INVESTMENT COMPANY INSTITUTE

PERSPECTIVE

Vol. 3 / No. 1

March 1997

Perspective is a series of occasional papers published by the Investment Company Institute, the national association of the American investment company industry.

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Mutual Fund Developments in 1996

by Brian K. Reid[1]

SUMMARY

The U.S. economy provided a favorable setting for mutual funds in 1996. The economy expanded at a healthy pace, job growth was strong, inflation remained subdued, and corporate earnings advanced further. In financial markets, short-term interest rates were stable, long-term rates rose modestly, and stock prices continued to move significantly higher.

Against this backdrop, mutual fund assets rose 25.5 percent to $3.5 trillion. About half of asset growth came from the performance of mutual funds—primarily reflecting the strong showing of the stock market—while the other half owed to new investments by mutual fund owners. Although the growth in assets was appreciable, it fell short of that posted in 1995 when the stock market was even stronger.

This article reviews mutual fund asset growth and net flows in 1996, with particular emphasis on the investment activity of households, by far the largest holders of mutual fund shares. The highlights of the review are as follows:

Assets and Flows

- Assets of equity funds increased 38 percent in 1996, buoyed both by fund performance and a $222 billion inflow of new cash. Although new investments were a record in dollar terms, as a percentage of assets the inflow amounted to 18 percent of assets, a figure well short of the high of 25 percent posted in 1993.
- Bond & income fund assets posted an 11 percent increase in 1996. Inflows were $13 billion, reversing outflows posted in the previous two years. The inflows last year, however, were substantially below those in the first part of the 1990s. The weakness in the flow of new cash into bond & income funds in recent years largely reflected rising interest rates since 1993, the relatively narrow differential between long-term and short-term interest rates, and the strength in the stock market.
- Assets of money market funds rose 20 percent in 1996, in part as shareholders continued to respond to the favorable differential between yields on money funds and other short-term instruments. Some short-term assets of nonfinancial corporations also flowed into money funds as these firms continued to outsource cash management services.

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Household Investments in Long-term Mutual Funds

- Households allocated about 45 percent of their net purchases of all financial assets in 1996 to long-term mutual funds (equity and bond & income funds), a somewhat higher percentage than in 1995.
- The bulk of household net purchases of long-term funds last year was in equity funds. Rising equity prices were a contributing factor to the large share of equity funds in household purchases, as was the growing role of mutual funds in retirement plans. Preliminary estimates suggest that inflows to equity funds from private pension plans may have doubled in 1996.

Household Direct and Indirect Ownership of Equities

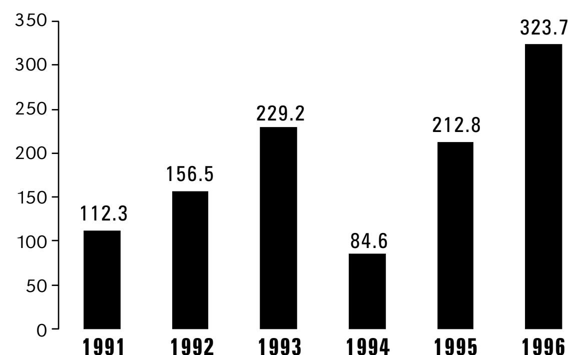
- Households indirectly purchased $221 billion of corporate stock in 1996 through mutual funds. At the same time, they liquidated about $210 billion of direct holdings of corporate equity, resulting in net acquisitions of equities either directly or indirectly of only $11 billion.
- In contrast to the near balance between purchases and sales of corporate equities, the value of corporate stocks held directly in household portfolios or indirectly through mutual funds rose last year to 31 percent of all household financial assets. The increased share reflected higher stock prices, and it continued a trend in place since the early 1980s. Household exposure to stock market risk in 1996, however, remained below that in the late 1960s.

Household Owners of Mutual Funds

- An estimated 37 million households owned mutual funds in 1996, representing 37 percent of all U.S. households. Most are longer-term owners, with 64 percent having made their initial purchase of a mutual fund before 1991. These longer-term owners have been the primary source of the inflows to mutual funds in the 1990s.
- The typical longer-term owner is middle-aged, holds a college degree, has household income of $60,000, has roughly 36 percent of household assets invested in mutual funds, owns three mutual funds of which at least one is an equity fund, often holds individual stocks, invests in mutual funds for retirement, recognizes the risk in investing in mutual funds, and normally assesses risk over a long-term horizon.
- Newer investors in mutual funds—those making their first purchase since the beginning of 1991—are younger than longer-term investors and consequently have lower household incomes, financial assets, and mutual fund assets. Apart from differences related to age, newer investors share many of the investment characteristics of their longer-term counterparts.

FIGURE 1

Net New Cash Flow to Mutual Funds, 1991-1996
(billions of dollars)



Source: Investment Company Institute

MUTUAL FUND FLOWS AND ASSETS

Overview

Assets of all mutual funds increased 25.5 percent in 1996 to stand at $3.539 trillion at yearend, just slightly below the all-time high reached in November. About half of the increase in assets was the result of $323.7 billion in new cash (Figure 1) and the other half was a result of investment performance.[2] The split in asset growth in 1996 between performance

[2] The breakdown between fund performance and new investments is derived from data supplied by mutual funds to the Investment Company Institute. For a given fund, new investments by shareholders are measured as net new cash flow, which is (1) sales of shares including those through exchanges from other funds within the same family of mutual funds but not including those through reinvested distributions less (2) redemptions of shares including those through exchanges into other funds within the same fund family. Fund performance is measured as the change in assets of the fund less net new cash flow. From accounting relationships, fund performance is net investment income plus realized capital gains plus the change in unrealized appreciation (depreciation) less distributions of dividend and capital gains to shareholders plus automatically reinvested dividend and capital gains distributions. Because a mutual fund must distribute virtually all net investment income and realized capital gains to avoid being taxed, net performance over a time span as long as a year roughly equals the change in unrealized appreciation (depreciation) plus reinvested dividend and capital gains distributions. From this perspective, fund performance is equivalent to retained profits plus unrealized asset appreciation.

The breakdown in the change in assets between performance and net new cash flow is computed for each fund on a monthly basis and then aggregated by type of fund. Assets of newly reporting funds that did not report data for the previous month are excluded from the computation. Thus, the aggregate split between performance and net new cash flow does not include assets of new reporters for the month in which they first began to report.

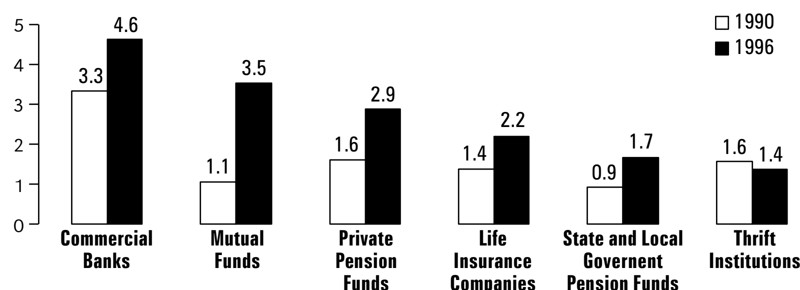
and new investments was roughly in line with that prevailing throughout the 1990s. The performance component last year largely reflected rising stock prices, in contrast to the first part of the decade when rising bond prices also were important.

At the end of 1990, mutual fund assets stood fifth among major financial intermediaries. The increase in security prices since 1990, along with the inflow of net new cash, now places mutual funds ahead of other major financial intermediaries—except for commercial banks—in terms of balance-sheet assets (Figure 2).[3] Since 1990, mutual fund assets have grown at an annual rate of 20 percent, as compared with 10.1 percent growth by private pension funds and 5.7 percent by commercial banks. The slower growth rate of commercial bank assets partly reflected the much more modest appreciation in the value of their assets.[4]

FIGURE 2

Assets of Major Financial Intermediaries, 1990 and 1996

(trillions of dollars)



Note: Data for 1990 are yearend; data for 1996 are at the end of the third quarter for all intermediaries except mutual funds which are for yearend. Commercial banks include U.S.-chartered commercial banks, foreign banking offices in the U.S., bank holding companies, and banks in U.S.-affiliated areas.
Source: Federal Reserve Board and Investment Company Institute

Equity Funds

Assets of equity funds increased 38 percent in 1996 to $1.751 trillion. The performance of these funds accounted for about half of the increase in assets, roughly in line with the contribution fund performance has made to asset growth since the beginning of the bull market in stocks in October 1990 but down from a two-thirds contribution in 1995.

Stock funds also posted a record $221.6 billion in net new cash flow in 1996 (Figure 3).[5] This inflow represented a 72.9 percent increase over that in 1995 and was $92.0 billion more than the previous high of $129.6 in 1993. New sales of equity fund shares rose 55.9 percent last year relative to 1995 to $449.3 billion. At the same time, redemptions rose 41 percent to $243.0 billion, and net exchanges were a record $15.3 billion.

Domestic funds. Domestic equity funds registered a $175.3 billion inflow in 1996, up from $116.5 billion in 1995. Growth and income funds led the advance, partly because of the growing popularity of index funds. The net flow to growth-and-income index funds in 1996 increased to $19.4 billion and accounted for nearly 30 percent of the inflow to all growth and income funds.[6] In 1995, the net flow to index funds represented slightly more than 24 percent of the net flow. Higher-risk fund types—aggressive growth funds and growth funds—also experienced a higher inflow, of $101.7 billion, in 1996, up from $72.5 billion in 1995.[7] These

[3] Commercial banks comprise U.S.-chartered commercial banks, foreign banking offices in the U.S., bank holding companies, and banks in U.S.-affiliated areas.

[4] Although it is common to use balance-sheet assets as a measure of a financial institution's level of intermediation activity, this measure has some shortcomings. First, because the assets of a financial institution can include liabilities of another financial institution, some double counting occurs. For example, private pension funds hold shares of mutual funds, and money market mutual funds hold certificates of deposit issued by commercial banks and thrifts. Second, commercial banks, mutual funds, and life insurance companies are not mutually exclusive entities. Mutual fund asset data shown in Figure 2 include variable annuities which are issued by life insurance companies. Commercial banks and their subsidiaries can serve as financial advisors for mutual fund companies, but the assets managed are reported on the balance sheets of mutual fund companies and not on those of commercial banks. Similarly, commercial bank balance-sheet assets exclude trust accounts, even though banks manage these assets. Finally, balance-sheet assets do not capture the off-balance-sheet activities of financial institutions such as asset securitization, backup lines of credit, and credit-card and mortgage servicing operations. See Mark Gertler and John Boyd, "Are Banks Dead? Or Are the Reports Greatly Exaggerated?" *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 18, No. 3 (Summer 1994), pp. 2-23 for a discussion of the credit-equivalent values for off-balance-sheet activities at commercial banks. They find that a credit-equivalent estimate of off-balance-sheet activities for commercial banks amounted to one third of their on-balance-sheet loans in 1993. Hence, because mutual funds do not engage in such off-balance-sheet activities, using total assets of financial institutions for comparisons of the level of financial intermediation activity likely understates the activity of commercial banks and other financial institutions relative to mutual fund companies.

[5] Unless otherwise noted, the term net flow refers to net new cash flow, inflow refers to a positive value of net new cash flow, and outflow refers to a negative value of net new cash flow.

[6] About three fourths of the net flow to indexed growth and income funds was captured by funds indexed to the S&P 500 stock price index. Despite the significant share of net flow captured by indexed funds within the growth and income fund category, assets of such funds amounted to only 12.6 percent of the assets of all growth and income funds at the end of 1996. Net flow to indexed funds outside growth and income funds was $2.6 billion in 1996, most of which was in growth funds and international funds.

[7] As in Figure 3, these data include precious metal funds. Discrepancies between the data cited in the text and Figure 3 are due to rounding.

FIGURE 3

Net New Cash Flow to Equity Mutual Funds, 1984-1996
(billions of dollars)

	Domestic							Memo:
	Aggressive Growth	Growth	Growth & Income	Income	Total	Foreign	Total	Total Assets
1984	1.1	0.6	1.4	1.8	4.9	0.9	5.9	83.1
1985	1.4	0.2	2.7	3.4	7.7	0.8	8.5	116.9
1986	1.6	1.6	9.2	5.3	17.7	4.2	21.9	161.5
1987	3.6	3.9	9.5	2.7	19.6	-0.6	19.1	180.7
1988	-2.9	-4.4	-5.2	-1.3	-13.8	-2.4	-16.2	194.8
1989	0.8	-0.9	4.1	0.6	4.6	1.2	5.8	249.0
1990	0.5	3.3	2.9	-0.4	6.3	6.5	12.8	245.8
1991	8.7	14.0	12.5	1.2	36.4	3.2	39.5	411.6
1992	13.4	24.9	27.3	6.4	72.1	7.0	79.2	522.8
1993	20.6	21.6	34.0	14.8	91.1	38.5	129.6	749.0
1994	25.3	22.3	19.4	8.4	75.4	43.9	119.3	866.4
1995	35.7	36.9	37.0	7.0	116.5	11.7	128.2	1,269.0
1996	55.5	46.2	65.0	8.6	175.3	46.3	221.6	1,750.9

Note: Aggressive growth funds include precious metal funds,income funds include income-equity and option-income funds,and foreign funds include global funds and international funds.
Source: Investment Company Institute

funds accounted for 58 percent of the net flow to all domestic equity funds in 1996, down from 62.2 percent in 1995. The inflow to income-equity funds rose slightly.

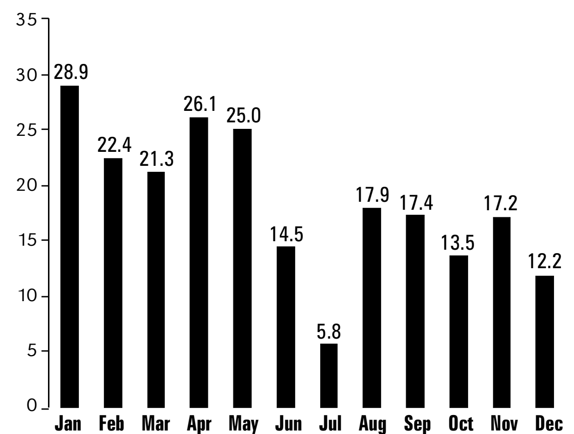
Foreign funds. Net new cash flow to foreign-related stock funds—international funds and global funds—rebounded to a record $46.3 billion last year from a $11.7 billion inflow in 1995, when mutual fund shareholders invested in robust U.S. stock markets. Despite the pickup, foreign-related funds captured only 20.9 percent of all equity fund flows last year, below the 33.1 percent share garnered over 1993 and 1994.

Intra-year pattern. Equity funds experienced heavy inflows in the first five months of 1996 (Figure 4). The $28.9 billion inflow in January set a monthly high, and the inflow in each of the next four months exceeded the previous record of $18.4 billion in January 1994 and never fell below $21.3 billion. As a result, by the end of May the cumulative net flow was just below the previous full-year record in 1993. The strong inflows came, in part, from seasonal flows to 401(k) accounts and Individual Retirement Accounts and from the investment of annual bonuses. The strength also likely reflected a firming in investor demand for stocks, as the elevated pace of inflows continued into May when upward seasonal pressures typically subside.

Net flow slowed in June and dropped in July as stock prices moved lower and volatility increased. The inflow rebounded thereafter with rising stock prices but remained below the elevated levels seen earlier in the year.

FIGURE 4

Net New Cash Flow to Equity Mutual Funds, 1996
(billions of dollars)



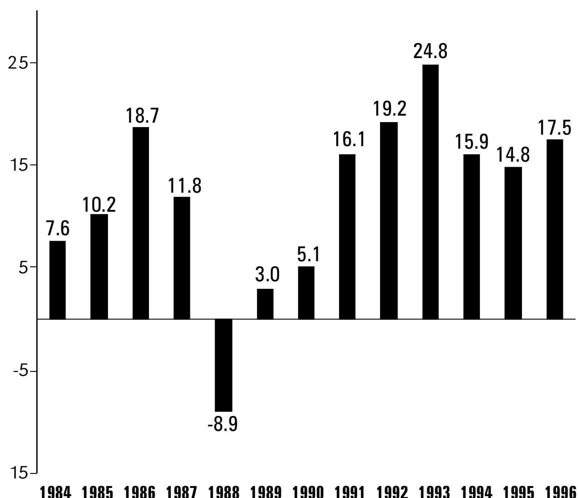
Source: Investment Company Institute

For the final seven months of the year, inflows averaged $14.0 billion and never moved above $17.9 billion.

Net flow relative to assets. Although the $221.6 billion in net new cash flow in 1996 was a record, it fell considerably short of an all-time high measured relative to assets of equity funds. That record

FIGURE 5

Net New Cash Flow to Equity Mutual Funds
(percent of previous yearend assets)



Source: Investment Company Institute

occurred in 1993 when the $129.6 billion net flow amounted to 24.8 percent of previous yearend assets (Figure 5). The net flow in 1996 represented 17.5 percent of yearend assets, which also was below the flow rates in 1986 and 1992.

Bond & Income Funds

Bond & income funds experienced an inflow of $12.6 billion in 1996, reversing outflows of the previous two years (Figure 6). The inflow was modest, however, compared with inflows of the mid-1980s and early 1990s when net flows ranged from $65.2 billion to $113.7 billion. The improvement in net flow last year was led by stronger inflows to high-yield funds, income-bond funds, and mixed funds,[8] which generally produced the highest returns among all types of bond & income funds. The improved flow also benefited from a slowing in the outflow from global bond funds. U.S. Government, Ginnie Mae,[9] and municipal bond funds continued to experience outflows that were roughly in line with those in 1995.

Net flow and interest rates. The overall weak inflow to bond funds last year is partly related to movements in interest rates. Since the mid-1980s, inflows to bond funds generally have occurred during extended periods of

FIGURE 6

Net New Cash Flow to Bond & Income Mutual Funds, 1984-1996
(billions of dollars)

	Mixed	U.S. Government and GNMA	Global	Corporate Bond	High Yield	Income Bond	Municipal	Total	Memo: Total Assets
1984	0.3	7.4	0.0	0.2	1.2	0.0	4.3	13.3	54.0
1985	2.0	42.8	0.0	0.9	4.4	1.2	13.9	65.2	134.8
1986	5.9	57.5	0.4	3.5	9.6	3.5	28.2	108.6	262.6
1987	4.1	2.9	0.7	0.6	0.6	1.1	0.9	10.9	273.2
1988	-2.5	-13.7	0.6	-0.2	3.2	0.5	5.1	-7.0	277.5
1989	4.3	-12.8	-0.1	0.8	-2.9	1.7	12.0	3.1	304.8
1990	2.3	-7.7	5.6	0.2	-5.1	3.2	9.9	8.5	322.7
1991	8.3	17.4	10.2	3.0	1.8	5.2	21.2	67.2	441.4
1992	22.7	29.8	-2.8	4.5	4.6	6.6	28.4	93.7	577.3
1993	40.4	6.1	4.5	4.3	8.6	11.5	38.3	113.7	761.1
1994	21.1	-39.9	-4.5	-1.6	-0.7	-2.3	-15.5	-43.4	684.0
1995	5.7	-13.9	-4.4	2.0	8.1	4.7	-7.0	-4.8	798.3
1996	10.4	-13.8	-0.9	2.4	12.3	8.6	-6.3	12.6	886.5

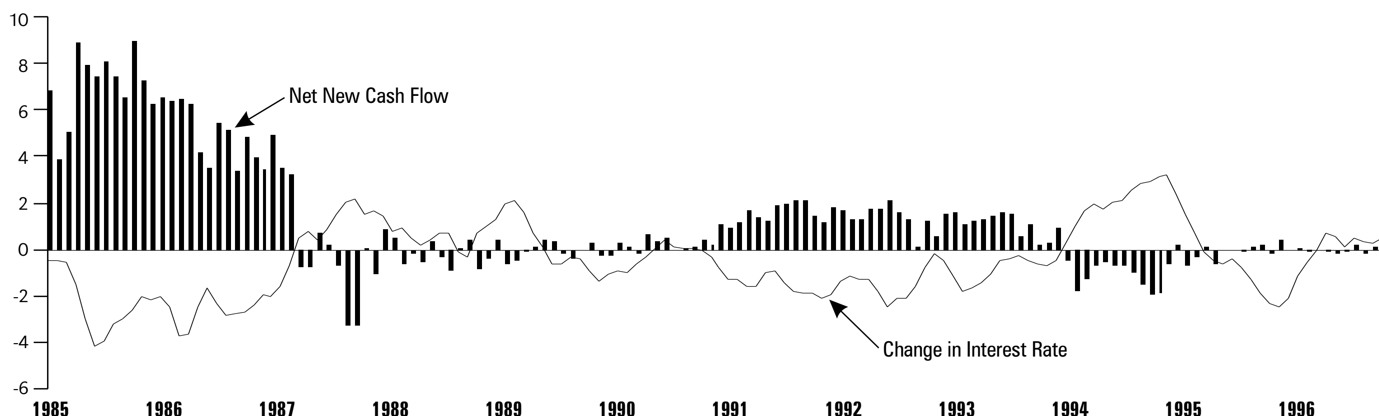
Note: Mixed funds include balanced funds, flexible portfolio funds, and income-mixed funds.
Source: Investment Company Institute

[8] Mixed funds comprise balanced funds, flexible portfolio funds, and income-mixed funds.

[9] U.S. Government bond funds seek income by investing in a variety of U.S. Government securities, including Treasury bonds, federally guaranteed mortgage-backed securities, and other government-backed issues. Ginnie Mae bond funds seek income by investing primarily in mortgage securities backed by the Government National Mortgage Association. To qualify for this category, the majority of a fund's portfolio must always be invested in mortgage-backed securities.

FIGURE 7

Net New Cash Flow to Bond Funds and Interest Rate Changes, 1985-1996
(percent)



Note: Net new cash flow is shown as a percentage of the previous month's outstanding assets. Interest rate changes are year-over-year changes in the constant maturity yield on the three-year Treasury Note.
Source: Federal Reserve Board and Investment Company Institute

falling interest rates and rising returns on bond funds, whereas outflows or weak inflows have been associated with rising interest rates and negative or low returns on bond funds (Figure 7). For example, in 1985 and 1986, interest rates moved sharply lower, causing heavy inflows into Ginnie Mae and U.S. Government bond funds. These flows ended abruptly in the spring of 1987, when the Federal Reserve tightened monetary policy, and did not resume until early 1991 when interest rates began a sustained downward movement. Heavy inflows into the broad range of bond funds continued until the Federal Reserve once again tightened policy in early 1994, producing outflows from bond funds.

In 1996, bond funds started the year with inflows, likely reflecting both seasonal influences and the downward movement in interest rates that had begun in 1995. Not unexpectedly, as rates began to rise in February, net flows weakened and turned negative in the second and third quarters. Falling yields late in the year may have helped to produce modest inflows in the fourth quarter. Flows to bond funds in both 1995 and 1996 likely also were dampened by the outsized total return of 56.2 percent on domestic equity funds over the two years[10] and by the relatively high return on short-term investments such as money market mutual funds. Indeed, during 1996, returns for taxable money funds generally exceeded those for U. S. Government and Ginnie Mae bond funds, and returns for tax-exempt money market funds were near those for municipal bond funds.[11]

Money Market Mutual Funds

Assets of money market mutual funds increased 19.8 percent last year to $901.8 billion, and for the first time since 1992, exceeded assets in bond & income funds. Assets of retail funds rose 8.4 percent to $449.7 billion, and institutional money fund assets rose 31.2 percent to $293.4 billion. Taxable money market fund assets gained 21 percent to $761.8 billion, while tax-exempt fund assets increased 13.6 percent to $140.0 billion.

Retail funds. Net new cash flow to all money market funds was $89.4 billion, essentially unchanged from that in 1995 (Figure 8).[12] Although the total net flow was unchanged, the inflow to retail money funds was down somewhat, largely because the spread between the yield on retail funds and

[10] Lipper Analytical Services, Inc., *Lipper Equity Fund Performance Analysis* (1996:Q4).

[11] Lipper Analytical Services, Inc., *Lipper Fixed Income Fund Performance Analysis* (December 31, 1996)

[12] The record inflow was $91.1 billion in 1981, when money market mutual funds experienced extraordinarily heavy inflows because market interest rates rose in conjunction with a tightening of monetary policy. Banks and thrifts were prevented from raising interest rates on most of their deposits because of interest rate ceilings in effect at the time.

FIGURE 8

Net New Cash Flow to Retail and Institutional Money Market Funds, 1984-1996
(billions of dollars)

	Retail			Institutional			Total	Total		Memo:
	Taxable	Tax-exempt	Total	Taxable	Tax-exempt	Total	Taxable	Tax-exempt	Total	Total Assets
1984	12.3	5.0	17.3	17.0	1.0	18.0	29.2	5.9	35.1	233.6
1985	-12.9	8.5	-4.4	-2.9	2.0	-0.9	-15.9	10.5	-5.4	243.8
1986	3.3	17.6	20.9	5.7	7.2	12.9	9.0	24.8	33.9	292.2
1987	6.7	-3.0	3.7	6.3	0.2	6.5	13.1	-2.9	10.2	316.1
1988	4.1	2.0	6.1	-5.6	-0.4	-6.0	-1.5	1.6	0.1	338.0
1989	51.1	3.5	54.6	11.5	-2.0	9.5	62.5	1.5	64.1	428.1
1990	4.2	4.5	8.7	13.1	1.2	14.3	17.4	5.8	23.2	498.4
1991	4.2	-1.0	3.2	0.2	2.0	2.2	4.4	1.1	5.5	542.4
1992	-27.9	3.0	-24.9	7.5	1.1	8.6	-20.5	4.2	-16.3	546.2
1993	-14.5	3.8	-10.7	-4.6	1.2	-3.4	-19.1	5.0	-14.1	565.3
1994	22.1	1.5	23.6	-14.3	-0.6	-14.9	7.9	0.9	8.8	611.0
1995	56.7	6.4	63.1	25.4	0.9	26.3	82.1	7.3	89.4	753.0
1996	49.2	7.5	56.7	30.0	2.7	32.7	79.2	10.2	89.4	901.8

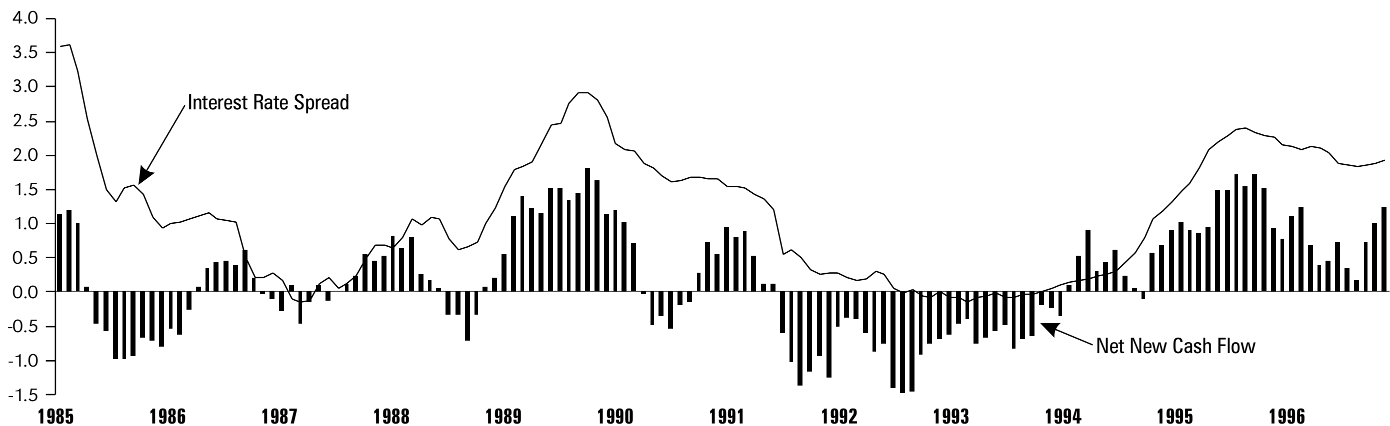
Source: Investment Company Institute

savings deposits narrowed (Figure 9). Interest rate differentials between these retail money funds and savings and short-term certificates of deposit affect the movement of cash into these funds. During 1995, the returns on retail money funds relative to savings deposits had climbed to a six-year high, as short-term interest rates rose with the tightening of monetary policy, while interest rates on savings deposits changed little. The Federal Reserve eased monetary policy on three occasions between July 1995 and January 1996, leading to a decline in the returns on retail money funds relative to rates on savings deposits. As a result, the inflow to retail funds slowed somewhat but, with the yield differential still high, remained strong.[13]

Institutional funds. Offsetting the decreased inflow to retail money funds last year was a pickup in the net new cash flow to institutional money funds, which rose from $26.3 billion in 1995 to $32.7 billion in 1996. The net inflow to these funds is very sensitive to the spread between the returns on these funds and open market interest rates, especially rates on one-day repurchase agreements. In 1996, the spread between institutional

FIGURE 9

Interest Rate Spread and Net New Cash Flow to Retail Money Market Funds, 1985-1996
(percent)



Note: Net new cash flow is a percentage of retail money market fund assets and is shown as a six-month moving averqge. The interest rate spread is the difference between the taxable money market fund yield and the average interest rate on savings deposits; the series is plotted with a six-month lag.
Source: IBC Financial Data, Inc., Federal Reserve Board, and Investment Company Institute

[13] Inflows last year were also supported by strong economic growth, which boosted household income.

FIGURE 10

Net Acquisition of Selected Financial Assets by the Household Sector[1], 1995-1996
(billions of dollars)

	1995	1996[2]
Total	556.1	625.9
Long-term Mutual Funds[3]	181.6	295.3
Deposits and Money Market Mutual Funds	202.1	201.8
Debt Securities	32.7	34.7
Corporate Equity[4]	-204.5	-210.4
Memo:		
Personal Saving	249.3	268.2
Net Increase in Liabilities	396.9	417.1

[1] The household sector includes individual households, personal trusts, and nonprofit institutions such as charitable organizations, private foundations, schools, churches, labor unions, and hospitals.
[2] First three quarters at an annual rate.
[3] Net purchases of stock and bond & income mutual funds by the household sector, including purchases made through bank personal trusts and private pension funds.
[4] Net purchases of corporate equity, including acquisitions through bank personal trusts, defined-contribution plans, and closed-end funds.
Source: Federal Reserve Board, Employee Benefit Research Institute, and Investment Company Institute

fund returns and short-term interest rates, however, was fairly narrow, suggesting that the heavier inflow was attributable to other factors. For instance, the narrow spread between bond fund yields and money market fund yields may have led some institutional investors to shift from bond funds to money funds. In addition, as corporate businesses continue to outsource cash management services, some short-term assets have flowed into institutional money funds. Indeed, nonfinancial corporate business holdings of money funds rose from $83.0 billion at the end of 1995 to $97.0 billion at the end of the third quarter of 1996.[14]

HOUSEHOLDS' NET ACQUISITION OF MUTUAL FUNDS AND OTHER FINANCIAL ASSETS[15]

Net acquisition of mutual funds. Households own the bulk of mutual fund assets and accounted for an estimated nine tenths of the net flow to long-term funds in 1996.[16] Thus, the financial investment activity of households largely determines the pace of flows to mutual funds. From this perspective, an important reason for the inflows into long-term mutual funds last year was that households chose to expand their overall purchases of financial assets. In fact, through the third quarter of 1996—the most recent data available—households made net purchases of financial assets at a record annual rate of $625.9 billion, up 12.6 percent from $556.1 billion in 1995 (Figure 10). The increase in net purchases of financial assets was partly financed through higher household saving, which rose 7.6 percent to $268.2 billion.[17] In addition, a pickup in household borrowing in 1996 indirectly helped to finance the increase in household purchases of financial assets.[18]

Households directed a significantly higher proportion of their purchases of financial assets to long-term mutual funds. Through the first three quarters of last year, stock and bond & income

[14] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Flows and Outstandings Third Quarter 1996* (December 11, 1996) (*"Flow of Funds Accounts"*).

[15] The analysis in this section is based upon data published in the *Flow of Funds Accounts*. The household sector includes nonprofit organizations, which accounted for 4.9 percent of sector assets in 1993, the latest year for which data are available. Unless otherwise noted, data for 1996 are through the first three quarters at an annualized rate.

Financial assets include deposits, commercial paper, corporate and government bonds, corporate equities, life insurance and pension fund reserves, investments in bank personal trusts, and equity in noncorporate business. Residential property, consumer durables, and other tangible assets are not included in the definition of financial assets for the *Flow of Funds Accounts*.

Unlike the net mutual fund flow data discussed in the previous section of this paper, household acquisitions of long-term mutual funds reported in *Flow of Funds Accounts* include reinvested dividend and capital gains distributions but exclude variable annuities. To make the mutual fund data more comparable to those discussed above, variable annuities have been added back to long-term mutual fund data reported in the *Flow of Funds Accounts* based on the assumption that all variable annuities are purchased and held by the household sector.

[16] The Investment Company Institute estimates that households own three quarters of all mutual fund shares. This estimate is as of yearend 1995 and includes holdings inside and outside employer-sponsored retirement plans and holdings through variable annuities. Another 15 percent of mutual fund shares are held in fiduciary accounts, and 10 percent are held by businesses, financial institutions, unions, endowments, foundations, and other nonpersonal organizations.

[17] Household saving, as a percentage of after-tax income, increased only marginally from 4.7 percent in 1995 to 4.9 percent in 1996.

[18] The bulk of household borrowing directly finances home purchases and consumer spending, which thus enables households to use disposable income to expand holdings of financial assets.

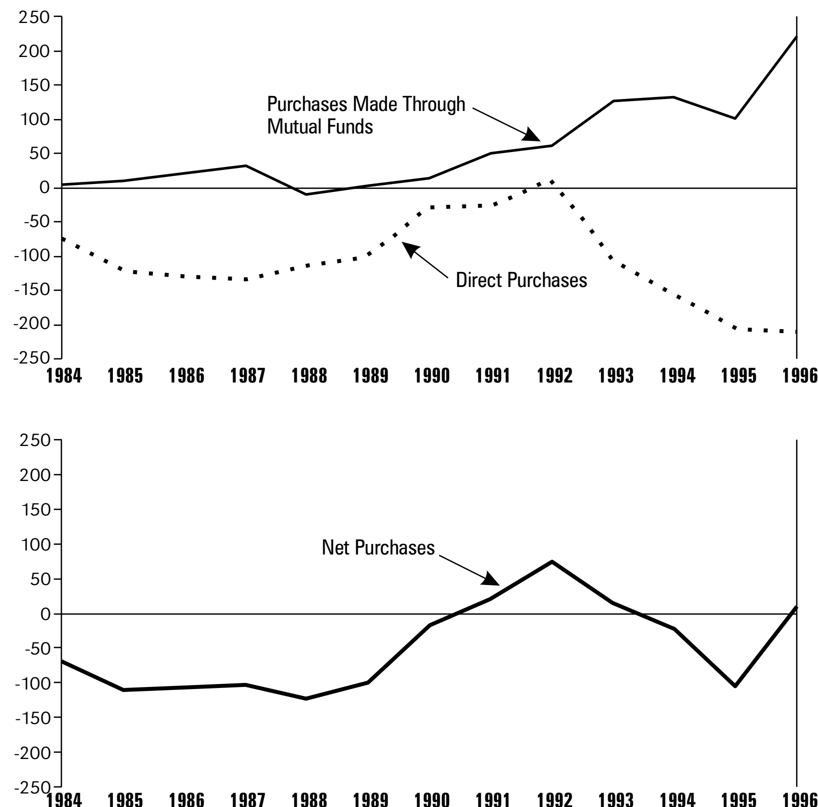
funds garnered a 47.2 percent share of household net acquisitions of financial assets, up from 32.7 percent in 1995.[19] The increased purchases of long-term fund shares, most of which were equity funds, likely reflected the strong showing of the U.S. stock market, and may have reflected heightened concern about investing for retirement, as the media and financial advisers stressed retirement savings issues and holding stocks for such long-term objectives.

Indeed, inflows to long-term funds from private pension plans—largely defined-contribution plans—doubled last year.[20] Since the late 1980s, mutual funds have captured an increasing share of the growing 401(k) market, which at the end of 1995 amounted to an estimated 38.7 percent of the $675 billion of outstanding plan assets, and industry reports suggest that the share likely increased further in 1996.[21]

Household net purchases of equity. On balance, households added very little to their overall holdings of corporate stocks last year, despite their investments in equity funds. Through equity funds, households made an estimated $221 billion of net purchases of corporate equities (Figure 11).[22] At the same time, they liquidated, on balance, an estimated $210 billion in their direct holdings of corporate equity. These sales primarily were the product of share retirements associated with corporate repurchase programs and with corporate acquisitions and mergers. On balance, the net stock purchases of households in 1996 amounted to only $11 billion.

FIGURE 11

Purchases of Equities by Households, 1984-1996
(billions of dollars)



Note: See text footnote 22 for an explanation of the construction of the data.
Source: Federal Reserve Board, Employee Benefit Research Institute, and Investment Company Institute

Last year's modest net additions of corporate stock marked the fourth straight year in which households either liquidated stock holdings or made small net purchases. Indeed, over this period, net sales of equity by households amounted to $100 billion. The magnitude of this liquidation points up the importance of considering the entire scope of household investment

[19] The record was 62.4 percent in 1993.

[20] The *Flow of Funds Accounts* do not distinguish mutual fund purchases in defined benefit plans from those in defined-contribution plans. Defined-contribution plans, however, hold most of the mutual fund shares held by private pension plans.

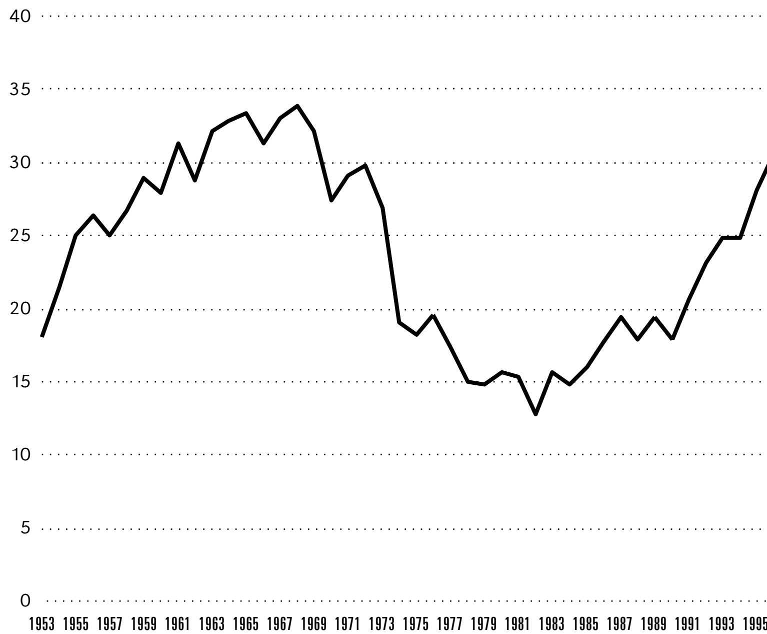
[21] Based on the *Flow of Funds Accounts* and Investment Company Institute data, only about one tenth of assets in private and public pension funds were held in mutual funds at the end of 1995.

[22] Direct purchases of equities include purchases through closed-end funds, personal trusts, and private defined-contribution plans. For 1984 and 1985, the defined-contribution-plan component is estimated by multiplying the net acquistion of equities of all private pension plans by the share of private pension assets held in defined-contribution plans. Equity purchases in subsequent years were obtained from the Employee Benefits Research Institute, *Quarterly Pension Investment Report*, Vol. 10, No. 3 (September 1996).

Equity purchases through mutual funds include those acquired by bank personal trusts and private defined-contribution plans. All private pension fund purchases of mutual funds are ascribed to defined-contribution plans, thereby overstating the actual purchases through mutual funds somewhat. Data for net sales and purchases of equities and mutual funds are from the *Flow of Funds Accounts* and are adjusted to include equity purchases through variable annuities.

FIGURE 12

Total Holdings of Equities by Households, 1953-1996
(percent of total financial assets of households)



Note: Data reflect equities held directly or through mutual funds, bank personal trusts and estates, and defined-contribution plans. See text footnote 23 for a more detailed discussion. Data are annual averages of quarterly data.
Source: Federal Reserve Board, Employee Benefit Research Institute, and Investment Company Institute

activity, not just that involving mutual funds, in considering the flow of cash into the stock market.

Equity share of household assets. Even though households have been net sellers of corporate equities during the past four years, the share of household financial assets held as equities has increased as a result of rising stock prices (Figure 12).[23] At the end of the third quarter of 1996, the value of household equity holdings, acquired directly or indirectly was an estimated $6.7 trillion and amounted to 30.7 percent of household financial assets. Nevertheless, the share of household assets held as corporate equities is below the peak of 33.9 percent reached in 1968, following the runup in the stock market during the 1960s.

Other household balance sheet developments. Household net acquisitions of other major financial assets in 1996 were about on pace with 1995. Net purchases of liquid assets—deposits and money market fund funds—were essentially unchanged, and households also directly bought about the same amount of debt securities in 1996 as in 1995. Within the latter class of assets, households continued to liquidate direct holdings of municipal bonds, as they did with indirect holdings through municipal bond funds. This may have reflected concern during the year with the "flat-tax" proposal that many viewed as adversely affecting the tax status of municipal bonds. There also has been a sizable reduction in outstanding tax-exempt bonds over the past three years that perforce has resulted in liquidations by the largest holder of such securities, the household sector. Households were net buyers of government-related securities in 1996, in contrast to outflows from U.S. Government and Ginnie Mae funds.

LENGTH OF FUND SHARE OWNERSHIP AND FUND FLOWS

The vast majority of the 36.8 million U.S. households that own mutual funds are long-term investors,[24] having made their first purchase of a mutual fund before the start of the current economic expansion in 1991 and before the beginning of the current bull market in equities in late 1990. In fact, approximately 64 percent of household owners made their first purchase of a mutual fund before 1991, with the remaining owners having made their initial purchase thereafter.

[23] Equity holdings of households is the sum of direct holdings of corporate equities and holdings through defined-contribution retirement plans, bank personal trusts, and mutual funds. Equity holdings through defined-contribution plans are estimated by multiplying the share of private pension fund assets held in defined-contribution plans by all equity holdings in private pension funds. Equity holdings in mutual funds are estimated by multiplying the share of all long-term mutual funds held by households, private pension funds, and bank personal trusts by the equity holdings of mutual funds. The share of private pension assets in defined-contribution plans is available beginning in 1984. Prior to that year, equity assets held directly by such plans are not included in household equity holdings, thereby understating slightly household equity holdings before 1984.

[24] Investment Company Institute, "Mutual Fund Ownership in the U.S.," *FUNDamentals* (December 1996). Mutual fund ownership includes that through employer-sponsored retirement plans as well as through other sources. The 36.8 million household owners in 1996 amount to 37.3 percent of all U.S. households and represent an estimated 63 million individuals. The estimated number of households owning mutual funds in mid-1994 was 30.2 million, and amounted to 30.8 percent of all U.S. households.

FIGURE 13

Selected Characteristics of Household Owners of Mutual Funds, 1995[1]

	First Purchase in 1990 or Earlier	First Purchase in 1991 or Later
Demographic Characteristics		
Median Age	46	37
Percent of Households		
Married	73	63
Employed, full or part-time	79	88
Minor children[2]	41	48
Four year college degree or more	60	55
Financial Characteristics		
Median household income	$60,000	$50,000
Median household financial assets[3]	$70,000	$25,000
Percent of Households Owning:		
Individual stocks	57	48
Individual bonds	27	19
Annuities	29	18
IRA	75	60
401(k)	51	50
Mutual Fund Ownership Characteristics[4]		
Median mutual fund assets	$25,000	$7,000
Median number of funds owned	3	2
Percent		
Household assets in mutual funds[5]	36	28
Fund types owned		
Equity	75	71
Bond and income	50	38
Money market	54	45
Households using purchase channels		
Sales Force	65	60
Direct Market	33	29
Investment Goal[6]		
Retirement	81	77
Education	24	27
Risk Tolerance Profile[7]		
Willing to take:		
Substantial risk with expectation of substantial gain	8	10
Above-average risk with expectation of above-average gain	36	38
Average risk with expectation of average gain	41	36
Below-average risk with expectation of below-average gain	10	13
No risk	6	3
Awareness: Agreed that investing in stock and bond funds involves risk.	96	100
Evaluations: Assessed risk of most recent stock or bond fund purchase	67	71
Horizon: Assess mutual fund risk in time frame exceeding five years	65	62

[1] Characteristics of primary financial decisionmaker in the household.
[2] Percent of married households.
[3] Excludes assets in employer-sponsored retirement plans.
[4] Excludes mutual funds in employer-sponsored retirement plans.
[5] Excludes any mutual fund assets held in employer-sponsored retirement plans.
[6] Multiple responses included.
[7] Responses of households with an investment goal.
Source: Investment Company Institute

Limited data that are available suggest that the longer-term investors have been the primary source of the inflows to mutual funds in recent years. For example, in 1993 and 1995, the estimated dollar volume of mutual fund shares bought by these longer-term shareholders was at least three times the purchase volume of newer investors in mutual funds.[25] Estimates are not available for the other years in the 1991-96 period, but the large proportion of sales attributable to these longer-term shareholders in 1993 and 1995 suggests that they were likely of similar importance in other years.

Characteristics of longer-term and newer investors. The primary financial decisionmaker of the typical household that invested in a mutual fund before 1991 earned a degree from a four-year college and is 46 years of age, married, and employed (Figure 13). Household income of these fund owners is $60,000 and holdings of financial assets (other than those in employer-sponsored retirement accounts) are $70,000, of which 36 percent is invested in mutual funds. Other investments include individual stocks, bonds, and annuities. Households that made their first mutual fund purchase before 1991, on average, own three mutual funds, most commonly an equity fund but very often a bond & income fund or a money market fund as well. They hold mutual funds primarily to reach retirement goals and, perhaps reflecting this objective, their horizon for evaluating investment risk extends beyond five years. The typical financial decisionmaker in these households recognizes that mutual funds involve investment risk and is willing to assume an average degree of risk in the expectation of an average return. Finally, the typical household that made its first purchase before 1991 purchased mutual funds through the advisor-assisted, sales force channel.

Newer buyers of mutual funds—households making their first purchase since 1990—are similar in many respects to longer-term owners, although there are notable differences, most of which likely reflect the younger age of new investors. The typical newer investor is 37 years old and has household income of $50,000, lower than that of longer-term owners. The newer owner has a smaller amount of financial assets and typically has a smaller amount invested in mutual funds. Apart from these differences, the newer investor, like the longer-term owner, has a strong preference for equity funds and has had investment experience in individual stocks, bonds, and annuities. Newer owners also have a long-term horizon for assessing risk, and the majority has purchased mutual funds through the adviser-assisted, sales force channel.

[25] The estimates are based upon unpublished data from household surveys conducted by the Investment Company Institute in 1994 and 1996. The 1994 survey, from which the 1993 estimate was derived, was a random sample of 3,139 households and was conducted primarily to estimate the number of households owning mutual funds. Each householder owner in the survey indicated the volume of purchases of stock and bond and income funds made outside of employer-sponsored retirement plans in 1993. The estimate was formed by dividing the aggregate purchases of longer-term owners by the aggregate purchases of newer owners. Other findings of the survey are reported in Investment Company Institute's, "Mutual Fund Ownership Among U.S. Households," *FUNDamentals* (September 1995). The estimate for 1995 was derived in a similar fashion from a survey conducted in 1996 of 2,644 randomly selected households; findings from that survey are in *FUNDamentals* (December 1996).

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