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Special Report

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Examples Of Mutual Funds Outflows Not Beginning Until The Public's Breakeven Point Is Crossed

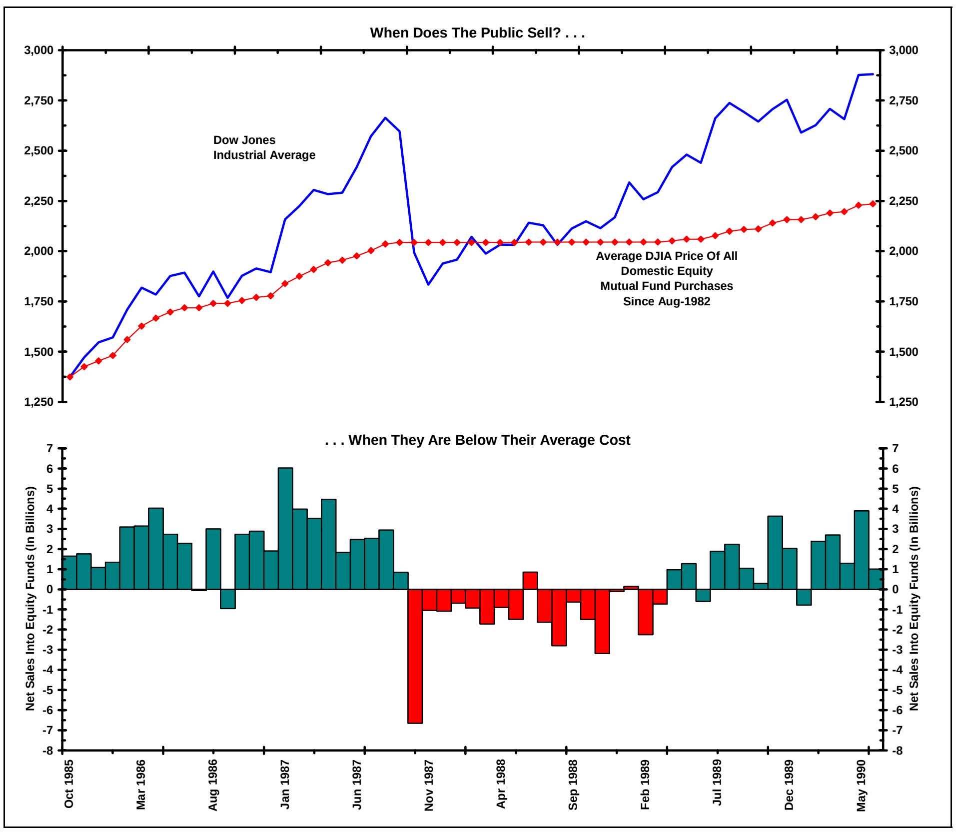
For years we have been tracking the public's average purchase price, or their "breakeven" point, for mutual fund holdings. It has been our contention the public will continue to put money into mutual funds (positive inflows) so long as their average purchase price or "breakeven" rate is below current market levels. When this situation is present, this means the public is holding an unrealized profit. When dealing with profits ("the house's money") they will be optimistic/aggressive and believe in a market's long-term potential.

Once, however, prices sink below their average purchase price, or breakeven level, the public is losing their original investment. We believe this changes the public's outlook for a market, causing them to become more pessimistic/conservative and sell their holdings (outflows).

The behavior we just described is not so different than gambling patterns in a casino. When amateur gamblers make money early in the evening and are playing with the house's money, they are typically more optimistic/aggressive than gamblers who are losing and playing with their own money.

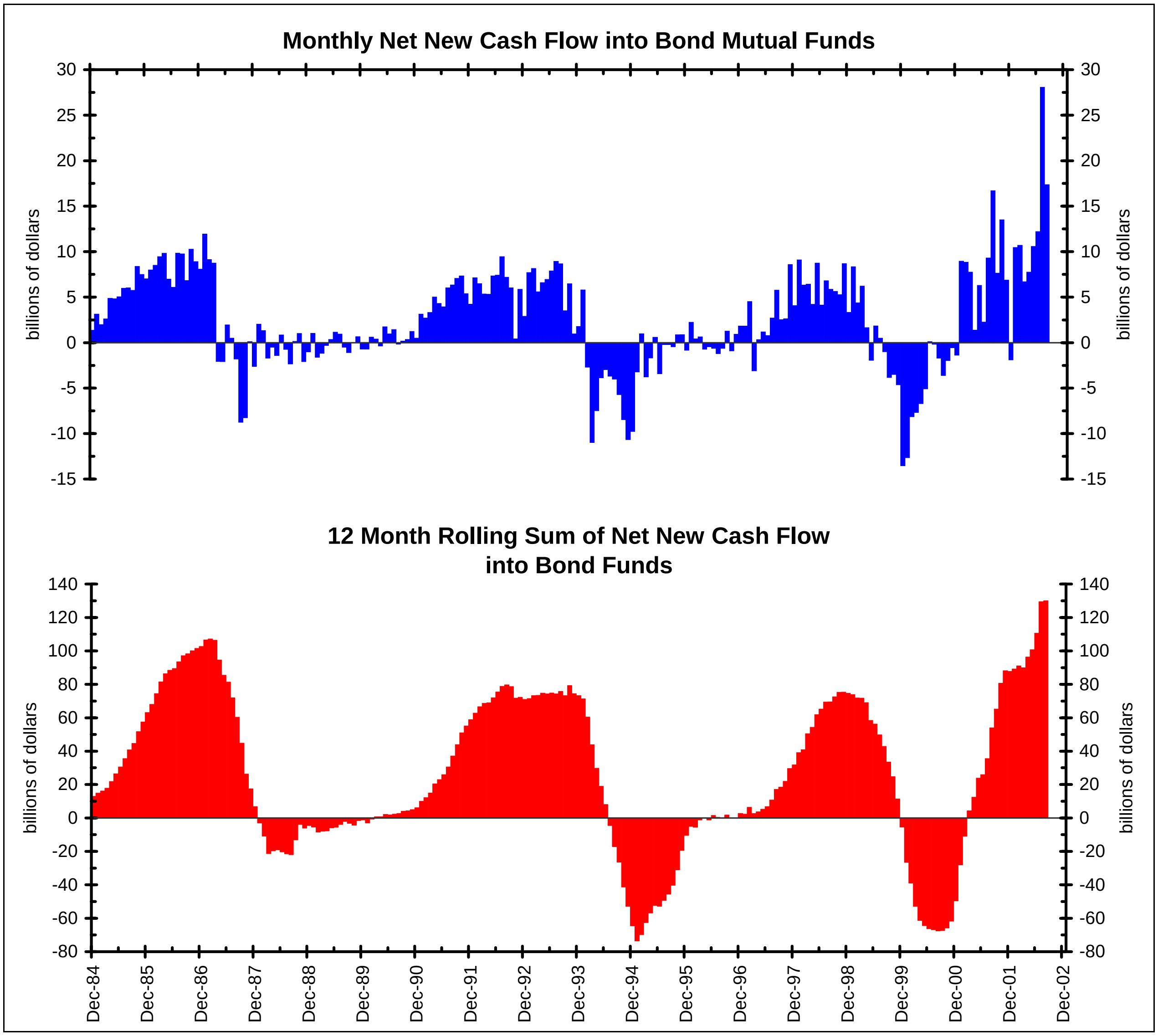
The 1980s Stock Market

Nice theory, but does this really work? The chart below shows mutual fund flow patterns in the 1980's. Net outflows began when the stock market fell below the public's breakeven level following the stock market crash of 1987. Outflows remained until the market rose above breakeven levels years later.



The 1990's Bond Market

We also find examples of this phenomenon in the bond market during the 1990s. In the spring of 1994, when bonds were undergoing their worst total-return year in history, bond funds did not see outflows until the public's unrealized profits were gone. Using a broad based fixed-income total return index weighted by the monthly flows into bond funds, we found that by April 1994, the public's breakeven was reached. This meant $178 billion of assets had no profits. Given that all bond funds had about $725 billion in assets in mid-1994, it is easy to see why bond funds had eleven consecutive months of outflows – record at the time. Only when the bond market rallied above breakeven levels in 1995 did inflows resume again. A similar story was seen in 1998/1999.



Conclusion

Presented here are some examples of the public selling both stock and bond funds only after the market sinks below their average purchase price, or "breakeven" level. This begs the question, if the market sinks below the public's breakeven levels and then the public starts to sell, how does the bear market ever stop? How did the market get down to the breakeven levels without mutual fund outflows depressing prices?

Remember mutual fund holdings are only a small (but significant) part of the markets (about 20% of the stock market, 12% of the bond market). The collective action of all the other non-mutual fund players will determine whether a market is going up or down. Mutual funds do not have enough size to dictate the trend of the markets, except for short periods of time (i.e., days to weeks).

Mutual fund holders often follow trends rather than create them. Within this context, the point at which they are making or losing money becomes critical.

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