Mutual Fund Investors And The Dollar

Aging Baby Boomers – and I do know a few – might recall an era when everyone and I do mean everyone, was a non-conformist. While we no longer wear the non-conformist uniform du jour as dictated by the mass-marketing industry for such things, we all engage in contrarian investment strategies.

There is a cottage industry based on the premise your fellow traders and investors lack the sense to come in out of the rain. These include private surveys of traders and analysts – I have shared my considerable ignorance with some of these – along with institutional brokers' surveys of their clients and even official readings such as the Commodity Futures Trading Commission's weekly Commitments of Traders reports.

So if everyone is a non-conformist, then why are most trading systems based on trend-following and not on mean-reversion? The answer, quite simply, is trend-following is the way to go all the way until the end of the move. Generally speaking, every high or low of significance in every market is bought or sold, respectively, by a professional. Amateurs waste their time and money picking tops and bottoms in exchange for a few headlines and other messes of pottage. None of the commentariat likes to admit it, but the most correct forecast for the market, day-in and day-out forever would be the unspeakably dull, "Today's is going to look very much like yesterday plus or minus a random drift term with a positive bias."

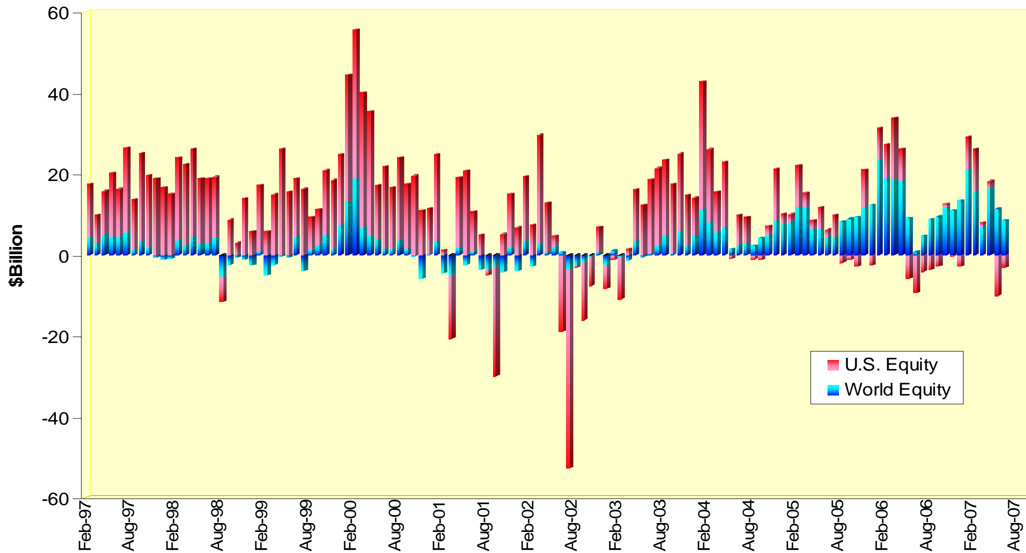
Mutual Fund Flows

With this in mind, let's turn to the issue of mutual fund flows as tabulated by The Investment Company Institute. Parenthetically, similar data exist for exchange-traded funds, but as the mutual fund data have a longer history and are not as rapidly changing as are the ETF data, we will confine ourselves to the mutual fund flows below.

If mutual fund investors are the sheep-like cretins some would make them out to be, we should expect net flows to follow performance. Investors would wait for prices to rise and then chase performance higher at which point all those clever contrarians will sell all manner of overpriced garbage to them. Then the collective doofuses (doofi?) will sell, confirming once again all those studies that say mutual fund investors underperform the indices.

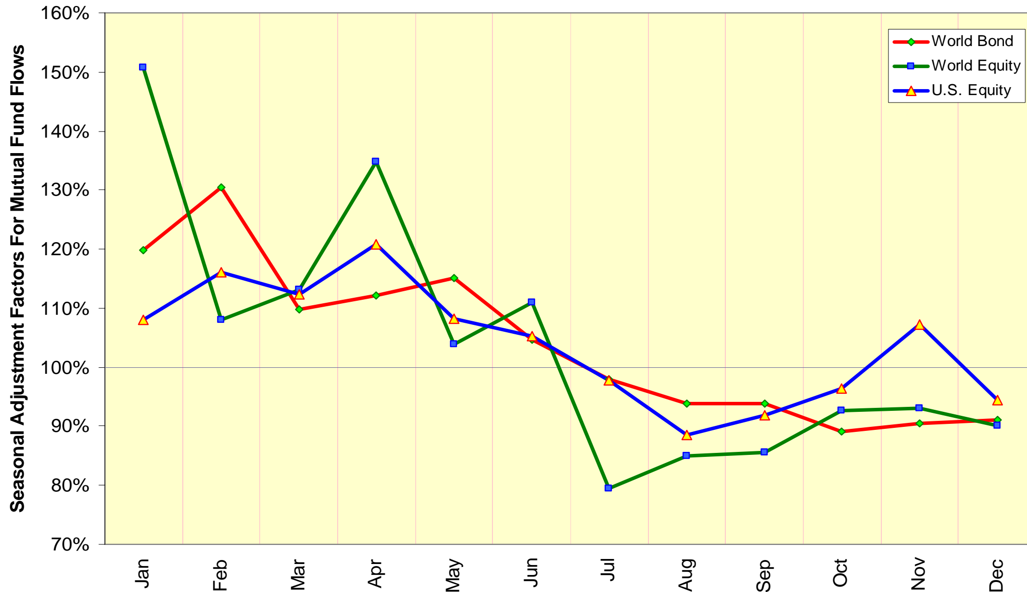
This seems apparent on the face. In addition, a corollary should apply to factors affecting markets as well: In the case of the dollar, we should have every reason to expect American investors to keep their funds parked at home when the dollar is strong and chase foreign assets higher when a declining dollar is making them more expensive.

If we look at the net monthly flows for both U.S. and world stock funds we see both confirmation and denial of the maxim flows follow performance. As an aside, bond funds were examined as well but proved uninteresting. Both domestic and world stock funds witnessed massive net inflows during the late 1990s bull market and U.S. stock funds were sold with abandon in mid-2002. However, in a rebuttal to the flows follow performance thesis, U.S. investors resumed buying world equity funds but not domestic equity funds during the 2003-2007 bull market.



Seasonality

The monthly data above are highly 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).



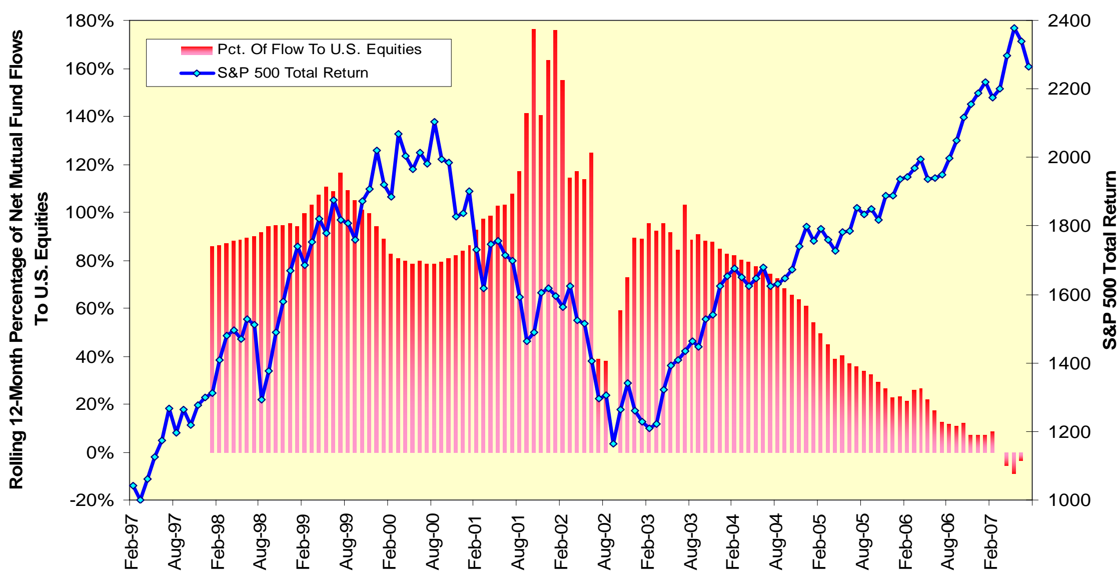
Aging Baby Boomers may remember the "January Effect," which was the contrarian favorite until everyone recognized it, at which point everyone ignored it in the most contrarian manner possible. Guess what? Net flows into world equity funds exhibit a pronounced January Effect; the seasonal factor here is 150.7%. 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 these flows are seasonal, neither any major currency nor the dollar index exhibits statistically significant seasonality.

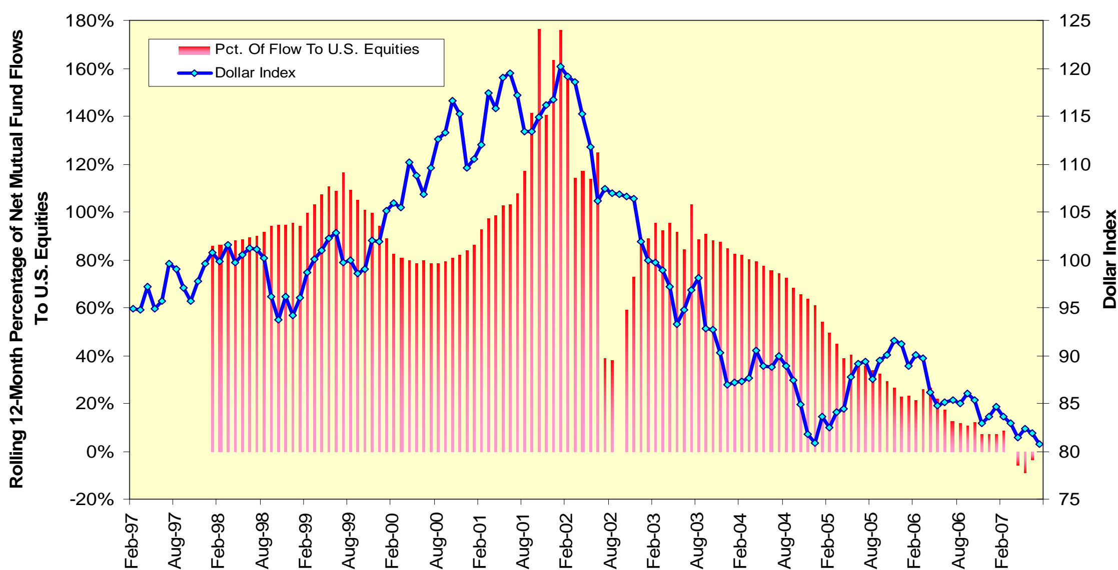
Rolling Sum Smoothing

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 straddling the boundaries between months. We can calculate the ratio of the U.S. flows' 12-month rolling sum to the combined U.S. and world 12-month rolling sum to get an idea how U.S. investors switch preferences.

U.S. stock fund investors shifted their flows very heavily into U.S. markets during the 2001-2002 bear market and then abandoned them, 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. Flows did not follow performance.



We can map this same rolling sum ratio against the dollar index. As the dollar rallied, particularly against the euro, in 2000-2002, U.S. equity investors avoided foreign funds. 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. This is a triumph for the contrarians.



The end result of all this is American mutual fund investors were chasing hot foreign stock funds and ignoring domestic stock funds during a bull market for stocks and a bear market for the dollar. Flows did not follow performance, but those who ran with the crowd made the wrong decisions, anyway.