

OPINIONS

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Analysis from ICI Chief Economist Brian Reid

Our report on “Trends in Mutual Fund Investing” for July shows a continuation of several trends in bond and stock mutual funds—activity that has attracted a great deal of attention and commentary in the media and online in recent weeks.

Considering historical investor patterns for the last 20 years, we are currently seeing weaker investor demand for domestic equity mutual funds than those patterns would lead us to expect. We typically see greater inflows into domestic equity funds at this point in the market cycle, and would expect those inflows to be coming now, particularly given the current savings rate among U.S. households. The data suggest a broader asset allocation story may be unfolding.

The July data continues some general trends:

- Outflows from money market funds: From January through July 2010, \$515.6 billion flowed out of money market funds. This is primarily related to the current low yields on those funds.
- Mixed patterns for domestic and international equity funds:
 - Funds invested in domestic equities have shown outflows for three months; year-to-date through July, these funds have seen cumulative outflows of \$29.6 billion.
 - Funds invested in international equities were in net inflow through July. Year-to-date through July, these funds had net inflows of \$27.9 billion.
- Continued strong inflows to bond funds: Bond funds attracted net new cash flow of \$185.6 billion from January through July.

Today's report does not include trends for exchange-traded funds; we will report ETF data for July later today. However, it is important to note that in the first six months of 2010, outflows from domestic equity mutual funds were partly offset by net purchases of ETFs that invest in domestic equities. As investor demand for ETFs grows, they must be considered in any analysis of household investors' attitudes toward equities.

The decreased demand for domestic equity funds and the shift toward bond and international equity fund investing began in 2005 and, with the exception of 2008, continue to the present.

Some factors that may be at play include:

Short run

1. Stock market performance. Major U.S. stock indexes are down slightly for the year, after the strong run-up in 2009. The weak performance of stocks in the past several months has reduced demand for equity funds. International stock markets have generally outperformed U.S. stock markets in dollar terms during the past several years.
2. Interest rates. Cash flow into bond mutual funds is highly correlated with the performance of bonds. The decline in interest rates in 2009 and 2010 pushed annual returns on investment-grade corporate bonds up by about 40 percent; returns for high-yield bonds have risen by nearly 70 percent.
3. Yield. In addition, low short-term interest rates and the relatively steep yield curve likely are enticing some investors, both institutional and retail, to shift out of money market funds—whose yields are hovering just above zero. Some retail investors may be moving assets into bond mutual funds.

Long run

1. Demographic factors. Older investors tend to have a lower tolerance for risk, so as the U.S. population ages, the aggregate risk tolerance is likely to drop. The leading edge of Baby Boomers has started to retire, and other Baby Boomers see their retirement approaching. As a result, some of these investors may be allocating a larger portion of their investments to fixed-income securities. Bond mutual fund inflows since 2004 have been stronger than can be explained by cyclical demand, suggesting that flows could be driven by such reallocation as a result of a longer-term demographic shift.
2. Diversification. The relatively strong inflows to international equity funds have been evident since the mid 2000s, and indicate an ongoing shift from domestic equity funds to international funds. In addition to the outperformance of foreign stocks relative to U.S. stocks, a portion of the greater demand may reflect investors' desire to increase the diversification of their assets across international equity markets.
3. Risk tolerance. ICI's [U.S. household surveys show](#) that in recent years, retail investors' tolerance for investment risk has flattened out or dropped across all age groups. One factor that may partly explain this development is that investors have recently endured two of the worst bear markets in stocks since the Great Depression during the past decade.
4. Increased use of asset allocation strategies. Investors are paying increasing attention to asset allocation—the mix of equity, fixed-income, and cash assets in a portfolio. The growing popularity of [target date funds](#)—funds that automatically allocate investors' funds among various asset classes and adjust that allocation toward fixed-income assets as investors approach retirement age—is an illustration of that trend. These funds' automatic allocations have likely led to an increased demand for bond mutual funds.

Note: ICI data cover about 98 percent of assets in the mutual fund industry. Our monthly data report tracks the assets and actual flows of money into and out of long-term (stock, bond, hybrid) and short-term (money market) funds.

Members of the media should continue to contact our media relations team (202/371-5413) for ICI data and interviews with me or my colleagues about the data. I'll continue to provide

additional written analyses as we have new information or commentary. --Brian Reid, ICI
Chief Economist, August 30, 2010

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