

Cash flow can be intriguing indication of investor psyche

To understand the psyche of investors, it's interesting to watch cash flow in and out of mutual funds and exchange-traded funds. The numbers tell an interesting story of risk tolerance, return chasing and general sentiment. Consider these figures to set the scene for how investors are making decisions:



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- The U.S. stock market peaked in October 2007. From the beginning of November 2007 through the end of November 2009, investors redeemed over \$210 billion from U.S. stock mutual funds, according to data from the Investment Company Institute. This is actual exiting cash flow, not related to market losses.

- Over the same period, bond mutual funds had incoming cash flow of nearly \$387 billion. Almost all – 92 percent – of the incoming bond investments have come since in the beginning of 2009. Incoming cash into bond funds has been higher than \$28 billion per month since April even as stocks have rallied significantly.

- During the past year, the total value of assets invested in bond-oriented exchange-traded funds has grown 107 percent while assets in stock-oriented ETFs have increased just 21 percent.

Not surprisingly, risk aversion has increased. Many people moved investments from stock funds to bond funds hoping for less fluctuation in their returns.

Since portions of the bond market have also rallied this year, posting returns beyond their long-term averages, some people are drawn to an expectation for continued stock-like returns from bonds, while taking on what they consider to be less risk.

SLOWING RALLY?

Considering the size of the stock market rally – a 64 percent gain for the S&P 500 index of large U.S. companies between March 9 and December 14 – many people have begun to wonder whether stocks will continue to be a better opportunity than bonds when this rally slows.

Roger Ibbotson and Peng Chen of research firm Ibbotson Associates summarized their answer in a recent article in Morningstar Advisor magazine. They go back to July of 1969 to demonstrate a 40-year return comparison. This period included three bigger-than-your-average-bear markets (1973-74, 2000-02, 2008-09). Over the 40 years, the U.S. bond market trailed S&P 500 stock market returns by an annual average return of only about one percent.

Ibbotson and Chen do not expect this close race between stocks and bonds to continue. They say an edge in stock performance, compensating for the extra risk taken to invest in them, is likely to return to markets over time.

SEEKING BALANCE

Often, being a contrarian instead of following the crowd is in an investor's best interest. Academics and research organizations have tracked investment cash flow and compared it with market cycles, frequently showing that when everyone is leaving stock funds is usually the best time to buy – and vice versa.

There is no doubt that stocks carry risk, even over long periods. And bonds might provide acceptable returns given their lower risk. Almost certainly, even the most risk averse investor should hold a meaningful percentage of stock-oriented investments for diversification and inflation protection. And the most aggressive investor might be wise to hold bonds.

But even more important is that intelligent investment strategy has moved far beyond a high-level discussion of stocks vs. bonds and cash to consider the large differences in types of stocks, bonds and alternative investments.

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