

ABSTRACT

Flight to Quality and Canadian Mutual Fund Flows

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This paper examines the asset allocation decisions of mutual fund investors, focusing on flight to quality considerations. Specifically, we study monthly net flows to the universe of Canadian mutual funds between 1991 and 2005 to see how investors vary flows across fund categories as economic conditions change. Using the default spread, term spread and short term interest rate as proxies for economic conditions, we find that an improvement (deterioration) in Canadian economic conditions causes investors to direct flows away from (towards) fixed income-type funds and towards (out of) equity based funds. For example, a one standard deviation increase in the term spread (1.13%) results in an 84% increase and a 74% decrease in the percentage of flows directed at Canadian equity and money market funds respectively. To further assess the significance of shifting risk preferences, we examine the flows to equity and money market funds surrounding three major crises: the Long Term Capital Management debacle, the Y2K problem and the 9/11 terrorist attacks. Each episode is accompanied by significant flows into money market funds and out of equity funds. For example, the August 1998 Long Term Capital Management failure sees Canadian investors move \$1,850 million into money market funds and \$627 million out of equity funds. Our results provide evidence both of a strong flight-to-quality motivation underlying aggregate mutual fund flows and of rationality in mutual fund investor asset allocation decisions.