



Demographics and the Decline of Equity Mutual Funds

By Paul Franchi

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Until the last few years, mutual fund flows followed performance. Recently, however, money has flowed disproportionately into bond funds and out of US equity funds despite a strong rally in the equity markets. Changing demographics explain this shift, which has important implications for advisors and the mutual fund industry.

What follows is the first of a series in which I will explore macro trends that are having a significant and often-misunderstood impact on the mutual fund industry today. In part two, I will explore the long-term trend in interest rates and monetary policy and how this impacts the distribution and advice side of our profession. In part three, I will provide a broad historical perspective on current issues surrounding the appropriate standard of fiduciary care for advisors and broker dealer reps and I will tie this back to the trends explored.

For at least three decades, the mutual fund industry has benefited from several wonderful tailwinds, some of which are in the process of shifting. Once these tailwinds become headwinds, it will be quite easy to recognize poor products and distribution strategies. Until then, fund executives need to apply the same forward-looking analysis and critical thinking currently used to pick individual securities in their approach to product, marketing and distribution. The beneficiaries of the emerging trends that I outline will be those firms that have a history of successful marketing to registered investment advisors. Some mutual fund companies have avoided this channel altogether. If you have ever asked the question "How do you market to RIAs?" pay special attention to what follows.

Examining the data on fund flows

The last six years for most equity-based mutual fund companies have been challenging. Fortunately for them, revenues are a function of assets under management and not net new flows; if funds were generating revenues purely on new asset flows, many would be facing illiquidity and insolvency today. But, most sales plans, business modeling, new product launches and planning considerations are based on what worked when the industry was growing rapidly and not what is appropriate for the current environment.

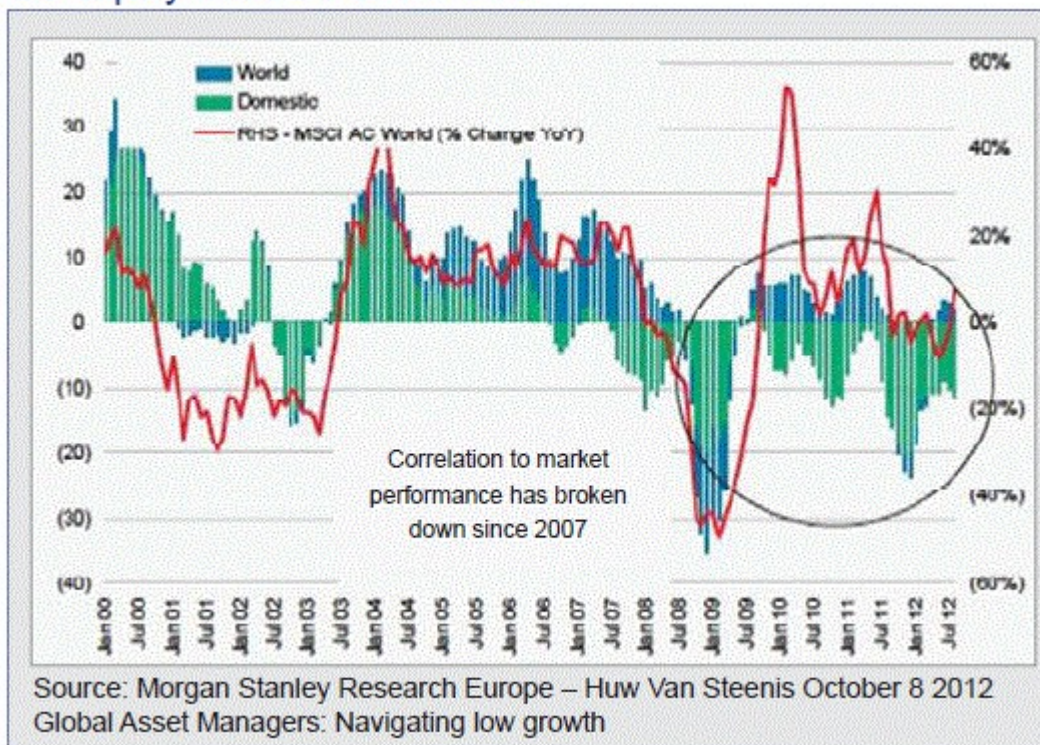
The surge into bond funds, especially in the last two years, has padded the bottom lines of many bond shops. But most industry participants, as they have done often in the past, are holding their breath waiting for the tide to turn – waiting for the familiar "rush" back into higher-margin equity funds.

The Investment Company Institute (ICI) in its yearly Fact Book has documented how both bond and equity mutual fund inflows are typically closely correlated with their respective market performances. In the past, investors have consistently lightened up on what was not working while stocking up on what was. (This approach rarely works, of course, but that’s another story.) In the 2012 edition, however, the ICI noted that domestic equity funds have now seen six consecutive years of outflows despite recent robust returns from equities. 2012 now marks year seven in this trend.

Both secular and demographic trends have been offered as possible explanations. The secular trend, as one might expect, is caution among investors after two major equity sell-offs in one decade. More important, though, has been the aging demographic profile of US investors and their need to reduce equity exposure in their portfolios.

Exhibit 1, below, illustrates net domestic and global equity flows. Note that the global flows have maintained some of their historical relationship to market performance – particularly on the upside.

Exhibit 1
US Equity Mutual Fund Flows



The discontinuity is stark. But what’s the link to demographics? Why are aging investors seemingly abandoning their historical behavior? The answer is in how investors’ equity preferences change as they age.

Exhibit 2 shows Vanguard’s analysis of what trends drive investors’ equity allocation decisions in accounts where target date funds (which provide the selection for the investor) are not used. It lends support for the suggestion that age generally plays a more important role in the amount of risk taken in a portfolio than does the incidence of volatility in the market place. Prevailing market conditions are noted as an influence with respect to plan participants, but predominantly during times when they are enrolling for the first time in defined contribution (DC) plans and the market is selling off. In such cases, those aged 55 and older show the most sensitivity to equity allocation when enrolling during market sell-offs. However this tendency across participants at large (including those who are already enrolled) for the period 2005–2010 was found to have been “muted”.

Exhibit 2
Equity Exposure, New Enrollees not using TDFs

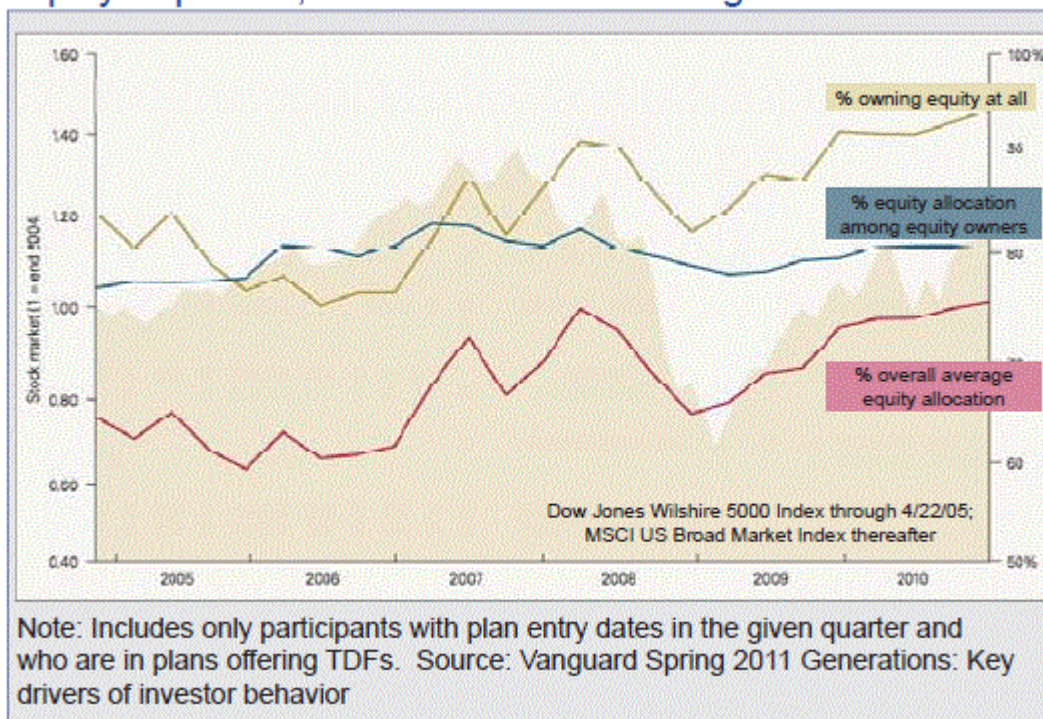
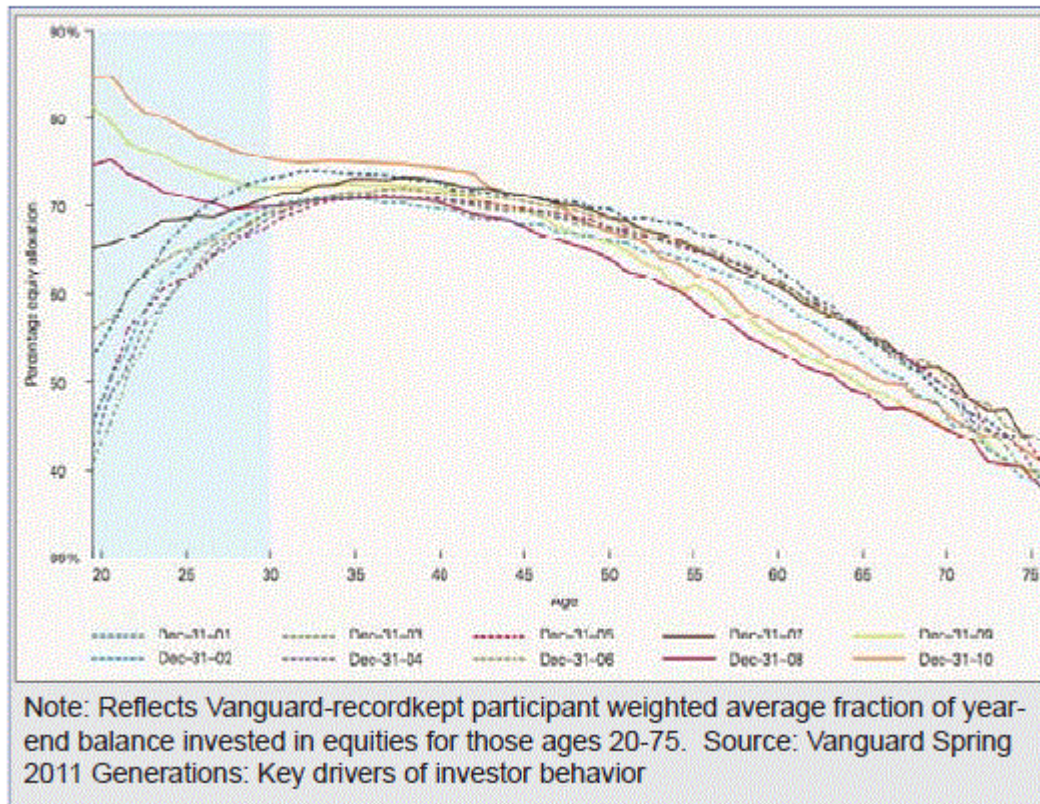


Exhibit 3 provides clearer insights into the average allocation to equities, which decline with the age of the investor over all time periods measured. If anything, at least the younger participants have been more inclined to increase as opposed to decrease their equity exposure at survey periods which correspond to volatile markets, as highlighted in the shaded area. An aging demographic profile in the US is playing a more pronounced

role in equity mutual fund flows than is the caution elicited from two market selloffs in one decade.

Exhibit 3

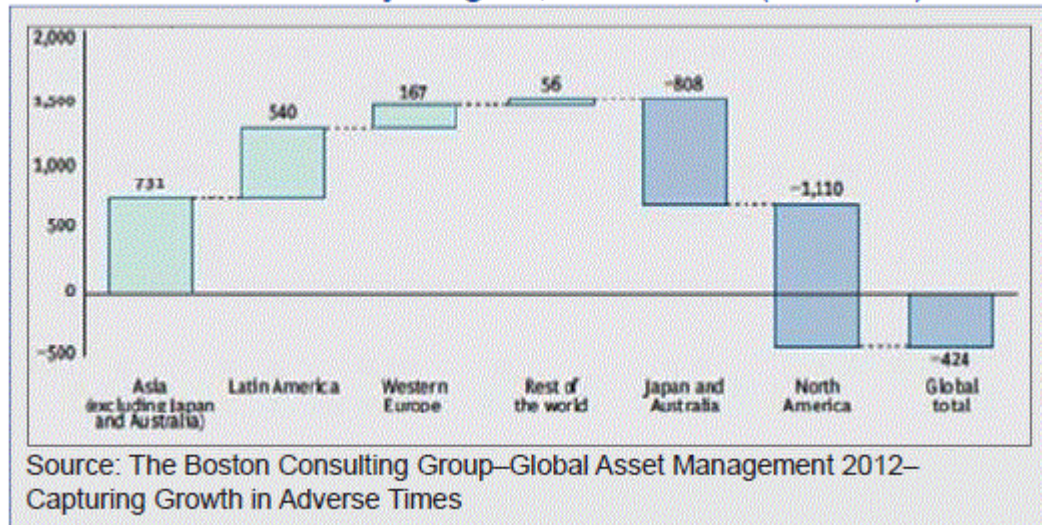
Average Equity Allocation in Plan Balance, by participant age and year



There's additional circumstantial evidence that aging investors are behind the changing flows, as stagnating growth in mutual fund assets under management is not a uniform phenomenon globally. While Japan and North America have suffered declines, the rest of Asia and Latin America (generally known to have younger average populations) have experienced positive growth. Exhibit 4, below, illustrates this difference by removing growth in total mutual fund assets attributable to market performance. The first four regions in light green illustrate net growth in billions of dollars due to net sales, from largest to smallest. The next two show net losses due to net outflows with the final bar representing the global total.

Exhibit 4

Net Growth in AUM by Region, 2007-2011 (\$billions)



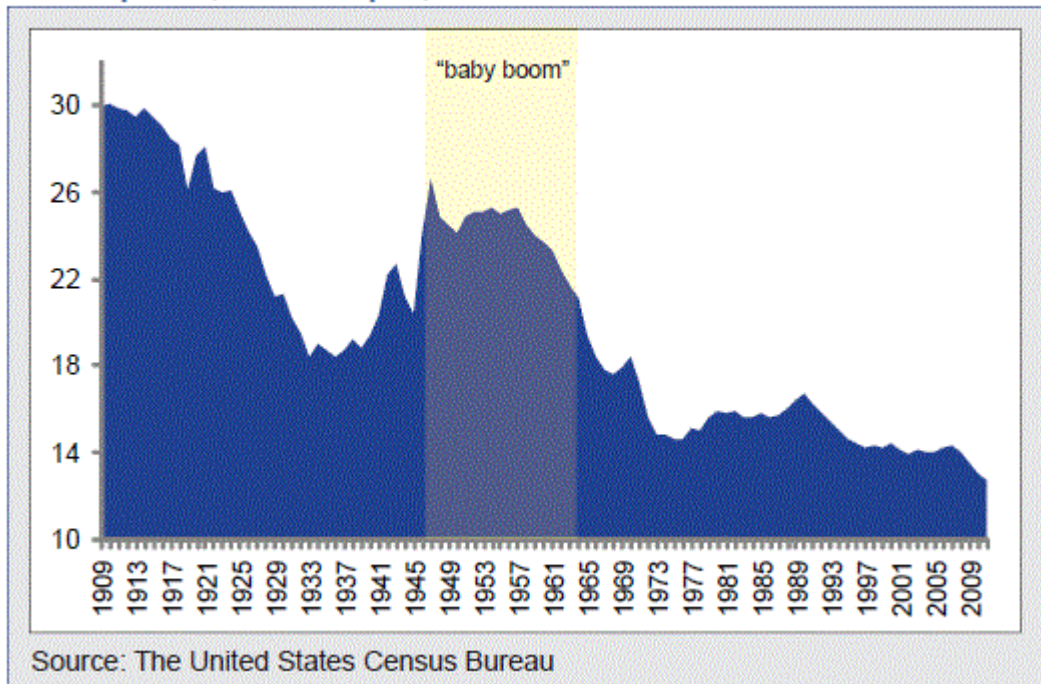
Demographics in the US and abroad

We are not yet accustomed to thinking of the United States as a “graying nation,” nor should we for a long while. But we do need to focus on the point at which the oldest investors in the baby boomer segment begin to modify their behavior.

Exhibit 5, below, charts annual births per 1,000 persons in the US. It shows the “baby boom” years of 1946 to 1964, when birth rates spiked to 25-26 births per 1,000 persons. But it also shows clearly why the baby “boom” should be more appropriately called the baby “recovery” – a snap back to the more traditional 30 births per 1,000 persons that took place before World War I.

Exhibit 5

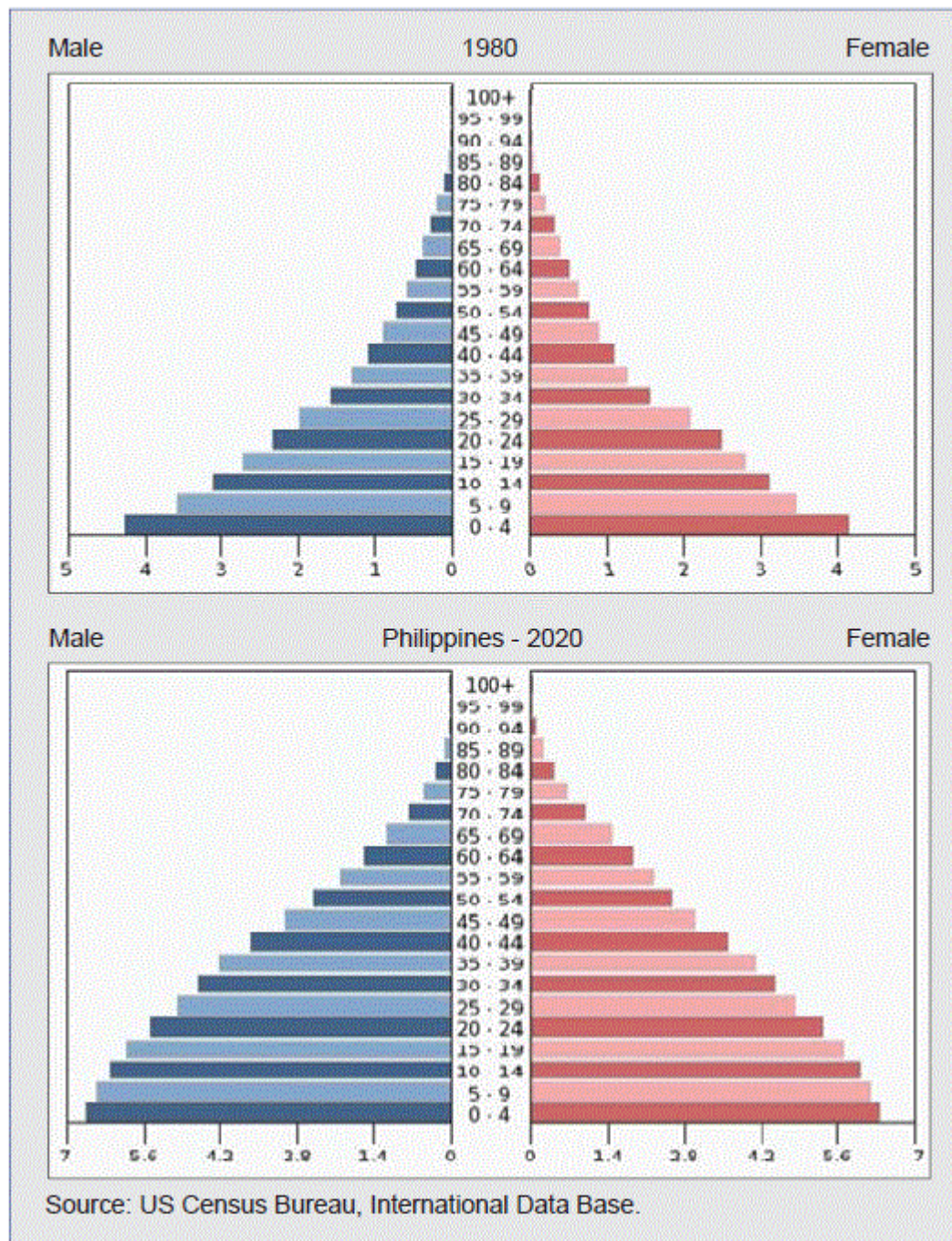
Births per 1,000 People, 1909-2011



Whatever you call it, the spurt in births occurred for reasons that are widely known – WWII victory brought closure to more than 15 years of struggle, including the collapse of the stock market, the Great Depression, and World War II. (What better way to celebrate?) After 1964, the US birth rate rapidly declined. Even when accounting for immigration trends, the age distribution in the US has skew unusually old by historical standards.

Most countries did not experience the same pronounced changes in population growth. The Philippines are a good example; year-after-year, decade-after-decade, there has been no pronounced change in the rate at which young Filipinos are being brought into the world. In such a scenario, mapping the population by five-year age increments – as in Exhibit 6, below – creates the familiar pyramid shape, wherein fewer and fewer people of older age form the top. The shape of this pyramid does not change meaningfully over time.

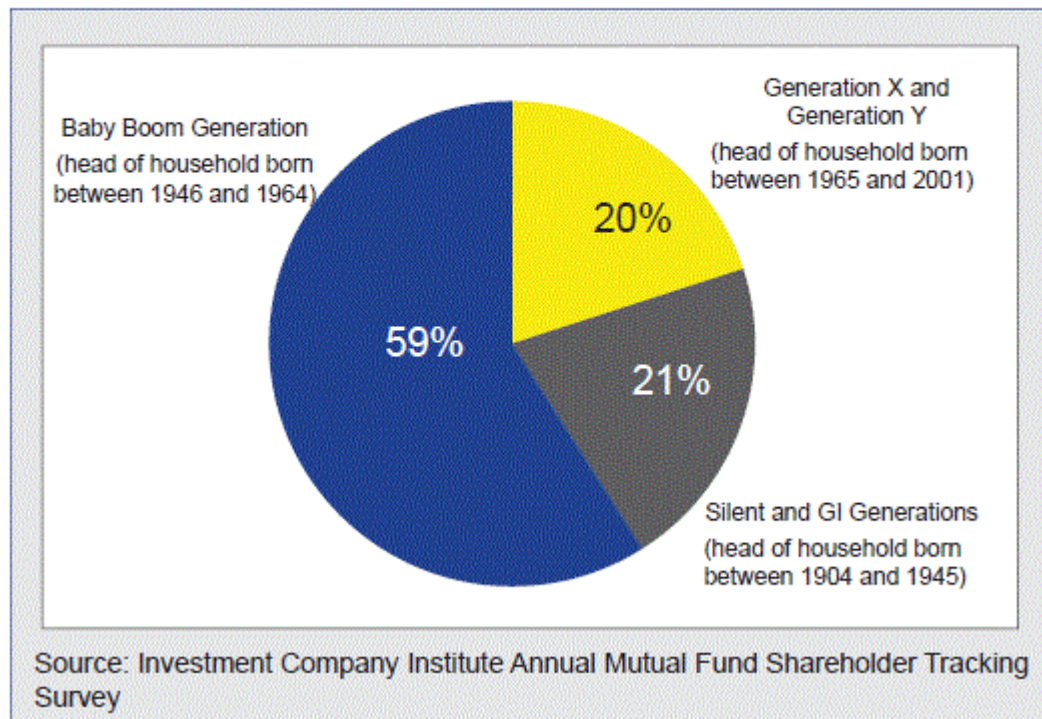
Exhibit 6
Age Distribution Chart, Philippines (population in millions)



Comparing a country like the Philippines to the US can be instructive, but for a proper comparison we first need access to wealth and wealth-accumulation behavior data. Exhibit 7 is a survey estimate showing that, as of 2009, 59% of mutual fund assets were held by baby boomers. Importantly, another 21% of the assets were owned by the

generation preceding them. I ran my own estimates for those data points against 2010 census data and confirmed this relationship. Speaking from personal experience, I can say that a significant portion of that 21% (held by those older than 67) is cared for by the 59%. The baby boomers hold sway over at least 75% of the pie!

Exhibit 7
Percentage of Total Mutual Fund Assets Held by Generation, 2009



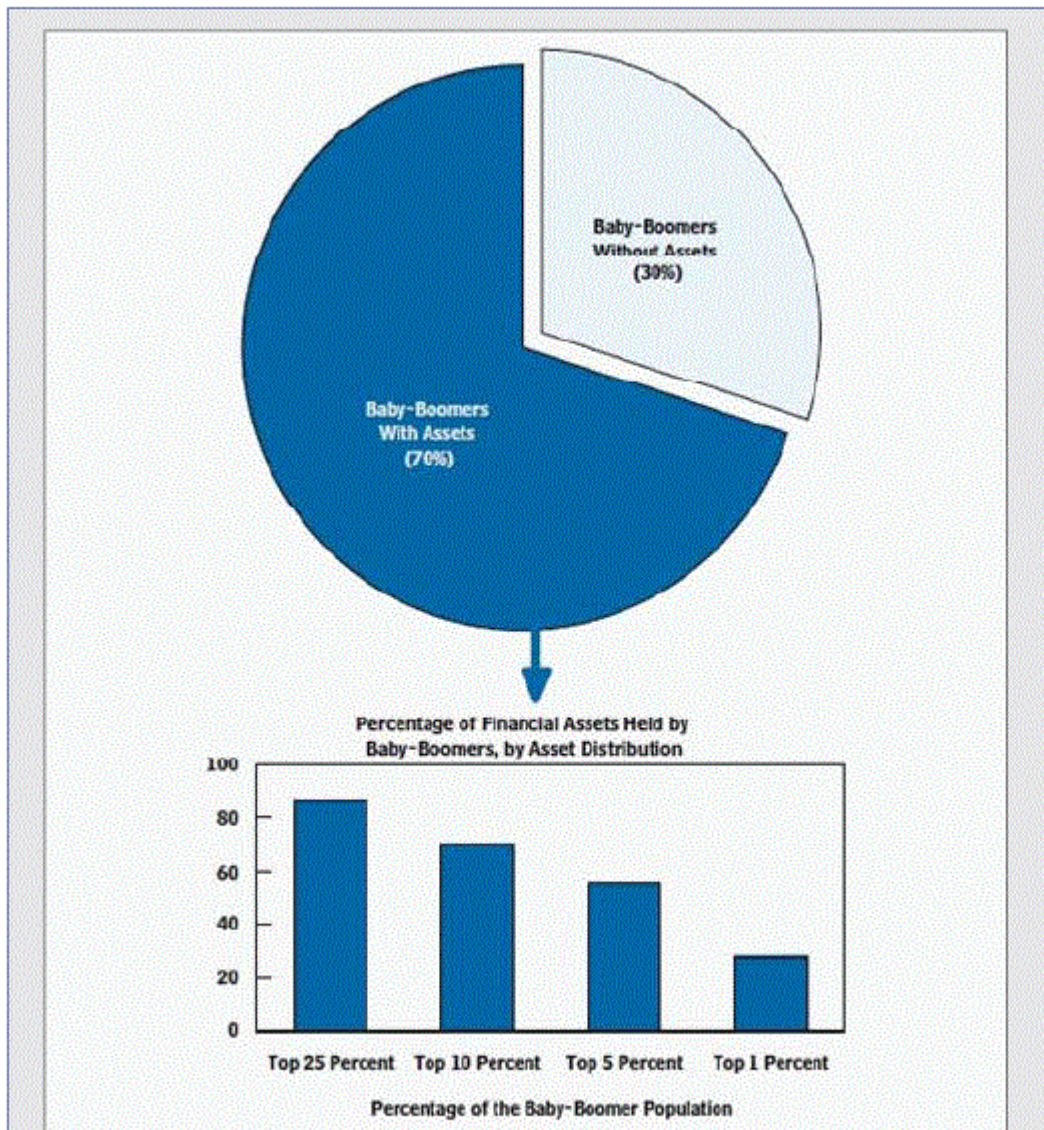
Wealth is not distributed uniformly throughout the baby boomer cohort. There is a reason why advisors target high-net-worth clients. Nearly a third of all baby boomers – 30 % – are completely without financial assets. Of the 70% who do have assets, the top 25% by wealth own more than 80% of all financial assets.

Hopefully, we will witness a time where the baby boomers with no assets obtain the means to save and invest and provide for themselves comfortably in retirement. This would be wonderful indeed and would wreak havoc on any conclusions to be drawn from this analysis. But it's far more likely that many will rely upon government support and even more will rely upon family and close relations for support and assistance in retirement – as generations have historically done before.

It is very easy to dismiss the influence of demographics with sweeping arguments such as “immigration will fix this.” There is no “fix” to be had here unless the immigrants are very

wealthy or unless there is a monumental and unprecedented creation and saving of wealth in the coming few years. Half of all baby boomers will be over 65 in less than a decade – they are going to be withdrawing a lot of assets very soon.

Exhibit 8
Financial Assets Held by Baby Boomers Households, by Asset Distribution

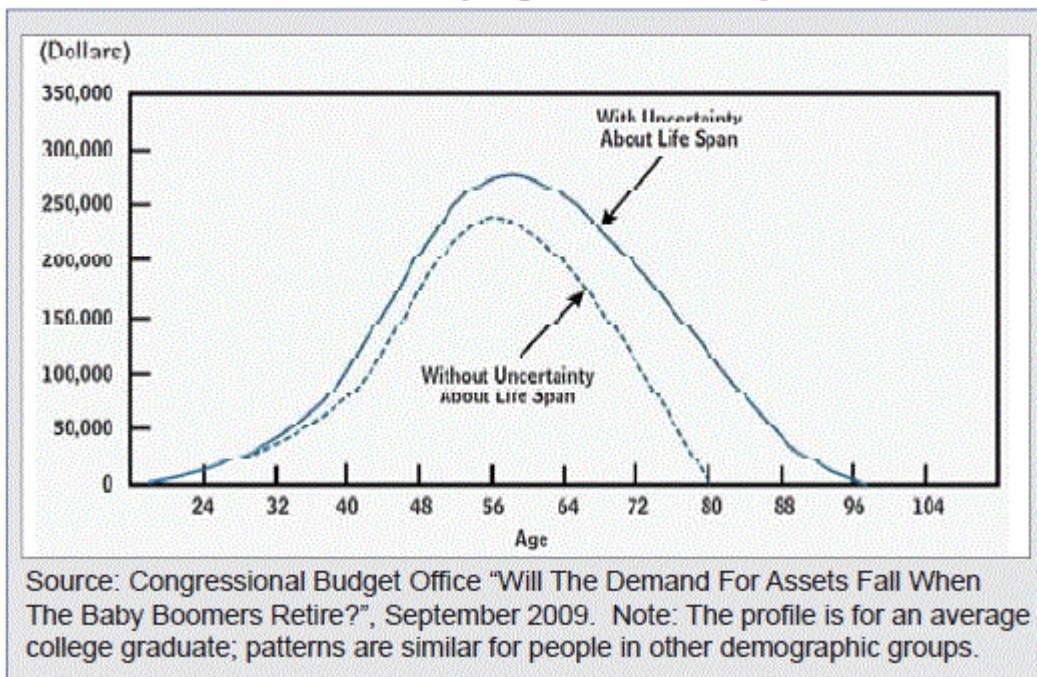


Source: Congressional Budget Office. Note: Financial assets consist of stocks, bonds, mutual funds, individual retirement accounts, and other saving instruments.

Arguments have been advanced that foreign investors will pick up sought after US financial assets to meet any softening from domestic demand. I accept this argument; but demand for US mutual funds and the corresponding impact to product and distribution dynamics is a separate issue. Foreigners do not typically make use of US mutual funds as a vehicle for investing.

We need to better understand the accumulation of assets by age. I have seen many different reported age ranges on this front and none have deviated wildly from what my own instincts suggest – that somewhere after age 30 is the point when most investors who are of the means to do so begin to meaningfully accumulate wealth. Sixty seems to be the peak time for that accumulation. After 60, on average, wealth accumulation reverses in order to support one’s standard of living.

Exhibit 9
Accumulation of Assets, by Age, in a Life Cycle Model



Returning to the comparison with the Philippines, the same age distribution chart for the US in 1950 is Exhibit 10, below. Were it not for the more than 20-year drop off in birthrate from the late 1920’s, this chart would look closer to the triangular shape of the Philippines, minus the higher infant mortality and shorter life span. The 0-4 age group here represents the leading edge of the baby boom generation, while the shaded section includes 11 million females and males per segment between 30 and 59, for a total of 132 million people. This is the “sweet spot” for wealth accumulation we saw in Exhibit 9.

Exhibit 10
Age Distribution Chart, USA (pop. in millions)

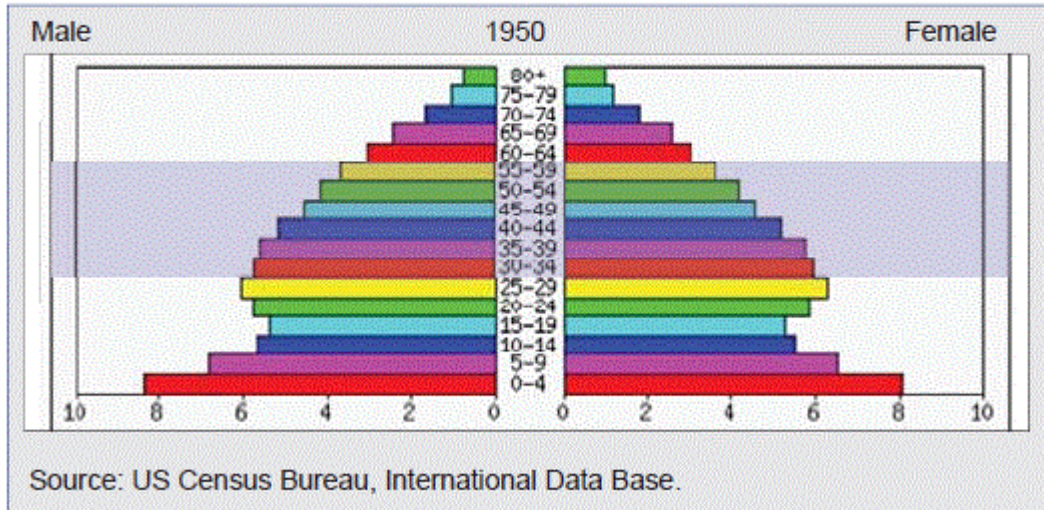
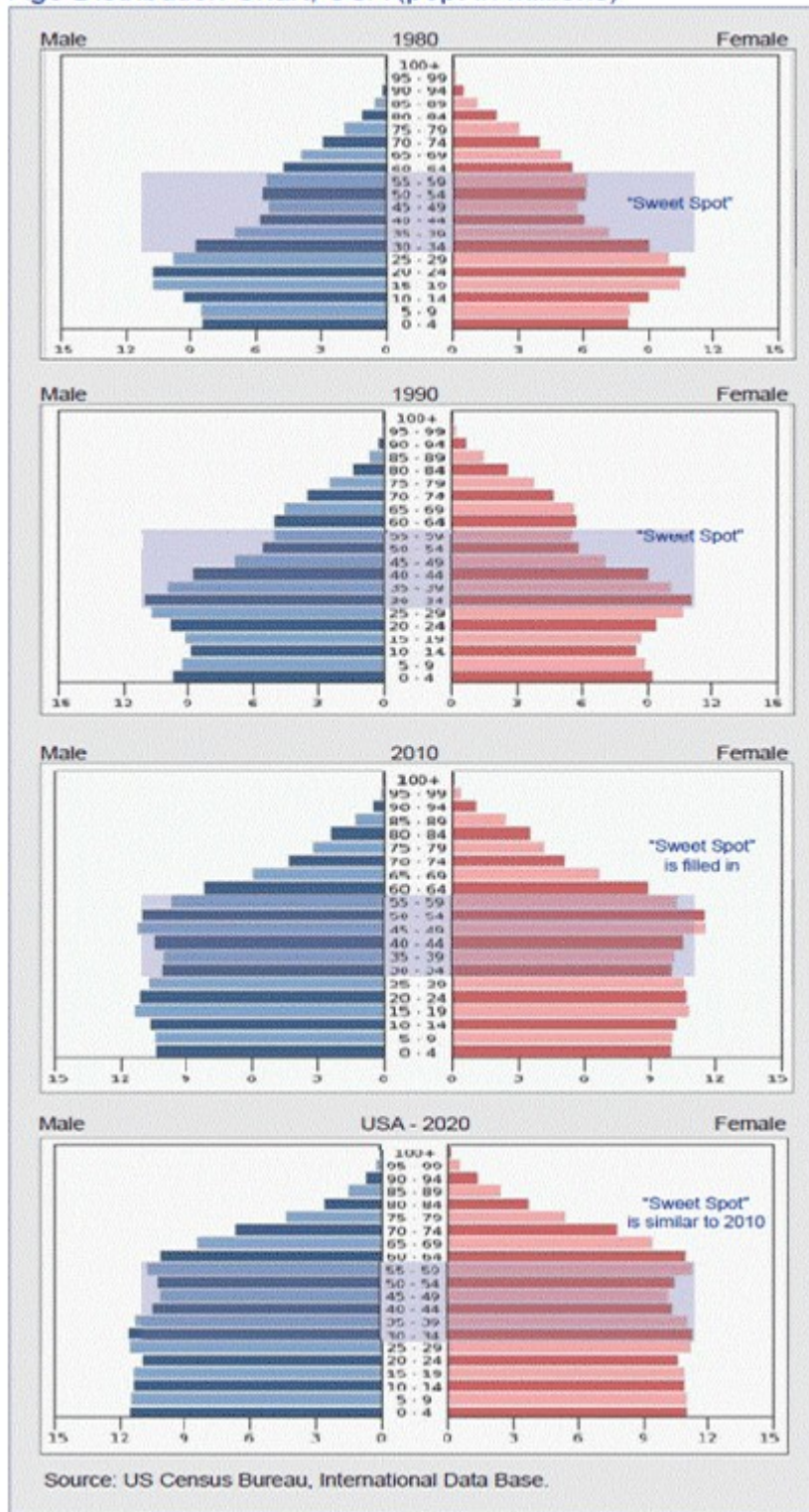


Exhibit 11, below, follows the movement of these baby boomers through the years. By 1980, the first crop of four-year-olds from the class of 1950 were adding 18 million people into the 30–34 year old segment of the “sweet spot,” expanding its membership to record numbers that persist today. The number of people in this “sweet spot” age bracket has never been as great or as large a segment of the population as it is today.

Exhibit 11
Age Distribution Chart, USA (pop. in millions)





Our four-year old baby boomers from 1950 were 44 years old by 1990 and had been hard at work saving and investing for 14 years. The sheer size of the baby boomer lump making its way up the age scale has already been felt in numerous industries – minivans for soccer moms, bifocals, even a new era of “flat” organizations that became the trend when just too many qualified associates each time would be vying for the one management position. The mutual fund industry is struggling with the same demographic onslaught as everyone else.

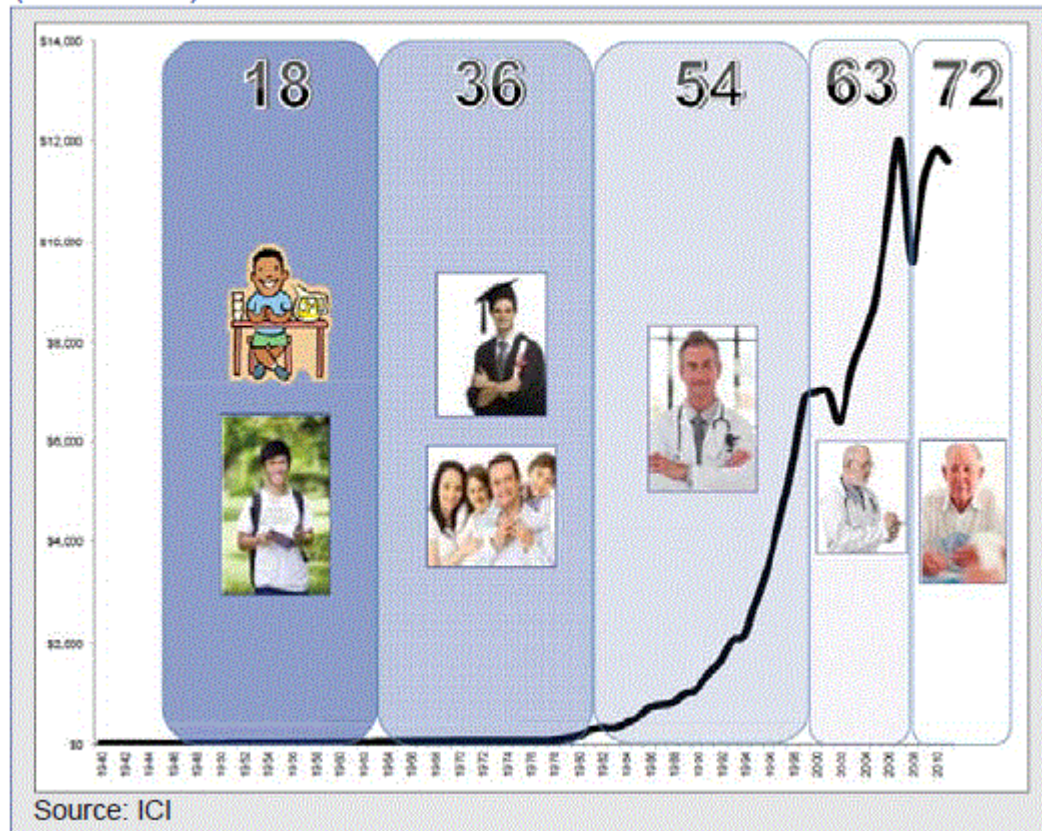
Projecting forward seven years to 2020, the total number of people in the “sweet spot” of wealth accumulation should be roughly equivalent to where it stood in 2010 the point where the numbers seems to have stopped growing. On its face, the needs of the population within the “sweet spot” should be roughly comparable to what they were in 2010, with commensurate demand for services. But the population segment over 60 will be a meaningfully higher percentage of the total, and will control more wealth than it does now. These investors have a different risk profile and use their wealth differently, auguring big changes for the investment industry.

A historical look at mutual fund assets

Exhibit 12 illustrates five different life stages, tracking the nominal rise in total assets under management in the mutual fund industry with a black line as they moved through each one. The first three periods cover 18-year intervals ending when the first baby boomers turned 18, 36, and 54 respectively. The next nine-year period takes us to 2008 when the first baby boomers reached age 63. The last segment (off the chart) ends in 2017, when the first baby boomers will turn 72.

Exhibit 12

Growth of Mutual Funds Total Assets under Management (\$ millions)



Mutual fund AUM started taking flight around the time the oldest baby boomer reached age 36, in 1982. By the time, in 2000, that the oldest baby boomer turned 54, the entire boomer generation was in that peak-earning “sweet spot” that I discussed above. These were the crucial 18 years; at the beginning of this period, most people didn’t know what a mutual fund was, but demand for this product over the course of the ensuing 18 years grew at such a fast clip that supply had difficulty keeping pace. For many years, sales people were drafted from other industries or guided through quick training programs and put on the road. Up-front sales loads of 4-8% were routine (with 9% being the limit). High commissions and expensive funds (by today’s standards) were the generally accepted means of gaining sought-after access to esteemed funds through your stockbroker.

This period was what Bob Veres of *Inside Information* refers to as the “hothouse years.” The financial planning profession as we know it today was in its infancy in the early 1980s, when NAPFA was formed. There was a small but fast-growing movement of break-away brokers rising to meet the demand of a rapidly growing pool of savers and investors under the fee-only financial planning model. On the institutional retirement front, the consulting

world was witnessing the birth of the break-away consultants. Excluding the odd temporary dip in the stock markets (and a particularly big one in 1987), everyone was happy and the world was a beautiful place.

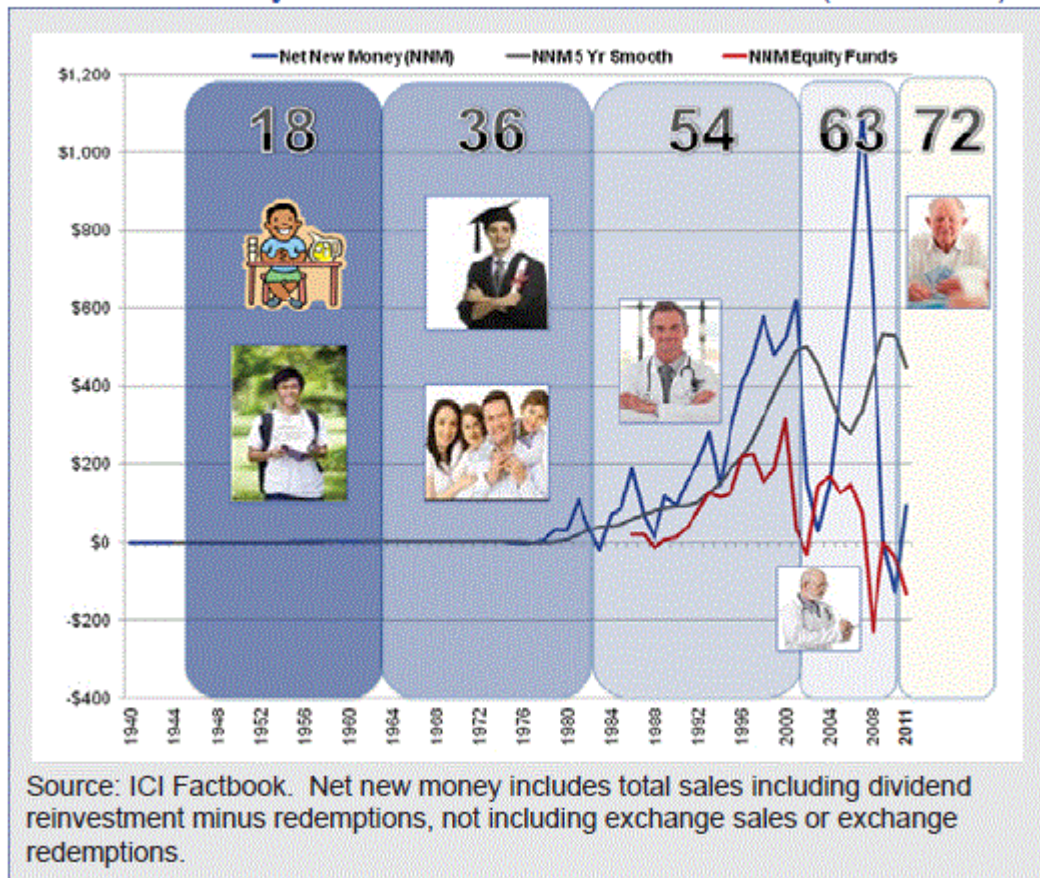
The 2000 peak and crash of the NASDAQ created only a momentary pause in the jet-fueled expansion of mutual-fund assets. Then came the huge selloffs of 2008, which coincided with the first year that many of the baby boomers reached age 62 and qualified for early retirement. This was also year three of net outflows for US equity funds.

A closer look at the numbers

Moving away for a moment from AUM measurements, which are tainted by performance, Exhibit 13 presents net-new money (NNM) for all mutual funds (blue line), equity mutual funds only (red line), and a separate five-year-smoothed measure of NNM for all mutual funds (black line). You can see that both NNM into equity funds and total NNM dropped noticeably as baby boomers began exiting the “sweet spot.”

Exhibit 13

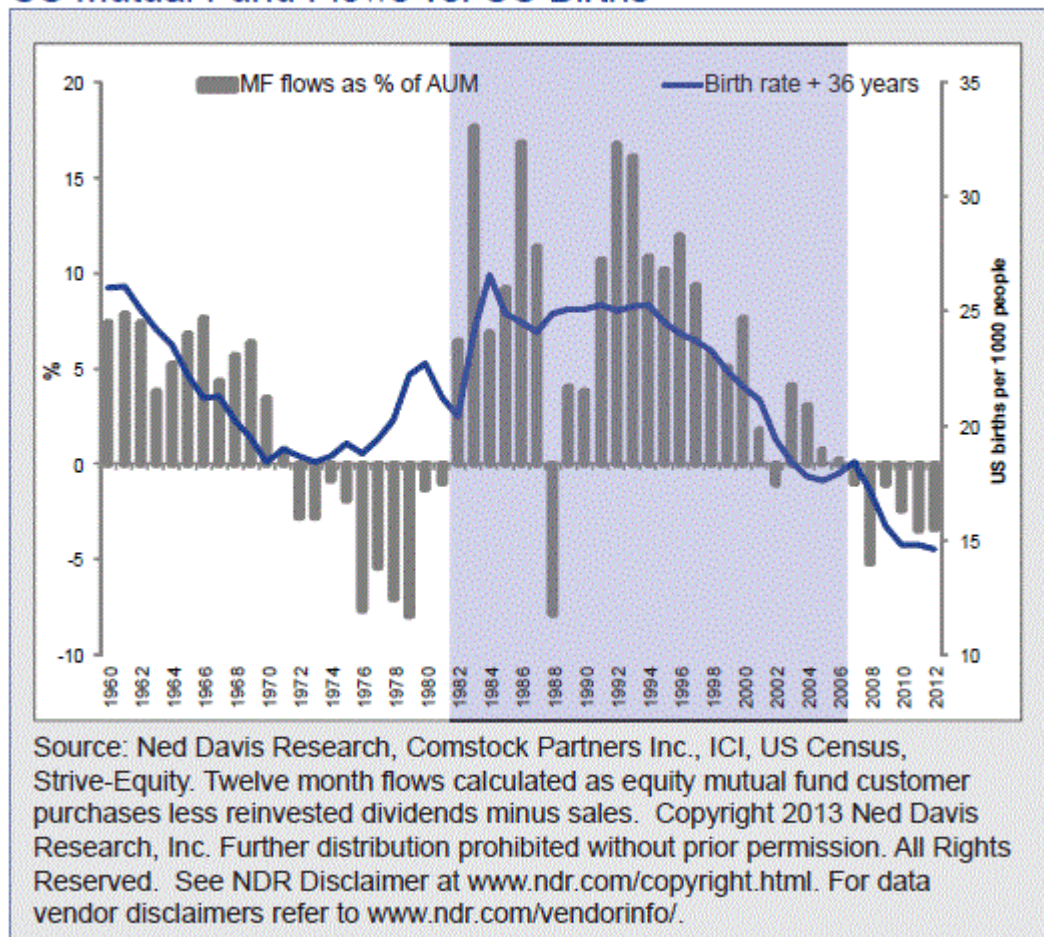
Net New Money invested in US Mutual Funds (\$ millions)



Net inflows are better than AUM for identifying trends, but they still represent nominal values. To adjust both for inflation and the much larger size of the industry today, I adapted the work of Ned Davis Research, which maintains a chart originally inspired by Comstock Partners, Inc. The chart was originally used to visually demonstrate a correlation between flow data and performance of a US market Index, but Davis was kind enough to provide me with the raw data so I could show a different relationship.

The result, Exhibit 14, shows relative inflows and outflows from domestic US mutual funds as a percentage of market capitalization (total assets). I have overlaid the US census births-per-1,000 data on this chart, with dates shifted such that net inflows or net outflows correspond to the birth rate data 36 years earlier.

Exhibit 14
US Mutual Fund Flows vs. US Births



The highlighted section emphasizes the period from 1982-2006 that began when the first baby boomers turned 36 years old (recall Exhibit 13). Their arrival at this crucial stage of



life effectively reversed a “funk” in flow data for the preceding years (which in turn may have resulted from the drop-off from the earlier high birth rate). See Appendix for more data.

Conclusion

Based on population data, the demand for a mutual fund sales infrastructure to meet the needs of the most important wealth accumulation age cohort stopped increasing sometime around 2010. The age group which will continue to expand for the next 10 years is the 60-plus category – a group that is not rapidly accumulating wealth and is, if anything, scaling down and reducing risk in their asset allocations.

The deflating baby-boom bubble means net sales of equity mutual funds will not increase in the immediate future. This explains (as noted by the ICI) why US equity mutual fund sales are not following market performance.

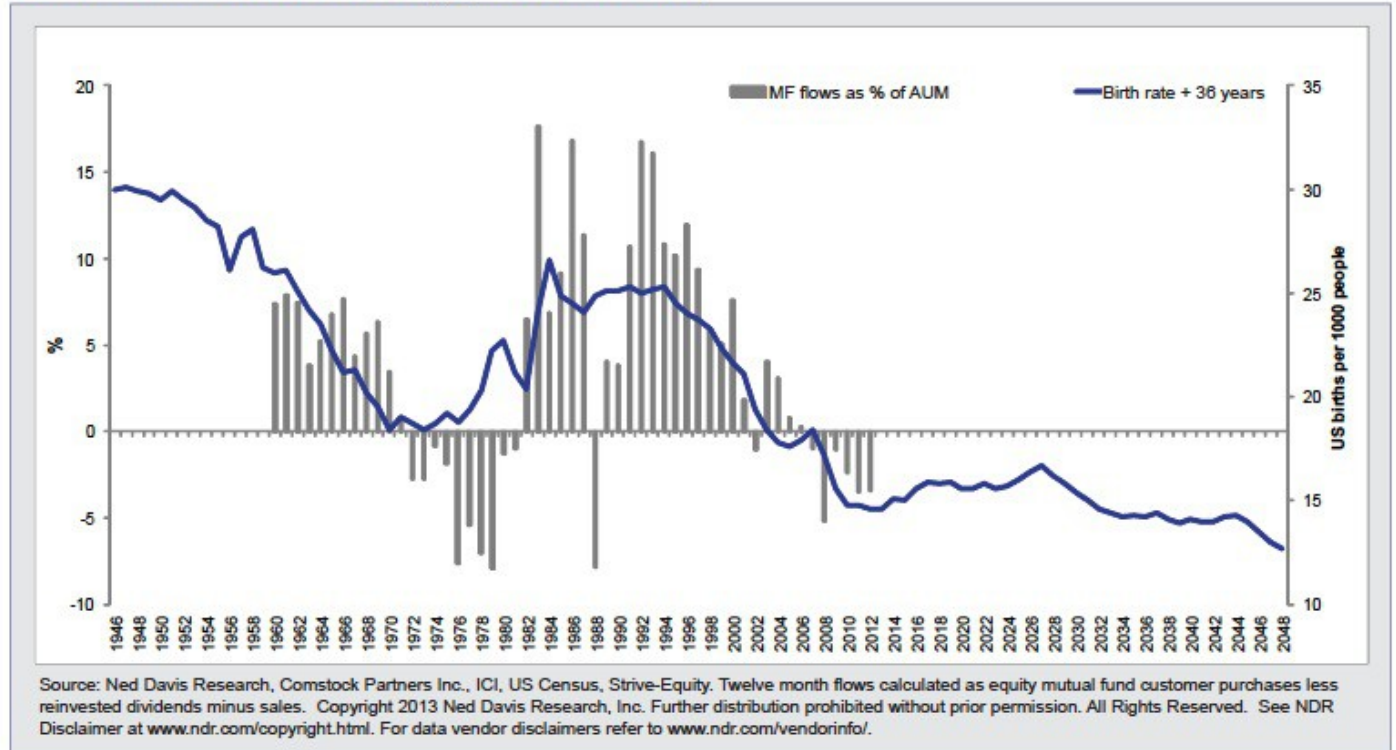
The question remains as to why international equities have not followed a similar pattern. Speaking from experience, advisors generally recognize international equities as riskier than US and allocate in smaller increments in conservative portfolios. If demographics are indeed responsible for the decrease in domestic equity allocations, older investors will be redeeming smaller portions of international equity assets. Younger investors will continue adding to their existing equity allocations, including larger allocations to international equities.

Demographics exert a powerful influence on mutual fund flows. But do they create a *fait accompli* or is there some product or distribution strategy that will mitigate the harm or even benefit from this trend? The more powerful trends in monetary policy (part 2) may provide some counterbalance. In part 3, I will offer some practical strategies based on all the trends analyzed.

Paul Franchi, is the founder of Strive-Equity, a consulting firm that assists mutual funds in executing their distribution strategies. His experience in the mutual fund industry spans a variety of roles including industry analysis, product development, marketing, sales and sales management.

Appendix

US Mutual Fund Flows vs. US Births (Expanded Time Period)



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