

Equity Mutual Fund Flows and *The Uncanny Timing of the Investing Masses*

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SUMMARY

Tracking net cash flows into and out of the mutual fund industry offers useful insights into the psyche of the investing masses. Not surprisingly, the public has a tendency to be overcome by fear and greed at the most inopportune moments. Consequently, large outflows from equity funds tend to occur near long-term lows in the stock market. The purpose of this paper is to illustrate the relationship between mutual fund flows and market extremes to help investors improve their timing of allocations into and out of the US stock market.

INTRODUCTION

In 1980, fewer than 6% of US households were investors in mutual funds. The industry achieved mass appeal among the public starting in the mid 1980s and by 1990 US mutual fund assets exceeded \$1 trillion for the first time. As of today, nearly half of all families own shares in a stock, bond, or money market fund. Industry assets exceed \$10 trillion in the US and \$20 trillion worldwide. **Figure 1** shows the net new cash flows into US equity mutual funds on a quarterly basis since 1986. The largest ever inflow occurred in the first quarter of 2000, when retail investors sent fund managers

Figure 1. Net Cash Flow into Equity Mutual Funds

New fund sales minus redemptions for all US equity funds, quarterly data, billions of USD

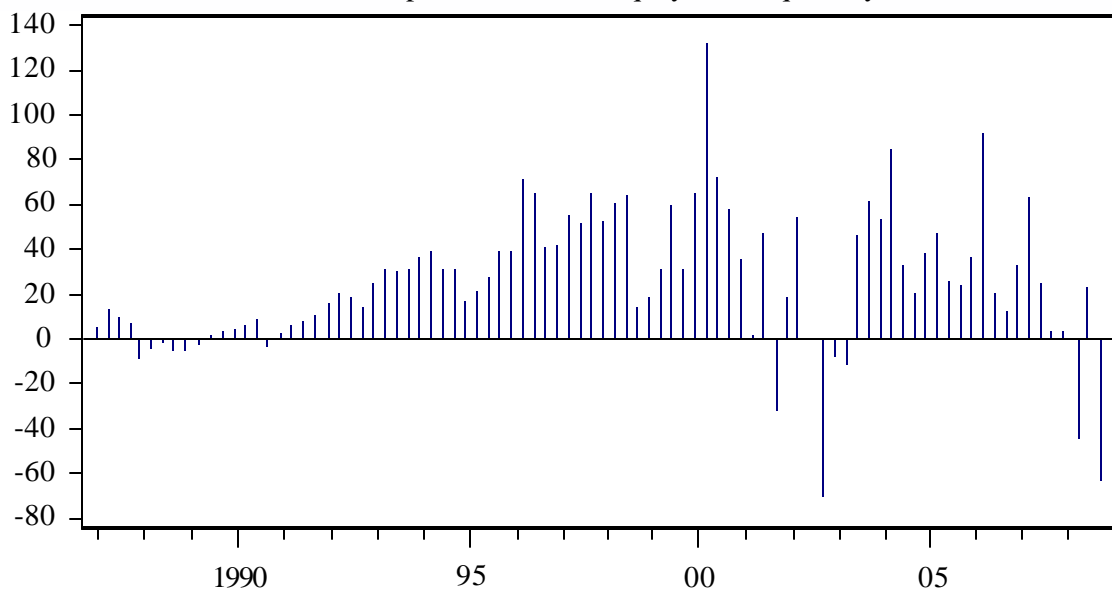
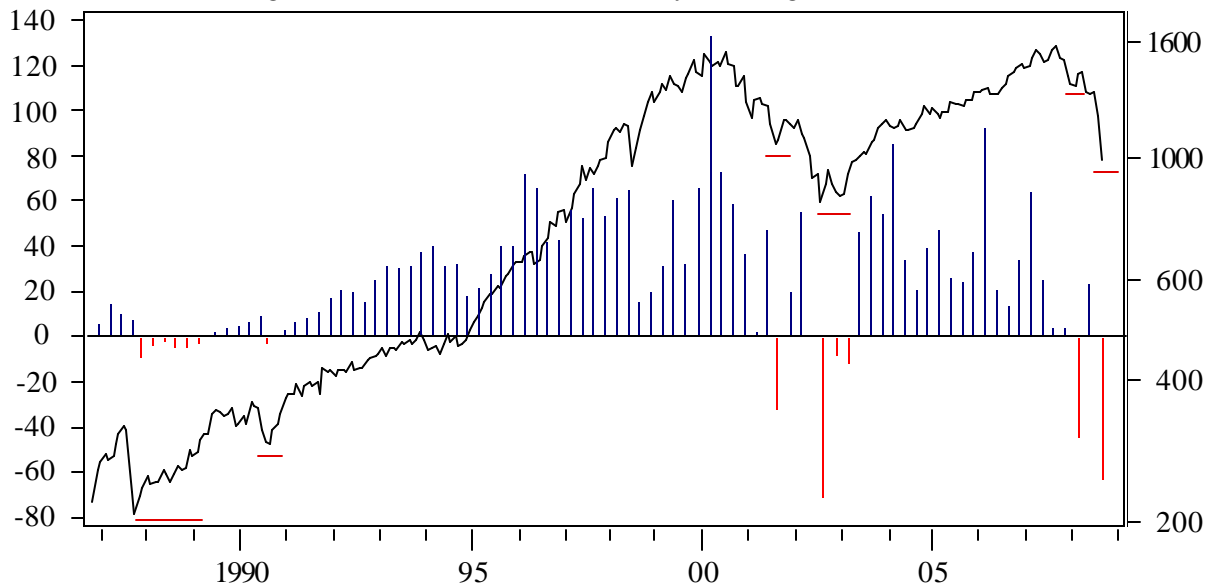


Figure 2. S&P 500 Index vs. Cash Flow into Equity Mutual Funds

Left scale: mutual fund quarterly data, billions of USD

Right scale: S&P 500 Index, monthly data, logarithmic scale



over \$130 billion of new capital. Unfortunately, the timing of the public could not have been worse as most US equity indices have yet to surpass the highs reached in 2000. Similarly, record outflows of over \$70 billion occurred in the third quarter of 2002, at precisely the low of the 2000-2002 bear market. In fact, the timing of mutual fund investors as a group has been uncanny, but also quite unfortunate, as they have been consistently wrong.

ANALYSIS

A detailed history of the relationship between fund flows and stock prices is seen in *Figure 2*. The quarter ending in March of 1987 generated what was then a record inflow of almost \$20 billion. Following the Crash of '87 in October, the fourth quarter saw record withdrawals from mutual funds, which also marked a low in the S&P 500 Index that has not been seen since. Afterwards, six consecutive quarters of equity fund redemptions, starting at the end of 1987, were matched by steadily rising stock prices, representing the proverbial “wall of worry” that the stock market often uses to climb to higher levels.

In 1990, with the onset of the first Gulf War and eventual recession, investors pulled money from equity funds. Once again the public was a net seller in the same quarter that produced a low in stock prices.

The first time investors failed to sell at the precise low followed the terrorist attacks of 9/11. Here, the outflows coincided with a short-term market bottom in the third quarter of 2001. The S&P 500 Index eventually declined to lower levels a year later. However, investors failed to buy at the bottom, and in fact set a new record for net redemptions of almost \$72 billion in the third quarter of 2002, just as the market bottomed.

Today, the world is experiencing another bout of extreme market turmoil. Based on the latest available data, mutual fund investors cashed out of US equity funds to the tune of over \$60 billion during the third quarter of 2008. Furthermore, preliminary estimates indicate that redemptions in the month of October, 2008 could exceed the present record of \$52 billion set in July of 2002. It appears that panic selling by the investing public is poised to signal a bottom in equities yet again.

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Marvin V. Bolt is President of Alpha Plus Advisors, LLC. From 2001 until 2006 Mr. Bolt developed systematic, quantitative investment strategies used to manage client assets at Thieme Securities, Inc., a FINRA registered broker/dealer, where he served as Financial & Operations Principle. Since 1994, he worked at various asset management firms, first as research analyst and later portfolio manager. Prior to that, he was an aerospace engineer in the conceptual aircraft design group at General Dynamics Corporation (now a division of Lockheed Martin Corporation). Mr. Bolt earned the Master of Science Degree in Aerospace Engineering from the University of Texas and the MBA Degree in Finance from New York University. He holds the NASD Series 7, 27 & 63 licenses.

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ABOUT THE COMPANY

Alpha Plus Advisors, LLC is an investment advisory firm based in New York and affiliated with RIM Group AG, Zürich. Using a variety of quantitative, systematic strategies the firm manages accounts for individual clients as well as the Manhattan Systematic Fund (Bloomberg Symbol: MANSYSA KY). The Fund has a track record approaching 4 years with approximately 20% annual returns and is available to sophisticated non-US investors.

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