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Stocks Anyone?

Why Mutual Fund Buyers Haven't Joined the Bull Market

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As the bull-market rally in stocks enters its second year, the gains thus far have been impressive. The U.S. stock market is up 72% from its March 2009 low—the fastest start to a bull market rally since the 1930s.[i] Unlike previous rallies, however, mutual fund investors do not appear to be swayed. While they plunked a record $385 billion into bond mutual funds during the past year, the move to put additional money into stocks has barely reached a trickle.[ii] This dynamic has been cited by some technicians as a healthy contrarian sentiment indicator—a signal that no one really believes this rally, and thus there is still plenty of money on the sidelines that can boost stock prices if investor skepticism ever becomes enthusiasm.

Traditional investor behavior

The behavioral patterns of mutual fund investors are viewed by many market technicians as a wide-ranging sentiment proxy for the broad public, which includes everyone from expert to novice investors. A common pattern of investor behavior goes something like this: Investors chase positive performance, moving into an asset category such as stocks after prices have gone up and the performance pattern is well-established. When prices go down, some investors tend to stop buying or shift their new purchases to another category, such as bonds or money markets. This sort of behavior is backward-looking and sometimes typifies a "herd mentality," where investors make choices based on old (and not forward-looking) observations, and they reinforce each other's actions as being the right thing to do because everyone else is doing it. Market technicians, therefore, see big mutual fund purchasing trends as a possible sign of excessively positive sentiment, which would cause the "smart" investor to take the opposite or contrarian position by shunning the asset category when it is being flooded with net new flows, and vice versa.

The classic example of when this contrarian thinking would have worked was near the peak of the technology-stock boom in the late 1990s, when investors poured record amounts into stock mutual funds. The all-time peak of net new stock mutual fund flows ($338 billion) occurred during the one-year period ending in September 2000—near the start of a more than two-year slide that shaved 49% off the market's total value.[iii] Three years later, when net redemptions of stock mutual funds hit all-time highs (investors were selling more assets in funds than they were buying), the stock market was just beginning its 2003 rebound that would start a four-year bull market (see Exhibit 1, page 2). At these turning points in the market, using extreme mutual fund flow signals as a contrarian indicator (doing the opposite of what other buyers were doing) would have worked quite well.

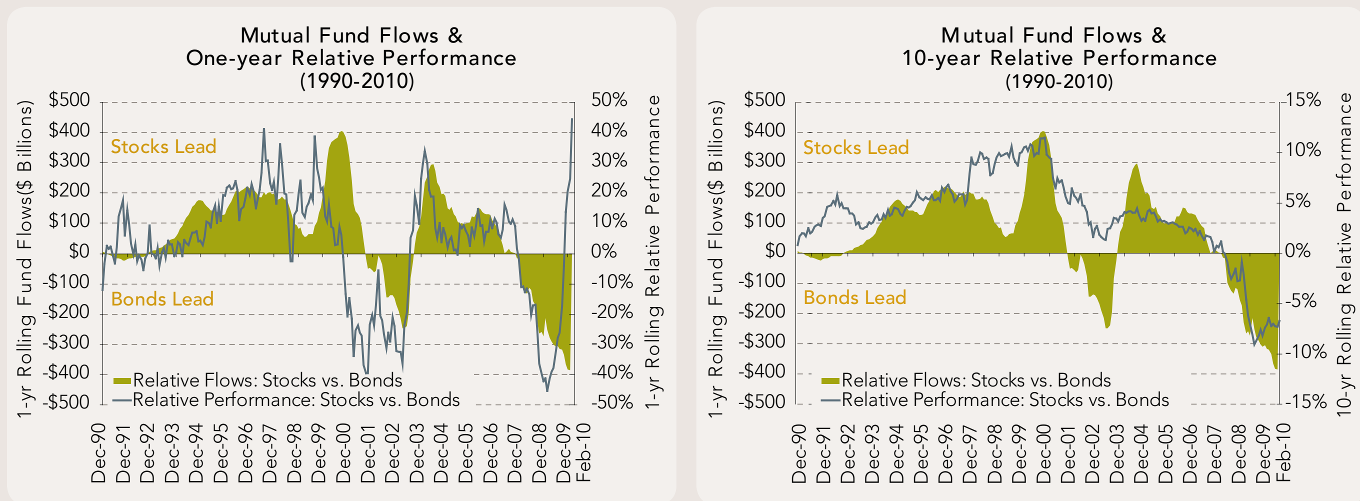
Why recent behavior may be different

The question this time is why is there no interest in stocks after a furious one-year rally? For investors looking for a contrarian indicator from this lack of buying, the problem is this: If mutual fund investors have not been chasing recent performance, how useful can flows be as a contrarian indicator? The premise of mutual fund sales as a proxy for what not to do is based on the idea that these sales represent performance-chasing, herd-following behavior. If recent fund flows do not follow that "herding" pattern, it seems their value as a sentiment indicator may have disappeared.

KEY TAKEAWAYS

- **Despite one of the biggest one-year stock market rallies in decades, U.S. mutual-fund investors have instead chosen to put new money into bond funds at a record pace.**
- **One explanation is that investors may be attracted to the longer-term outperformance of bonds relative to stocks over the past 10 and 20 years—which could possibly be a signal that this performance leadership trend is nearing an end.**

EXHIBIT 1: During the past year, investors have put a record amount of money into bond funds while stocks have outperformed bonds by more than 44% (left)....but on a 10-year basis (right), bonds have handily outperformed stocks, which raises the possibility that investors may be herding to bonds based on the longer-term relative performance of the two asset classes.



Relative Flows refects net sales to stock funds minus net sales to bond funds. **Relative Performance** reflects total stock returns minus total bond returns. All references to stocks represented by the Standard and Poor's® 500 Index. All references to bonds represented by the Barclay's Capital® U.S. Aggregate Bond Index. Source: Ibbotson Associates, Investment Company Institute, FMRCo (MARE) as of 2/28/10. *Past performance is no guarantee of future results.*

Are investors more intelligent or shell-shocked?

It is possible that the behavior of mutual fund investors may have undergone some sort of transformation. Perhaps it is not necessarily that we are wiser or less prone to peer pressure, but maybe just a bit shell-shocked from the brutal 2007-2009 bear market that was the worst since the 1930s. Put that together with the bear market in the early 2000s, and collectively stocks provided the worst calendar-decade returns on record. On top of that, current news about the economy still emphasizes high unemployment, huge government budget deficits and general uncertainty about the vigor of the economic recovery. In that environment, it's easy to understand how investors would be reluctant to put new money to work in the stock market.

Traditional stock/bond flow pattern

While undoubtedly these considerations are part of the story, a fuller explanation can be uncovered if we broaden this discussion to include the other major (non-cash) asset class—bonds. Because bonds are viewed as less-risky assets, they often see greater mutual-fund flows when investors move away from stocks, and vice-versa. Exhibit 1 (above) shows the swings between one-year performance and flows of both bond and stock mutual funds. In general, when stocks have performed better than bonds, as they did for most of the 1990s, stock mutual funds gathered more flows. When stocks declined, as they did from 2000-2002 and 2007-early 2009, bond funds typically received more flows.

2009-2010 anomaly: A lack of herding to stocks

The performance line at the end of the one-year chart (above left) shows the one major anomaly to this traditional behavioral pattern during the past year: stocks have been outperforming but bond fund flows have continued to dominate. Bonds made small gains in 2008, easily outpacing stocks during the bear market. So in early 2009, perhaps investors were chasing recent bond returns and avoiding stocks given the recent downturn. During the past year, however, bonds posted decent returns but trailed stocks by the widest performance margin in at least three decades (44%). Yet, investors actually took money out of stock funds on a net basis during the past year. Meanwhile, the $385 billion of net flows investors put instead into bond funds is more than they ever put into stock funds during a 12-month period—even during the technology bubble of the late 1990s. Fund investors clearly were not chasing recent performance because they would have switched to stocks to fit their historical pattern of behavior.

Fresh perspective: Longer-term performance trend

What if investor memories are longer than just 12 months? Sure, stocks posted heady gains during the past year, but 2009 featured the conclusion of some of the worst 10- and 20-year stock performances relative to bonds ever recorded. For example, bonds bested stocks by more than 9% per year over the 10-year period ending in February 2009—the worst ever (see Exhibit 1). Going back even further, the 30-year period ending in March 2009 was the best on record for Treasury bonds relative to stocks, with stocks barely outpacing bonds over the three-decade period.[iv] While recent relative performance has slightly improved the long-term picture for stocks, bonds have still been more attractive in the long run.

So perhaps investors continued to put net new money into bond mutual funds (and not stock funds) because they were attracted by long-term bond performance instead of short-term stock moves. In other words, maybe investors were chasing 10-year bond performance instead of one-year stock returns. Looking back at history, the record flows into stock funds during 2000 also coincided with the conclusion of some of the best 10 and 20-year periods for stock performance relative to bonds in decades (Exhibit 1). Maybe when longer-term performance rotations between stocks and bonds are particularly one-sided, the long-term performance becomes more powerful than short-term rotations in the minds of investors. At these extremes, investors may simply overlook near-term gyrations and favor what appear to be the long-term performance winners.

If this is true, and if mutual fund sales indeed offer some type of contrarian sentiment forecast, it seems the record net flows into bond funds would represent a cautionary signal for bonds relative to stocks. That doesn't mean bonds will necessarily decline or stocks will necessarily go up, but it is worth noting that record attention to one asset category over another after a long period of outperformance has often tended to be the high-water mark for a relative performance cycle.

Investment implications

Whether or not there is any validity to mutual fund sales being a contrarian sentiment indicator or not, when record amounts of money pile into one asset category they push up the prices and valuations of that asset class, invariably pushing down the future expected returns for those assets. For bonds, that means yields are currently near historical lows, making above-average gains more difficult. It is very possible there are some longer-term factors at work that could keep demand for bonds high indefinitely, including an aging population looking for income and a post-2000s bear-market realization by investors that they have a lower tolerance for risk than they originally thought. But the current lack of interest in putting new money to work in stocks, along with 30 years of lackluster stock performance, should give investors some comfort that owning stocks may be one of those non-backward looking, non-herd mentality, contrarian decisions that are sometimes rewarded over the longer-term. ■

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[i] Stock market performance from March 9, 2009 through March 9, 2010. Source: FMRCo. (MARE) as of 3/23/10.
[ii] Source: Investment Company Institute, FMRCo. (MARE) as of 2/28/10.
[iii] The S&P 500 Index declined 49.1% from a peak on 3/24/00 to a trough on 10/09/02. Source: New York Times, Haver Analytics, FMRCo. (MARE) as of 3/23/10.
[iv] For the 20-year period ending 2/28/09, the BC U.S. Aggregate Bond Index outperformed the S&P 500 Index by 0.22%. For the 30-year period ending 3/31/09 the S&P 500 Index outperformed the Ibbotson Associates (IA) SBBI Long-term Government Bond Index by 0.39%. The IA SBBI LT Govt. Bond Index was used because it has a longer history than the BC U.S. Aggregate Bond Index. Source: Ibbotson Associates, FMRCo. (MARE) as of 3/23/10.