

Mutual Fund Investors And The Dollar

Approximately 95 percent of investors and traders identify themselves as contrarians. An equally approximate and complementary 5 percent of investors and traders actually comport themselves in a contrarian manner. Have you yet to hear a self-important financial swami get up on television and declare, “Yeah, I run with the herd. Get a hunch; buy a bunch. You know the drill: I buy when everyone else is buying and sell when everyone else is selling. How else do you propose I keep a 1 percent management fee on other people’s money?”

Even more remarkable are the number of services who sell information based on the premise your fellow human beings are dolts. These include private sentiment surveys, brokerages tallying up their clients’ positions and even official readings such as the Commodity Futures Trading Commission’s weekly Commitments of Traders reports.

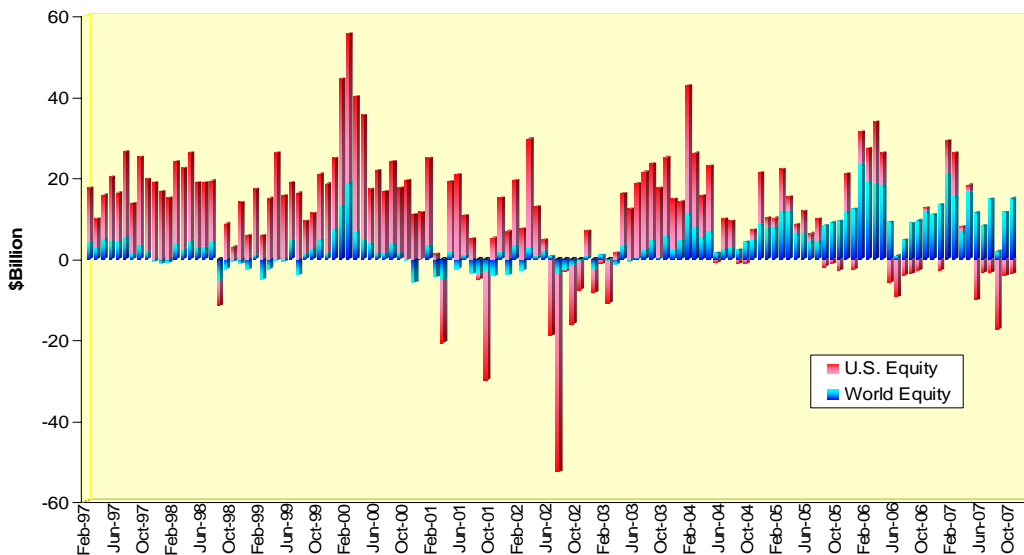
The Investment Company Institute (ICI) collects data on flows into and out of mutual funds. Similar data exist for exchange-traded funds, but as the mutual fund data have a longer history and are not as rapidly changing as the ETF data, we will confine ourselves to the mutual fund flows below.

What Determines Flows?

A presumption derived from herding behavior is flows follow performance; investors are scared to buy at market lows and then come storming in well after a bullish move is underway. This seems so apparent on the face it scarcely warrants a cocked eyebrow. A corollary should apply to factors affecting markets as well: In the case of the dollar, we should have every reason to expect American investors to keep their funds parked at home when the dollar is strong and chase foreign assets higher when a declining dollar is making them more expensive.

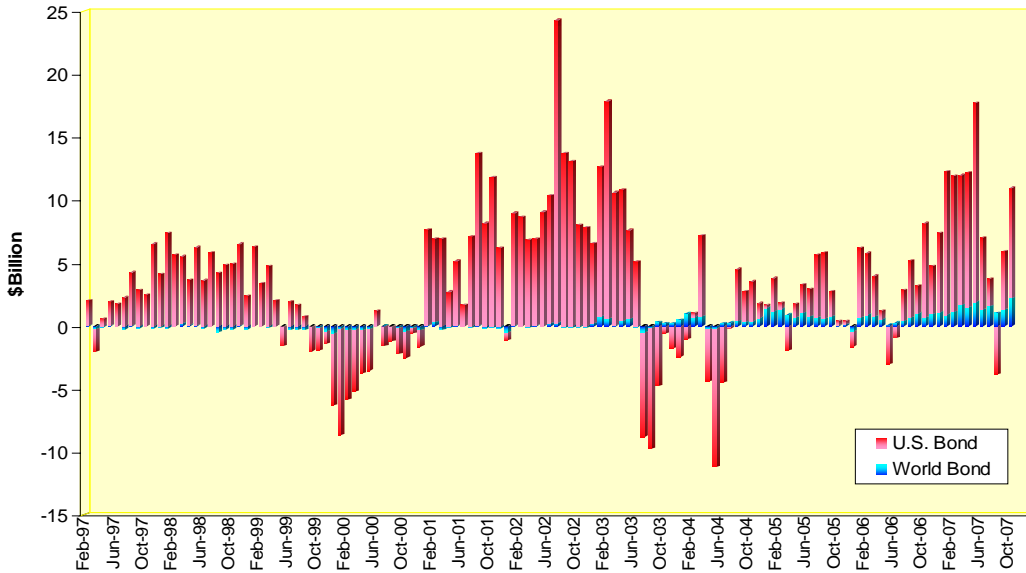
If we look at the net monthly flows for the four fund categories of U.S. and world stock and bond funds we see both confirmation and denial of the maxim flows follow performance. Both categories of stock funds clearly enjoyed massive net inflows during the late 1990s bull market and U.S. stock funds were sold with abandon in mid-2002. However, as we shall see in detail below, U.S. investors resumed buying world equity funds but not domestic equity funds during the 2003-2007 bull market.

Monthly Flows Into Equity Mutual Funds



Moreover, buyers of domestic bond funds were aggressive in mid-2002 and again in 2006-2007. The first period corresponded with both a bull market in bonds and a bear market in stocks; the latter occurred in precisely the opposite environment. This cursory examination indicates we can make no blanket statements on the order of “flows follow performance.”

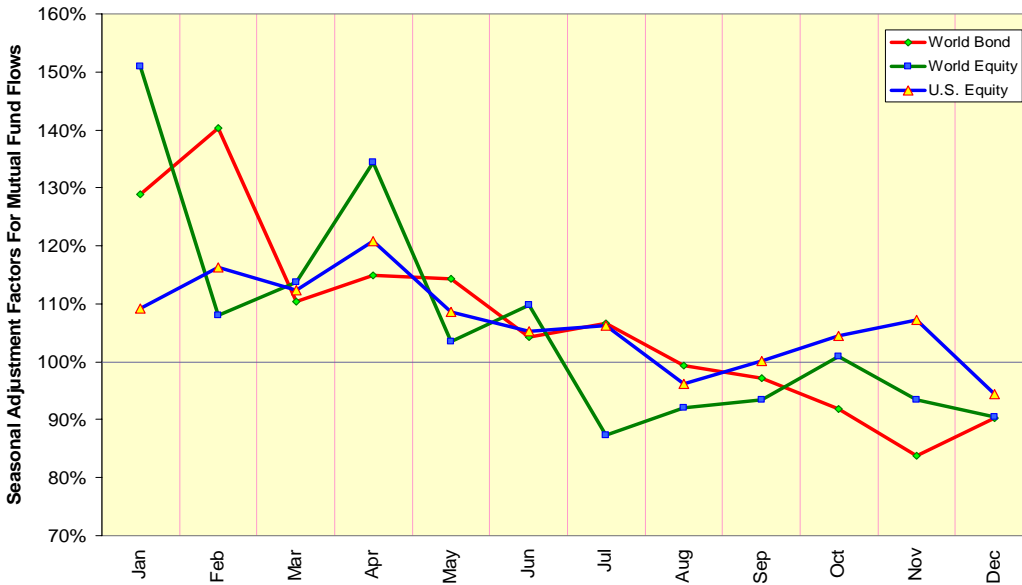
Monthly Flows Into Bond Mutual Funds



Seasonality

Monthly data can be noisy and certainly are driven by seasonal factors. While the flows into U.S. bond funds are not statistically seasonal, the flows into world bond funds and both U.S. and world equity funds are seasonal. The average monthly factors, plotted below, contain some surprises (these factors are divisors; numbers greater than 100% indicate seasonal strength while numbers less than 100% indicate seasonal weakness).

Look Where The Real January Effect Is



Remember the “January Effect,” that supposed slam-dunk trade of small stocks rising in January? Net flows into world equity funds exhibit a pronounced January Effect; the seasonal factor here is 151.0%. Net flows into world equity funds decline into July and remain weak through the remainder of the year. Net flows into U.S. equity funds are strongest in April and November and weakest in August, while net flows into world bond funds are strongest in February and decline into October.

While these flows are seasonal, neither any major currency nor the dollar index has statistically significant seasonality.

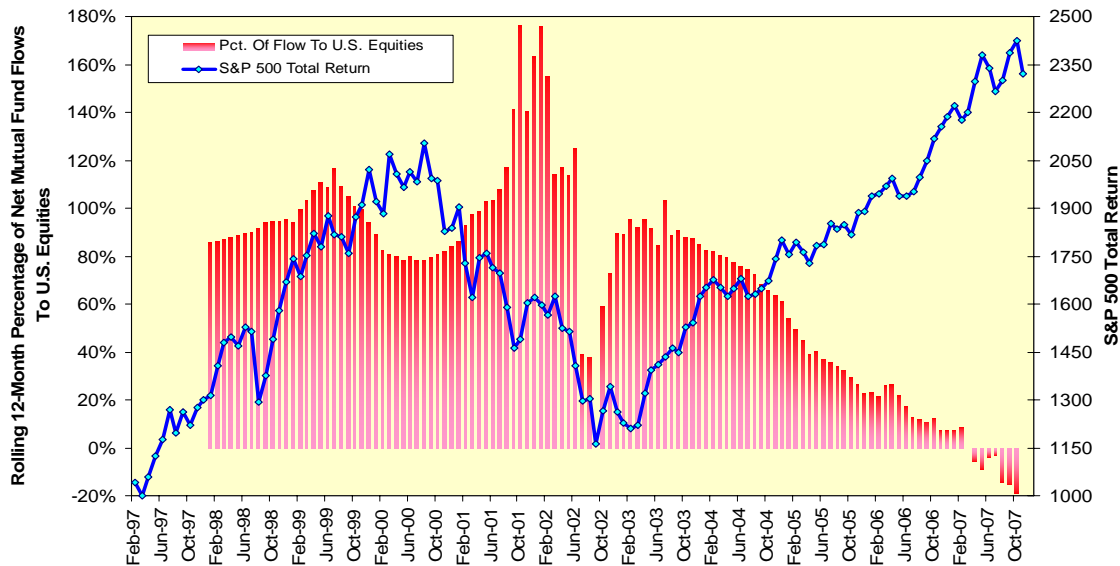
Sum Like It's Hot

While we could use the seasonally adjusted series to eliminate some of the distortions, a 12-month rolling sum of net flows produces a high signal-to-noise ratio and eliminates some of the artificial distinctions produced by flows at the end or beginning of months.

$$RollingSumRatio = \frac{\sum_{i=1}^{12} U.S.Flows_i}{\sum_{i=1}^{12} U.S.Flows_i + \sum_{i=1}^{12} WorldFlows_i}$$

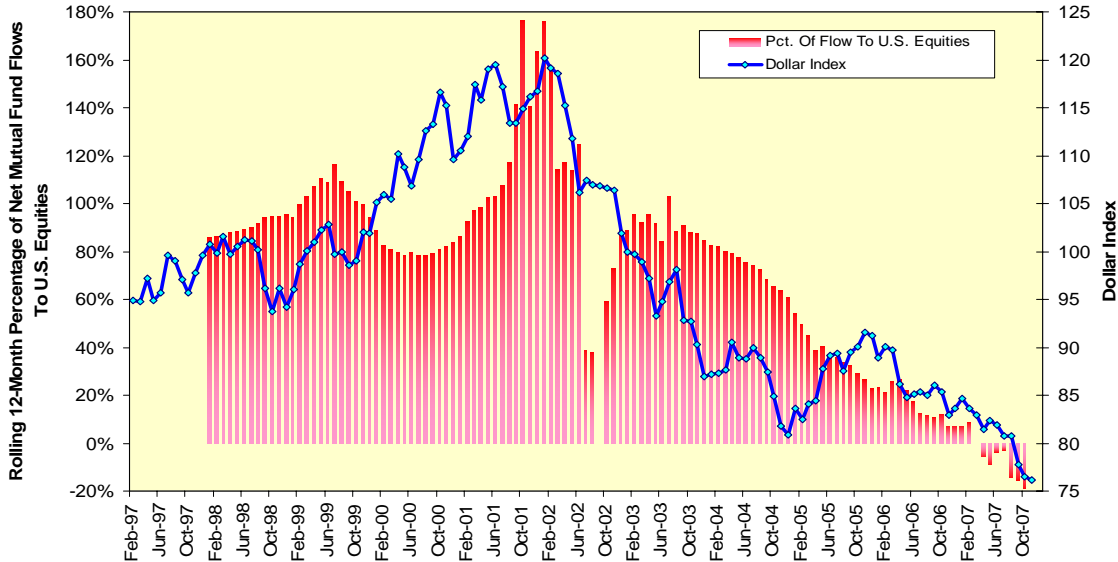
This measure produces a very distinct pattern. U.S. fund investors shifted their flows very heavily into U.S. markets during the 2001-2002 bear market and then abandoned it, never really to return. As the total return of the S&P 500 rose fairly steadily from 2003 onwards, U.S. equity fund investors sent their dollars overseas. As noted above, flows did not follow performance.

U.S. Stock Mutual Fund Investors Stayed Away From 2003-2007 Rally



Next, let's compare this same rolling sum ratio to the dollar index. As the dollar rallied, particularly against the euro, in 2000-2002, U.S. equity investors eschewed the opportunity to swap the greenback for foreign shares. Once the dollar's 2002-2004 decline began, U.S. equity investors began buying increasingly expensive foreign shares. Restated, the American equity mutual fund investor stayed away from a domestic rally and paid up for foreign stocks after the bear market ended in 2002. We really cannot find too much good to say about this observed behavior.

U.S. Stock Mutual Fund Investors Chase Dollar Performance

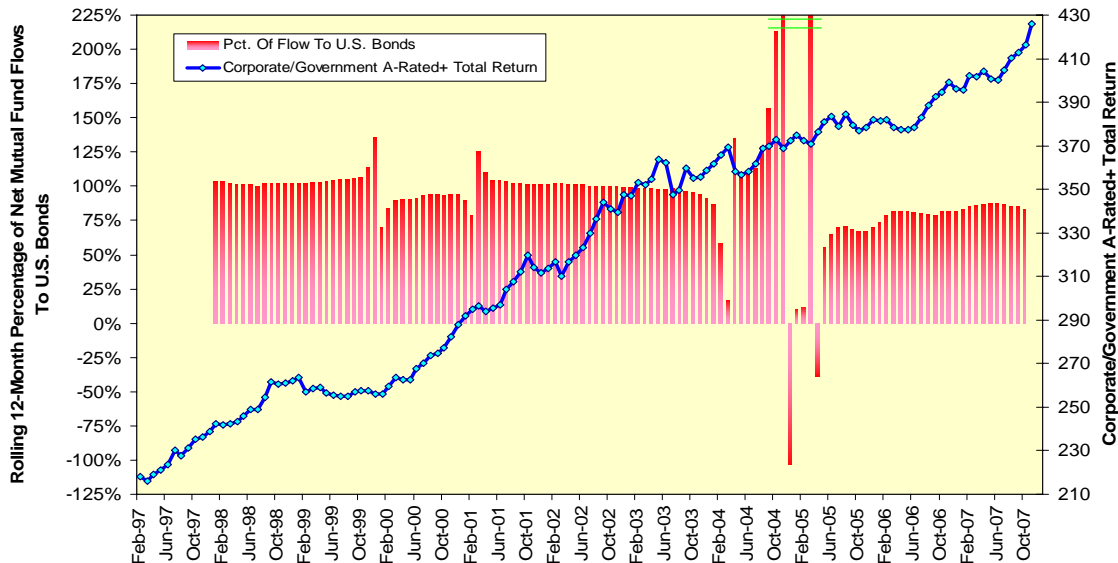


Bond Flows

The situation for bonds is appreciably different. If we construct the same sort of rolling 12-month sum ratio as we did for stocks, we find there was only one period of distortion. This occurred during the early phases of the Federal Reserve's 2004-2006 rate-hike campaign. Some of the ratios went off-scale and are marked on the charts below with green bars.

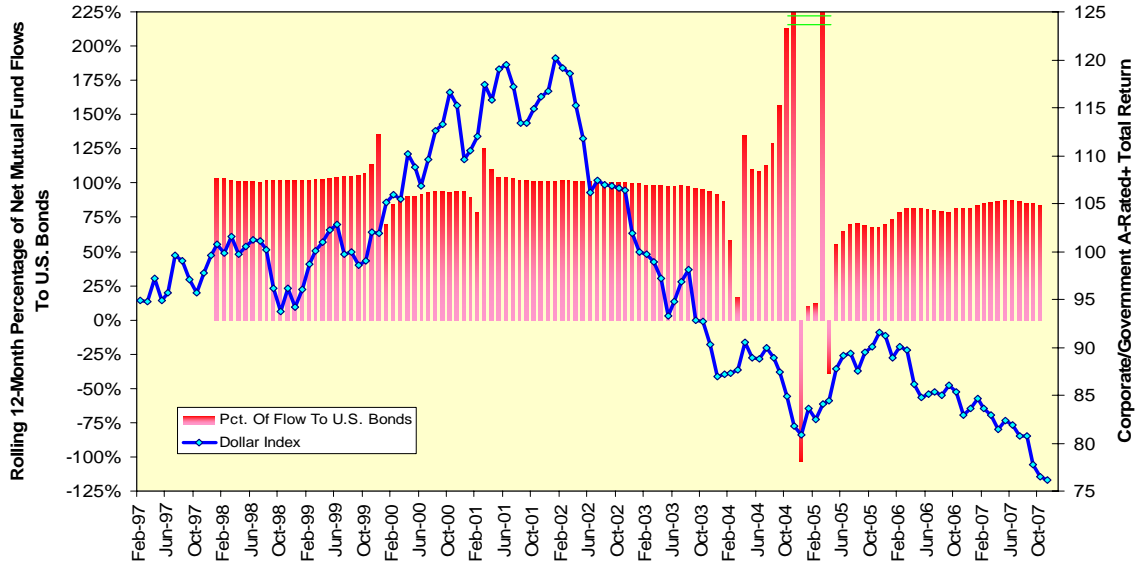
The U.S. bond fund investor acts indifferent to changes in performance as measured by the total return on the Merrill Lynch index of A-rated corporate and government bonds. Funds do not follow performance one way or the other.

U.S. Bond Mutual Fund Investors Global Investing Patterns Indifferent To Returns



We can reach the same conclusion with respect to the dollar index. During the trough of the dollar's late-2004 selloff, net inflows into U.S. bond funds turned negative. This reversed quickly, and the previous stasis was restored.

U.S. Bond Mutual Fund Investors Did Not Chase Dollar Lows



While currency movements are determined in part by relative prospective returns on assets between two economies, mutual fund flows appear to be a poor way of measuring those returns. Other metrics, such as forward-looking price/earnings ratios or yield curve shapes do a better job in this regard.