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www.biancoresearch.com

Market Facts

Mutual Fund Seasonality: Villain Or Culprit?

By Howard L. Simons (847) 304-1511
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Three weeks into the year, the influx of new money that was widely expected to backstop stock prices has been largely absent, leaving the market in the grip of persistent selling in one of the worst starts to a year in a generation. – Barron's, January 24, 2005

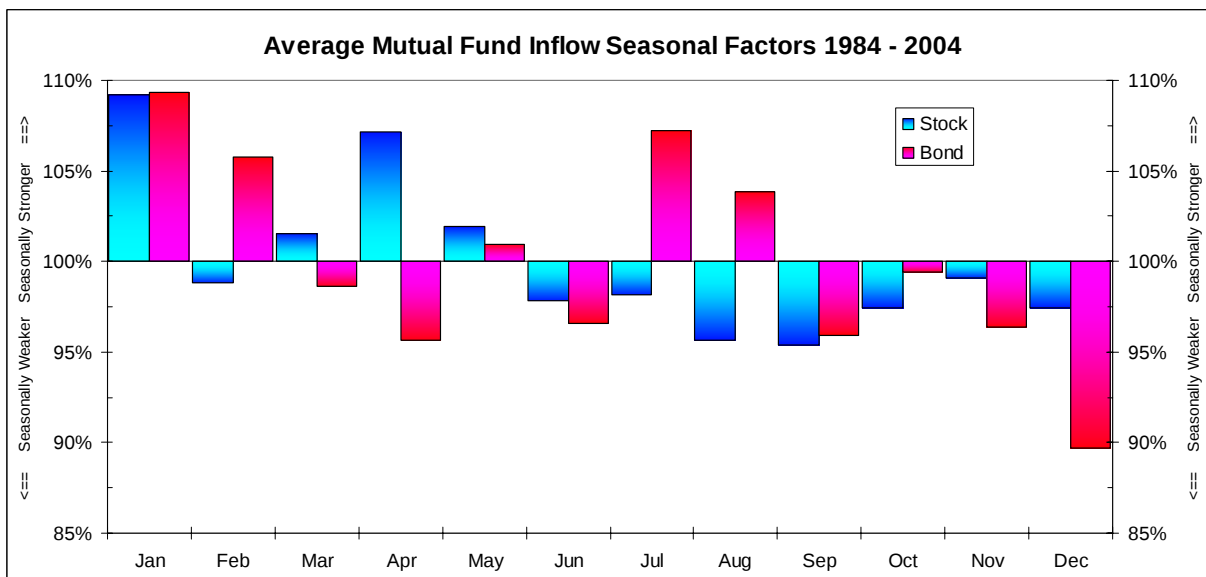
The list of American investors who by self-admission have lost money by virtue of paying too much for stocks is short. All downturns, therefore, must be considered the fault of someone or something else. Seasonal flows into and out of mutual funds are alleged to be the cause of U.S. stock market's weak performance to-date in January 2005.

How so? The answer proffered is the equity mutual fund inflows expected to arrive in January failed to materialize. **The blame for weakness is now returned safely to where it belongs: Elsewhere.**

The simple fact, however, is mutual fund inflows into both equity and fixed income funds do exhibit

significant seasonal tendencies. The **average** seasonal adjustment factors for the past two decades for equity (blue columns) and fixed-income (red columns) are depicted below. The factors effectively are divisors; monthly factors in excess of 100% denote seasonal strength, while those less than 100% denote seasonal weakness.

January is in fact the seasonally strongest month for both stock and bond mutual fund inflows. May is the only other month with seasonally strong flows for both classes of mutual fund. June and the entire September-December trimester are weak for both classes of mutual fund inflows.



Stock Fund Patterns

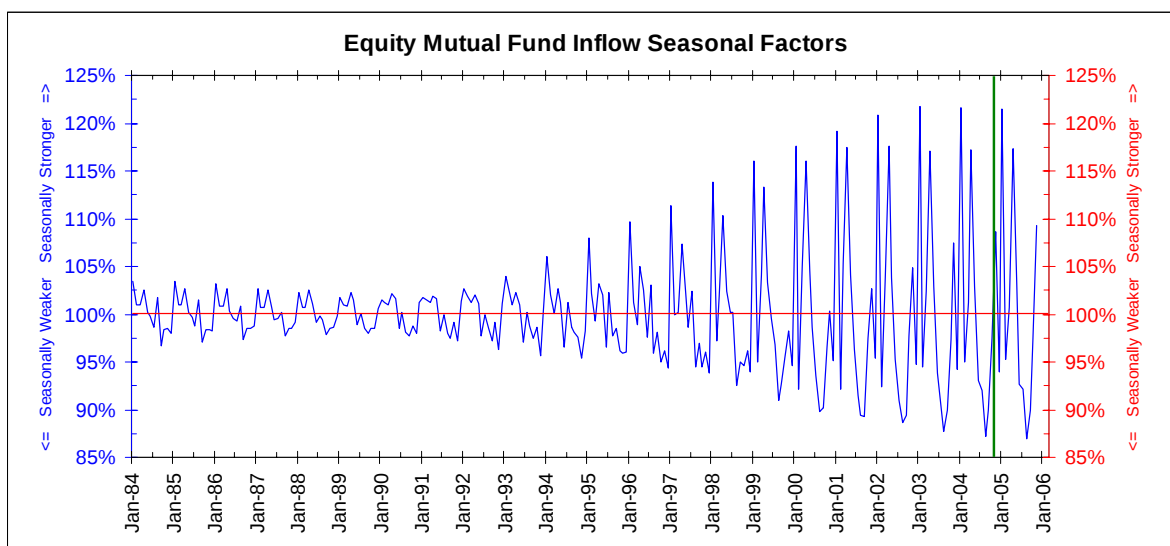
The consolidated seasonal factors over a 21-year sample obscure a structural change in stock mutual fund seasonality. Prior to the takeoff of the late 1990s bull market, factors oscillated between 95% and 105%. After the bull market took off, stock mutual fund inflow seasonality became increasingly

pronounced as the amplitude increased to a range of 85% to 125%. This is consistent with the shorter holding times and increased trading turnover for equity funds observed in this period. Seasonality incorporates variance within its calculation.

The rate of seasonality's expansion ended with the bear market of 2000-2003. The 12-month forward

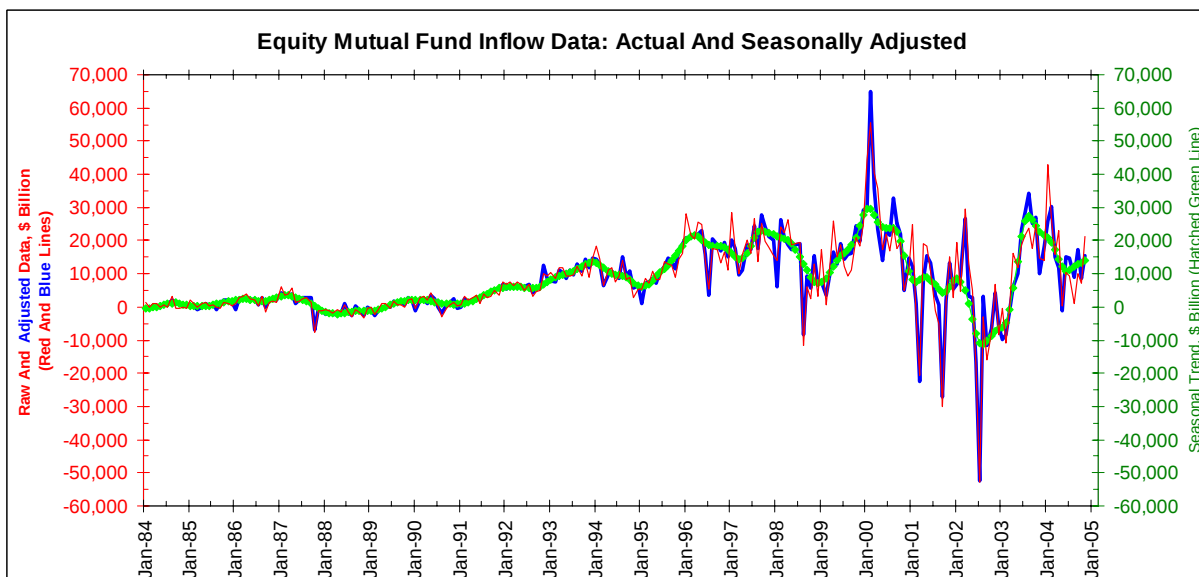
projection of these factors calculated by the seasonal adjustment program (X11 ARIMA;

projections to the right of the green line) maintains the current cyclicity.



The assertion of greater swings in equity mutual fund inflows and outflows and the profound effects of seasonality can be seen in the chart below. The raw seasonal inflows (red line) and the seasonally adjusted inflows (blue line) both witnessed

increased volatility after 1995 and in particular after 2000. The trend-adjusted series (hatched green line) rose and fell more in pace with market movements, confirming the traditional adage of flows following performance.

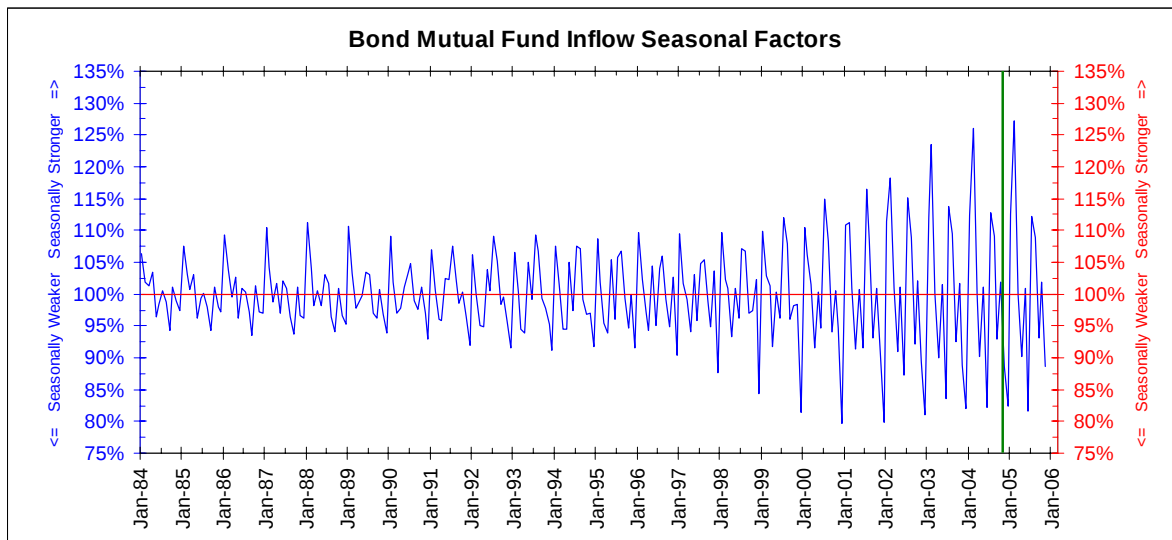


Bond Fund Patterns

Bond investors are alleged to have different motivations than their equity brethren, capital preservation and current income among them, and we impute greater rationality to them. **However, if seasonal swings are any indication, bond mutual fund investors are quicker on the trigger than are stock investors.** The peak-to-trough range for bond mutual fund inflow seasonality (75% to 135%)

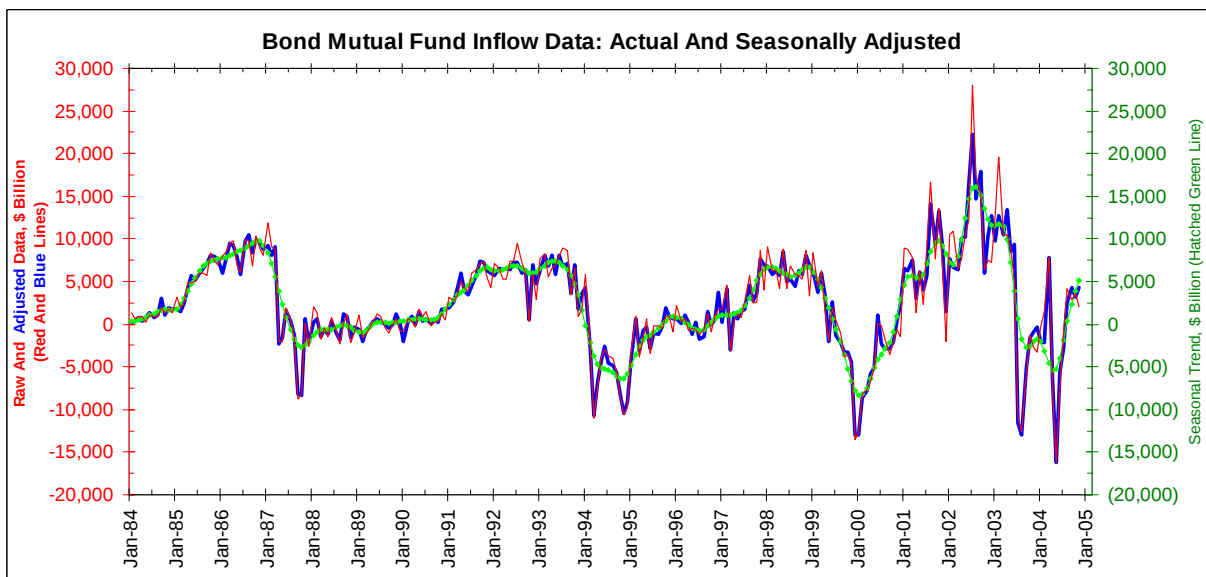
exceeds that of stock mutual funds inflows (85% to 125%).

The amplitude of seasonal adjustment factors declined slightly from the mid-1980s to the mid-1990s and then expanded sharply during the bond market rally of recent years. The peak months for bond inflows are February; December is the weakest month for inflows.



The greater seasonality of bond fund inflows over stock fund inflows is consistent with the chart below. It shows the differences between the raw data (red line) and the seasonally adjusted data (blue line) are not as extreme as they were for stock mutual fund inflows. This stands in contrast to the observed

volatility between stocks and bonds. Bonds have greater mutual fund flow seasonality but less short-term price volatility. In contrast to stocks' compression of volatility into single events, bonds diffuse their volatility over longer periods.



Conclusion

Seasonality is but one contributor to the movement of any market. Its contribution relative to more powerful fundamental and even to short-term technical factors in any market is small. Reliance upon seasonal factors in investing, while legitimate as a single input, should not be a governing factor of any sort.

Patterns work until they are recognized, at which point rational investors discount their effects and

trade in anticipation thereof. The persistence and indeed the amplification of seasonal factors suggests investors as a class have chosen not to discount seasonality and are in fact ignoring those who promote it as an explicatory variable in markets.

So we have good news and bad news: The good news is rational investors wisely minimize seasonality. The bad news is failure to discount seasonality assures its existence into the near future and thus its continuation as an excuse for those who should know better and yet somehow do not.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511 Fax (847) 304-1749
e-mail: research@biancoresearch.com
<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 304-1511
James A. Bianco jbianco@biancoresearch.com

Strategists/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Neil Bouhan nbouhan@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 876-1825
Fritz Handler fritz.handler@arborresearch.com
Patrick Lovett pat.lovett@arborresearch.com
Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595
e-mail inforequest@arborresearch.com
<http://www.arborresearch.com>

For more information about Arbor Research & Trading and its services:

Director of Fixed-Income Sales (800) 876-1825
Daniel Lustig dan.lustig@arborresearch.com
Director of International Sales (847) 304-1560
James L. Perry james.perry@arborresearch.com

Arbor Research & Trading (UK) LTD

75 Cannon Street London England EC4N 5BN
Phone 44-207-556-7309 Fax 44-207-896-1887

For more information:

Director of Arbor (UK) 44-207-556-7309
Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com