling for time-varying industry-level factors, country-specific effects, and macroeconomic fundamentals. Changes in benchmarks not only impact asset allocations, but also capital flows, abnormal returns in aggregate stock and bond prices, and exchange rates. These systemic effects occur not just when the benchmark changes are announced, but also later, when they become effective. By impacting country allocations, benchmarks explain apparently counterintuitive movements in capital flows and asset prices, as well as contagion effects.

JEL Classification Codes: F32, F36, G11, G15, G23

Keywords: benchmark indexes, contagion, ETFs, international asset prices, international portfolio flows, mutual funds

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