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Where Has All The Money Gone?



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Key Points

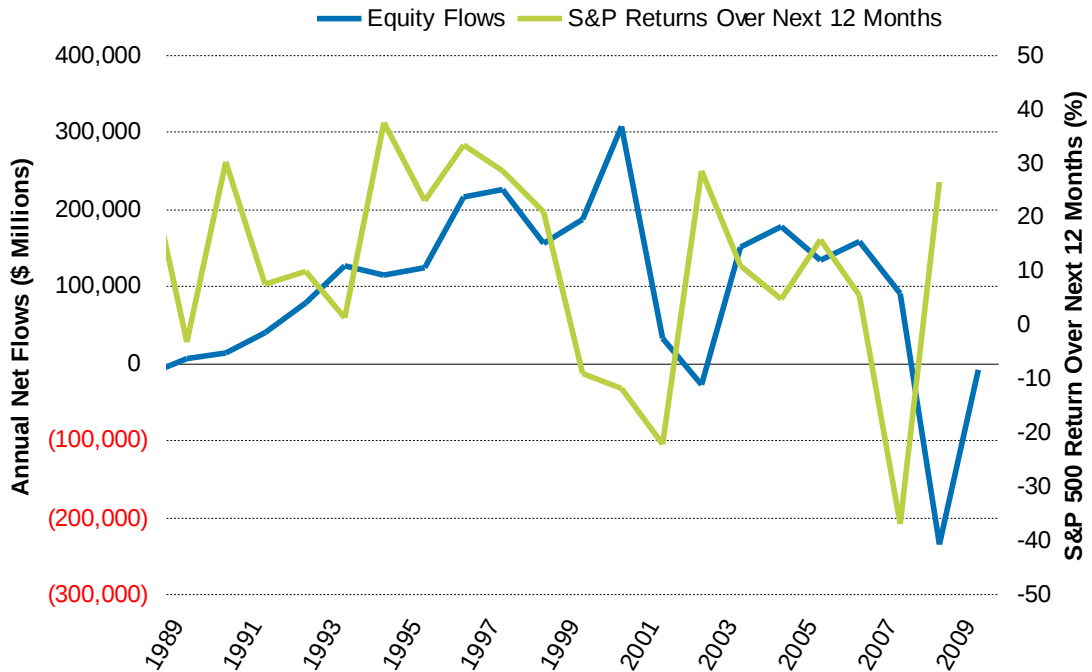
- *Investors, in aggregate, have a poor track record of timing the market.*
- *Fund flows into fixed income have been sky-rocketing since the fourth quarter of 2008 – a cautionary flag for the asset class.*
- *Several areas within fixed income have been especially favored by investors.*
- *Fixed income will always have a place within a balanced and diversified portfolio.*

For an investment decision-maker, analyzing fund flows data can provide valuable information; they allow us to see beyond what other investors are saying to what they are *actually doing* with their money. Are investors favoring one area of the market over another? Are they overlooking other sectors? Are they punishing others? With the benefit of hindsight, we can also see how successful (or unsuccessful) investors have been in their decision making.

(As a data junkie, fund flows data is a treasure trove as there are so many ways to slice and dice the data. If the introduction didn't already make that apparent, it will be clear by the end of this article. But stick with me, there are some shocking numbers ahead!)

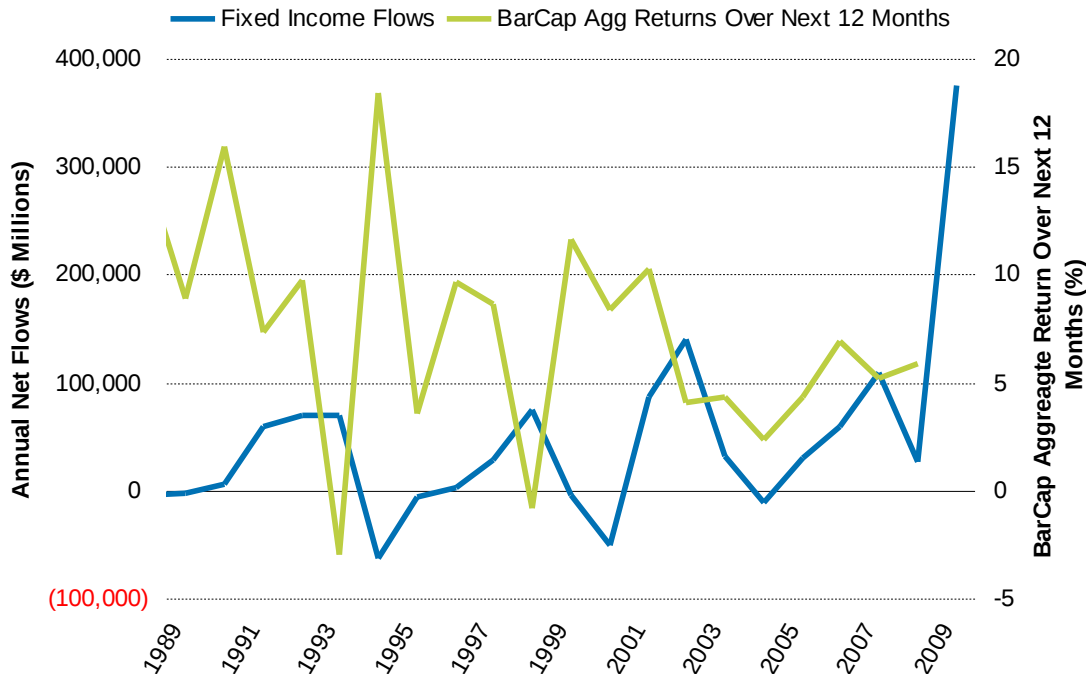
We have discussed numerous times how investors in the aggregate are poor at timing the market and there are numerous studies that show this (Dalbar Study, Morningstar Investor Returns, etc). But let's spend a few paragraphs and charts reviewing this concept using fund flows, before examining what investors are doing today with their money.

The Investment Company Institute (ICI) provides fund flows data stretching back over 20 years. Below is a chart looking at annual flows into equity funds from 1989 through 2009. Mapped onto this is the return of the S&P 500 over the following year. Were investors "good" at predicting 12 month returns, you would expect these charts to match up better. But this is not the case. In 2000 flows to equity funds peaked at roughly \$300 billion. The stock market was down nearly 12% in 2001 (and down roughly 22% in 2002). Investors in aggregate pulled money from equities in 2002, just in time for a roughly 29% return in 2003. And then in 2008, investors pulled over \$200 billion from equities, only to see the market rise over 26% in 2009.



Source: Flows data comes from Investment Company Institute as of 12/31/09. S&P 500 Returns data from Morningstar Direct.
Disclaimer: You cannot invest directly in an index. Past performance is no guarantee of future results.

Are investors better at timing the market in a different asset class, say fixed income? As the chart below demonstrates, investors in aggregate are no better at timing the market in fixed income.



Source: Flows data comes from Investment Company Institute as of 12/31/09. Barclays Aggregate Returns data from Morningstar Direct.
Disclaimer: You cannot invest directly in an index. Past performance is no guarantee of future results

As demonstrated by the above charts, fund flows (like other measures of sentiment) serve as a contrarian indicator. Once everyone has already piled into a trade, there are fewer marginal buyers to push prices higher. It does not take much for a reversal to happen. And vice versa. Once everyone has sold out of a trade, there are fewer people left to sell and push prices lower.

Take another look at the fixed income flows chart above. In 2009 investors poured roughly \$375 billion into fixed income funds. A lot of this was driven by flows out of money markets as investors searched for higher yields. But that is more than 2.5x the prior largest inflow into fixed income. As far as sentiment indicators go, that is a big, red flag waving for the fixed income asset class.

We could debate whether this flow toward fixed income is appropriate – maybe investors had too much equity to begin with or it is natural to see an increase in fixed income as baby boomers enter retirement – but that is not the aim of this article. (For the record, I would argue that much of the fund flows to fixed income is reactionary or people reaching for yield.) And in pointing out that the fund flows to fixed income have been extreme, I am **not** arguing that investors go out and sell all of their fixed income exposure. Fixed income still has its place (as it always has and will) within a balanced and diversified portfolio. With the rest of this article, I would like to delve further into the fund flows data and examine where, within fixed income, assets have been directed.

To see where fund flows are going within fixed income, we turn to Morningstar which not only breaks the fixed income mutual fund universe into over 20 sectors but also provides monthly net fund flow data going back to 1998. Trying to present data on all 20 sectors would be messy and cloud the message of this piece, so I am going to take some liberties and highlight a few sectors which have seen noteworthy flows: Emerging markets (EM) bonds, municipal national short-term bonds, long-term bonds, short-term bonds, and world bonds. (In the end, I will point out some areas of the bond market which have not received the same attention from investors.)

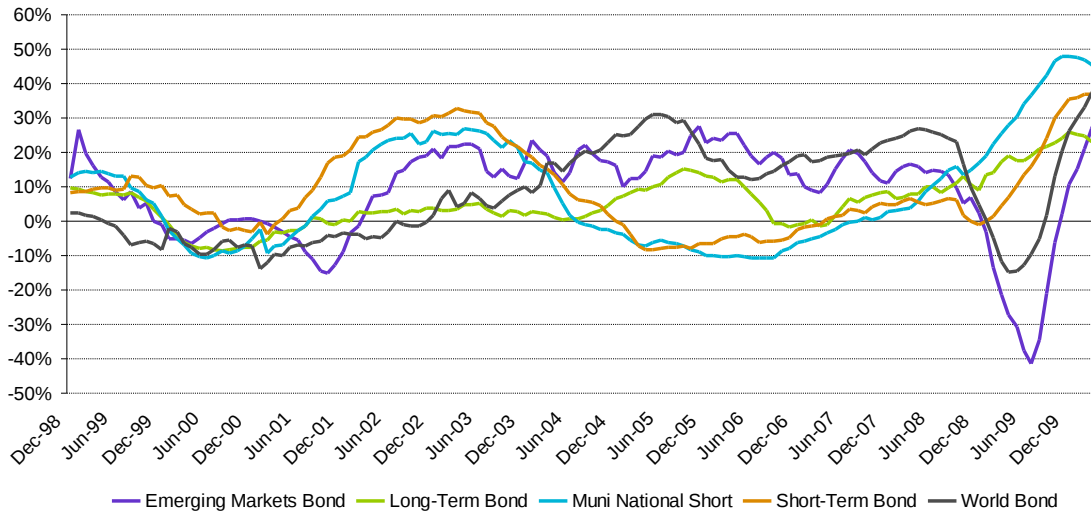
Below is a chart looking at annual net flows into each of the above mentioned sectors. With the exception of EM debt, each of these sectors saw a record level of inflows in 2009. (And EM debt was not far off prior highs!) Looking at 2010 inflows (as of 4/30/10), each sector has continued to see massive inflows. EM debt has already seen more inflows this year than in any prior calendar year (or any rolling 12 Month period prior to 2010, for that matter). And if flows continue at the current pace, 2010 will blow-away any other calendar year. Long-term bond and short-term muni have seen flows ebb slightly, but the pace of flows would still surpass any year prior to 2009.

Net Flows (\$ millions)					
Year	Emerging Markets Bond	Long-Term Bond	Muni National Short	Short-Term Bond	World Bond
1998	236.9	512.3	1,795.7	2,003.1	368.2
1999	-27.2	54.9	216.2	2,908.5	-1,099.9
2000	20.4	-383.8	-733.9	-907.8	-906.7
2001	-234.9	17.6	1,223.2	7,631.9	-410.3
2002	747.1	261.1	6,591.6	18,627.2	237.2
2003	977.9	127.8	5,435.5	16,040.1	1,644.0
2004	1,272.3	559.5	-1,007.0	124.2	6,509.9
2005	2,662.8	1,322.5	-2,742.4	-4,966.0	5,821.4
2006	2,068.0	-103.4	-1,649.1	-1,950.1	7,950.5
2007	1,953.4	996.4	823.7	4,279.2	14,297.9
2008	315.0	1,192.2	5,964.8	-957.6	3,072.6
2009	2,134.9	5,148.0	35,368.8	50,502.3	24,936.5
YTD 2010	4,748.2	1,612.1	5,591.5	19,190.9	18,673.4
2010 pro-rated	14,244.6	4,836.3	16,774.4	57,572.8	56,020.2

Source: Morningstar Direct Fund Flows Data as of 4/30/10.

These absolute numbers are outstanding, but we do need to provide some context. One way to do to this is to compare the size of the inflows relative to the size of the asset class; a \$2 million inflow is more significant if the asset class has \$4 million versus \$400 million. Below is a chart looking at the rolling 12-month net flows relative to the amount of assets invested in each sector. A higher ratio suggests that recent flows represent a larger portion of the assets within a sector. This could be a sign of hot or inexperienced money entering the market. For each of these sectors this ratio is at or recently reached an all-time high. And, with the exception of long-term bonds, flows within the last 12 months, represent a third or more of the assets under management in these sectors.

Ratio of Rolling 12 Month Flows / Assets Within Asset Class



Source: Morningstar Direct Fund Flows Data as of 4/30/10.

Take another look at the list of sectors I have presented. Muni short-term and short-term bonds intuitively make sense on this list as beneficiaries of money market funds yielding next to nothing; investors are extending duration in search of yield and these sectors are the next step out. But, long-term bonds? One of the more consistent concerns we have heard is about rising rates. If investors are truly concerned with rising rates, we would expect to see outflows (or at least muted flows). EM debt and world bonds are means to avoid rising rates in the US. However, rates are low in many countries across the globe and concerns around sovereign debt (see Greece and Europe) are on the rise.

Two fixed income sectors which have seen noteworthy inflows are bank loans and inflation-protected bonds. I did not include them in the above list because judging by the ratio of net inflows to overall invested assets, neither of these sectors are seeing anything unprecedented. However, the absolute size of the flows is large and historic for the two sectors. Bank loans, year-to-date are on pace to receive roughly \$16 billion, more than double their prior annual high. Inflation-protected saw a record \$18 billion in flows in 2009 (the prior high was just shy of \$9 billion) and is on pace this year to match the flows of last year.

As promised, there are some fixed income sectors which have not seen as dramatic flows. High yield is notably not on the above list despite strong returns in 2009. The sector has seen decent flows since 2009 (roughly \$22 billion), but the sector has seen stronger flows in the past (2002-3, for example). A former investor favorite, multi-sector bonds, is also conspicuously absent from this list. Like high yield, the sector has seen decent flows (roughly \$17 billion) but this is approximately half of the assets investors bestowed upon the asset class in 2006-7.

Several areas of the fixed income asset class have also seen outflows during this period. Since 2009 investors have pulled money from long government bond funds. And the ultimate contrarian play in the fixed income space, as measured by fund flows, would be to hold cash. Money market funds have seen money pour out on the order of \$800 billion since 2009 (total includes taxable and municipal money markets).

Ok. So what's the point, Jeff? Should I go out and sell my fixed income funds? **Again, I am not saying 'go, sell your fixed income funds.'** What I am trying to say is that fixed income (and some specific sectors within fixed income), have received unprecedented amounts of love from investors – and investors in aggregate have been notoriously poor at timing the market. I think much of the fund flows have been reactionary – to the market turmoil of 2008 and a “lost” decade in equities. Additionally, these massive flows have come on the heels of a nearly 30-year bull market in interest rates and at time when absolute rates are at generational lows. **Fixed income still has a place within a balanced and diversified portfolio** and investment decisions should be based on more than just fund flows or sentiment.

My takeaways for investors are three fold:

1. Recognize that there are risks in the fixed income market and a *lot* of money has flowed there recently.
2. Re-evaluate allocations to some of the sectors highlighted in this article.
3. Adjust expectations for the asset class. As Bill Gross, manager of PIMCO Total Return (the largest mutual fund in the world and a recipient of his fair share of these flows to fixed income) said in a recent interview; “bonds have seen their best days.”¹

(I warned you that fund flows were data heavy. Hopefully, you managed to stick with me till the end. For those who did, I will reward you with a little fact you can use at your next cocktail party. When you find yourself in a conversation with someone bragging about owning Bill Gross' PIMCO Total Return [and yes, people do brag about this. Maybe I go to different cocktail parties than most.], ask them if they know how much money the fund took in over the past year. The answer: just over \$52 billion for the one year ending 4/30/10. That is One Billion dollars a week! That is also more assets than most mutual funds have - only 11 other funds have over \$52 billion in total assets under management!)²

¹ Keene, Thomas and Susanne Walker. “Pimco's Gross Says Bonds Have Seen Their Best Days, Recommends Holding Cut.” Bloomberg. 3/25/10. <<http://preview.bloomberg.com/news/2010-03-25/pimco-s-gross-says-bonds-have-seen-their-best-days-recommends-holding-cut.html>>

² Morningstar Direct Fund Flows Data as of 4/30/10.

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