Despite equity bounce in October, investors flee to bond funds

By Editor Test *Tue, Nov 15, 2011*

'After the ups and downs of recent months, investors seem to be suffering from volatility fatigue,' said Ari Nachmany of Strategic Insight.

Combined U.S.-stock and international-stock outflows of $21.1 billion roughly mirrored inflows of $23.7 billion to taxable- and municipal-bond funds, as net long-term mutual fund inflows to reached only $745 million in October, according to Morningstar Inc.

Additional highlights from Morningstar's report on mutual fund flows:

- Investors redeemed $18.2 billion from U.S.-stock funds in October, the greatest monthly outflow for the asset class since $22.7 billion in July.
- Overall, U.S.-stock outflows reached $53.5 billion for the year to date. Outflows for the asset class are on pace to match or exceed 2010's redemptions of $63.6 billion and 2008's record outflow of $77.4 billion, especially given that outflows from the asset class have picked up in the second half of the year for the last five calendar years.
- Inflows of $2.1 billion to diversified emerging-markets equity funds prevented international-stock funds, which sustained outflows of $2.9 billion in October, from losing even more. Emerging-markets equity funds have seen strong monthly inflows in 2011 despite the fact that these funds are significantly underperforming U.S.-stock funds.
- Taxable-bond funds, with inflows of $21.7 billion, had their strongest month since September 2010. Intermediate-term and high-yield funds dominated the asset class, taking in a combined $18.6 billion during the month. High-yield bond funds had a record month for inflows, collecting $8.8 billion in new assets.

In addition to Morningstar's data, the following summary of mutual fund flows in October 2011 was issued by Strategic Insight. Data differed in some respects.

Thanks to demand for taxable bond funds, US stock and bond mutual funds saw net inflows of $1.1 billion in October 2011 (in open-end and closed-end mutual funds, excluding ETFs and funds underlying variable annuities). October marked the second consecutive month of net inflows to long-term funds, after net inflows of $1.9 billion in September

Investors poured $19 billion into taxable bond funds in October, more than $16 billion of which went into high-yield bond funds and intermediate-term bond funds. Bond fund investors seemed to be either creeping out on the yield curve from short-term bonds or plunging into riskier high-yield bonds in search of higher income. October's net inflows were the biggest monthly flows for taxable bond funds since they drew $20 billion in May.

Muni bond funds, meanwhile, saw net inflows of $1.9 billion – up a bit from September's $1.7 billion and evidence that investors are no longer worrying about widespread muni bond defaults.

“With low interest rates set to continue and investors feeling risk-averse, we expect the search for income and safety to persist into 2012,” said Avi Nachmany, director of research for Strategic Insight. “This should mean continued demand for select bond funds.”

Equity mutual funds saw net outflows of $20 billion, with $18 billion of net redemptions coming out of domestic equity funds. Although the S&P 500 index returned +10.9% in October, including sharp increases early in the month, investor behavior seemed more a reaction to the losses suffered in August and September.

“After the ups and downs of recent months, investors seem to be suffering from volatility fatigue,” said Ari Nachmany of Strategic Insight. “It may take several months of consecutive gains to generate sustained enthusiasm for US equity funds. In the meantime, we expect investors to look for ways to reduce portfolio volatility.”

“Alternative” or less-correlated asset classes did well in October. Commodities mutual funds, managed futures mutual funds, and long/short mutual funds all saw positive net flows during the month (and global tactical allocation funds also saw modest net inflows).

Despite positive flows into emerging markets funds, international equity mutual funds saw net outflows of $2 billion in October. Equity funds have seen $1.4 billion in net outflows in the first 10 months of the year.

Money-market funds saw net outflows of $21 billion in October, as institutional money funds in particular continued to experience net redemptions. In the first 10 months of 2011, money funds experienced total net outflows of $215 billion, as institutional investors shunned their near-zero yields.

US exchange-traded funds (ETFs) in October experienced $19 billion in net inflows. Leading the way in net inflows were diversified emerging markets ETFs ($4.6 billion in inflows) and high yield ETFs ($2 billion).

Through the first 10 months of 2011, ETFs (including ETNs) saw net inflows of $94 billion, a pace that could produce the fifth straight year of $100 billion or more in inflows to ETFs. At the end of October 2011, US ETF assets stood at $1.08 trillion (rising from $970 billion at the end of September).