CHAPTER

3

US Mutual Funds

A mutual fund is an investment company that pools money from shareholders and invests in a portfolio of securities. In 2022, 115.3 million individual investors in 68.6 million US households owned mutual funds, relying on them to meet long-term personal financial objectives, such as preparing for retirement, education, or a home purchase. US households and institutions also use money market funds as cash management tools. Mutual funds had net outflows of $1.1 trillion in 2022, or 4.2 percent of year-end 2021 total net assets. Changing demographics, portfolio rebalancing, and investors' reactions to US and worldwide economic and financial conditions play important roles in determining how demand for specific types of mutual funds—and for mutual funds in general—evolves.

IN THIS CHAPTER

Overview of Mutual Fund Trends

With $22.1 trillion in total net assets, the US mutual fund industry remained the largest in the world at year-end 2022. The majority of US mutual fund net assets at year-end 2022 were in long-term mutual funds, with equity funds alone making up 51 percent of US mutual fund net assets. Money market funds were the second-largest category, with 22 percent of net assets. Bond funds (20 percent) and hybrid funds (7 percent) held the remainder.

Investor Demand for US Mutual Funds

A variety of factors influence investor demand for mutual funds, such as funds' ability to assist investors in achieving their investment objectives. For example, US households rely on equity, bond, and hybrid mutual funds to meet long-term personal financial objectives, such as preparing for retirement, saving for emergencies, or saving for education. US households, as well as businesses and other institutional investors, use money market funds as cash management tools because they provide a high degree of liquidity and competitive short-term yields.

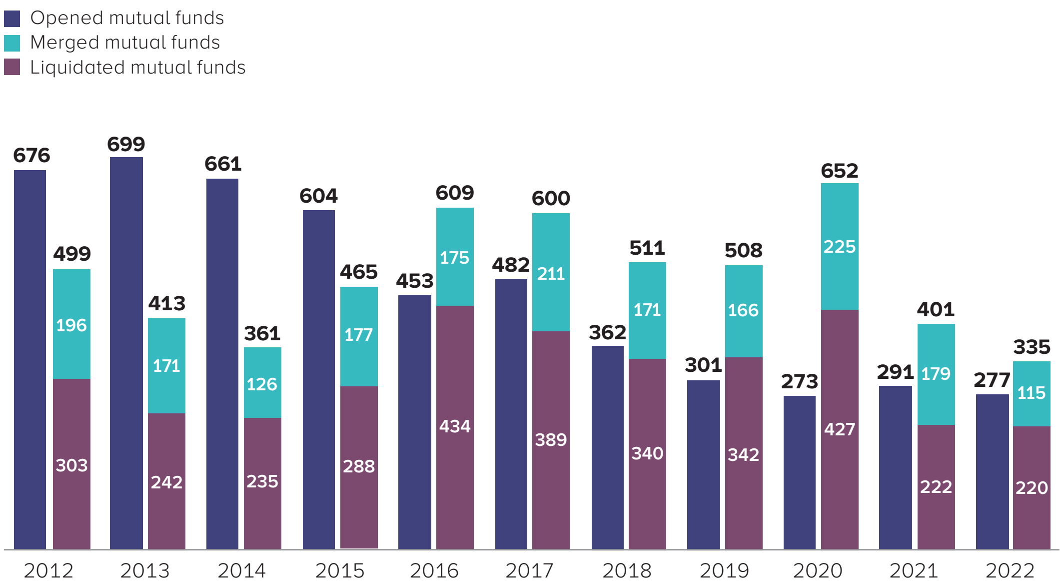
Investor demand for mutual funds decreased sharply in 2022—driven by outflows from long-term mutual funds. Equity mutual funds experienced significant outflows in 2022, reflecting the sharp decline in equity markets and an ongoing shift to other products. In addition, demand for bond mutual funds weakened considerably in 2022, as the Federal Reserve raised interest rates at the fastest pace in four decades to combat rising inflation, which led to significant losses in bond markets. Demand for money market funds steadily shifted from outflows to inflows as investors—particularly retail investors—were attracted to rising short-term yields.

Entry and Exit of US Mutual Funds

Mutual fund sponsors create new funds to meet investor demand, and they merge or liquidate those that do not attract sufficient investor interest. A total of 277 mutual funds opened in 2022 (Figure 3.1). The number of new mutual funds offered in 2022 was relatively even with 2021, as an increase in the number of equity fund launches offset a decrease in the number of hybrid and taxable bond fund launches. During the same time, the number of mutual funds that were either merged or liquidated decreased 16 percent to 335 funds, as sponsors eliminated fewer equity mutual funds from their lineups.

FIGURE 3.1

Mutual Funds Enter and Exit the Industry Because of Competition and Investor Demand



Note: Data include mutual funds that do not report statistical information to the Investment Company Institute and mutual funds that invest primarily in other mutual funds.

Investors in US Mutual Funds

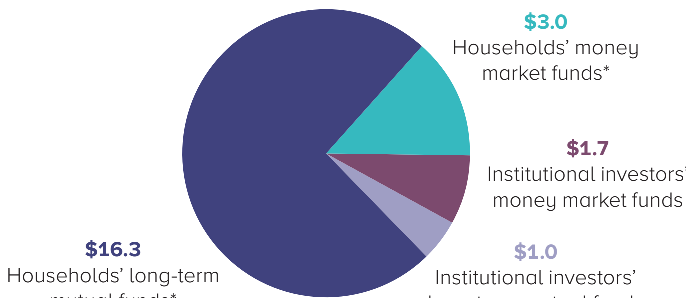
Demand for mutual funds is, in part, related to the types of investors who hold mutual fund shares. Retail investors (i.e., households) held the vast majority (88 percent) of the $22.1 trillion in US mutual fund net assets at year-end 2022 (Figure 3.2). The proportion of long-term mutual fund net assets held by retail investors is even higher (94 percent). Retail investors also held substantial money market fund net assets ($3.0 trillion), but this was a relatively small share (16 percent) of their total mutual fund net assets ($19.4 trillion).

In contrast, institutional investors, such as nonfinancial businesses, financial institutions, and nonprofit organizations, held a relatively small portion of mutual fund net assets. At year-end 2022, institutions held 12 percent of mutual fund net assets (Figure 3.2). The majority (64 percent) of the $2.7 trillion that institutions held in mutual funds was in money market funds, because one of the primary reasons institutions use mutual funds is to help manage their cash balances.

FIGURE 3.2

Households Held 88 Percent of Mutual Fund Total Net Assets

Trillions of dollars, year-end 2022



Mutual fund total net assets: $22.1 trillion
Long-term mutual fund total net assets: $17.3 trillion
Money market fund total net assets: $4.8 trillion

* Mutual funds held as investments in individual retirement accounts, defined contribution retirement plans, variable annuities, 529 plans, and Coverdell education savings accounts are counted as household holdings of mutual funds.

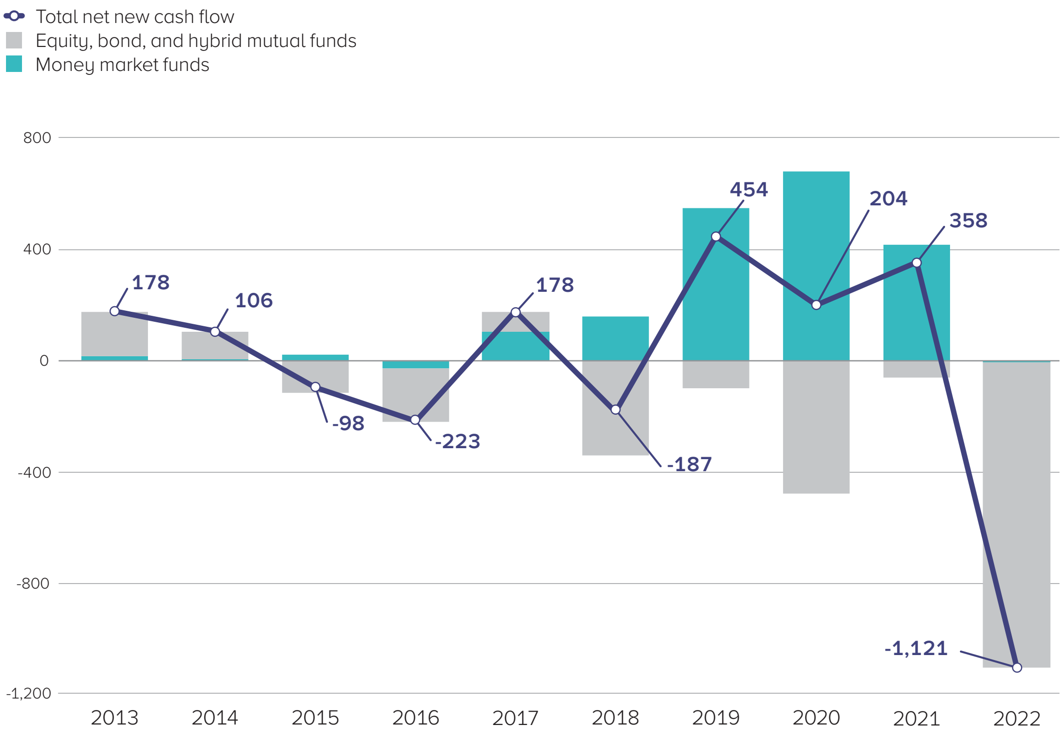
Developments in Mutual Fund Flows

Overall demand for mutual funds as measured by net new cash flow—new fund sales less redemptions, plus net exchanges—weakened considerably in 2022 (Figure 3.3). In 2022, mutual funds had net outflows of $1.1 trillion (4.2 percent of year-end 2021 total net assets), following net inflows of $358 billion in 2021. Long-term mutual funds experienced net outflows of $1.1 trillion in 2022, while money market funds saw net outflows of $4 billion. A number of factors—including broad-based declines in financial markets, a rising interest rate environment, ongoing demographic trends, and demand for indexed products—appeared to influence US mutual fund flows in 2022.

FIGURE 3.3

Net Outflows from Mutual Funds Were Primarily from Long-Term Funds in 2022

Billions of dollars, annual



The US Economy and Financial Markets in 2022

The year proved to be a challenging one for the US economy and financial markets. After expanding at a brisk 5.9 percent pace in 2021, real GDP grew more slowly (2.1 percent) in 2022, as the economy struggled with persistent inflationary pressures throughout the year. In response to stubbornly high inflation, the Federal Reserve increased the federal funds rate at a rapid pace in 2022—raising it by 25 basis points in March, followed by hikes of 50 to 75 basis points at each of the six remaining Federal Open Market Committee (FOMC) meetings to end the year at a target range of 4.25 to 4.50 percent.

The swift increase in short-term rates caused the Treasury yield curve—which illustrates the difference between the yields on long-term Treasuries and short-term Treasury bills—to flatten considerably during the year. By year-end, the yield curve had inverted, which is typically considered an indicator of a looming recession by market participants.

Capital markets experienced significant volatility and losses during 2022, as the economic outlook deteriorated amid persistently high inflation, aggressive monetary policy tightening, and the effects of Russia's invasion of Ukraine, among other factors. Stock markets in the United States ended 2022 close to bear market territory, falling 19 percent.* Additionally, rising labor costs, higher interest rates, and slowing sales growth eroded profits of corporations, while the strengthening of the US dollar—an offshoot of the Federal Reserve's interest rate hikes—further devalued the overseas earnings of US corporations. During 2022, the VIX† averaged 25.6 and surpassed 30—a level generally considered to signal heightened volatility from increased uncertainty, risk, and investor fear—on 19 percent of trading days. Bond markets also experienced significant losses during this period. Rising interest rates deteriorated bond valuations and resulted in substantial losses of 12 percent in 2022 even after including interest income.‡

Long-Term Mutual Fund Flows

Although net new cash flows into long-term mutual funds are typically correlated with market returns, they tend to be moderate as a percentage of total net assets even during episodes of market turmoil. Several factors may contribute to this phenomenon. For example, households (i.e., retail investors) own the vast majority of US long-term mutual fund net assets (Figure 3.2). Retail investors generally respond less strongly to market events than institutional investors do. Most notably, households often use mutual funds to save for the long term, such as for retirement or college. Many of these investors make stable contributions through periodic payroll deductions, even during periods of market stress. In addition, many mutual fund shareholders seek the advice of financial advisers, who may provide a steadying influence during market downturns. These factors are amplified by the fact that net assets in mutual funds are spread across 115 million individual investors who have a wide variety of individual characteristics (such as age or appetite for risk) and goals (such as saving for retirement, emergencies, or education). Investors are also bound to have a wide range of views on market conditions and how best to respond to those conditions to meet their individual goals. As a result, even during months when funds as a whole experience net outflows, many investors continue to purchase fund shares.

* As measured by the Wilshire 5000 Total Market Index.
† The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a widely used measure of expected stock market volatility.
‡ As measured by the S&P US Aggregate Bond Index.

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Equity Mutual Funds

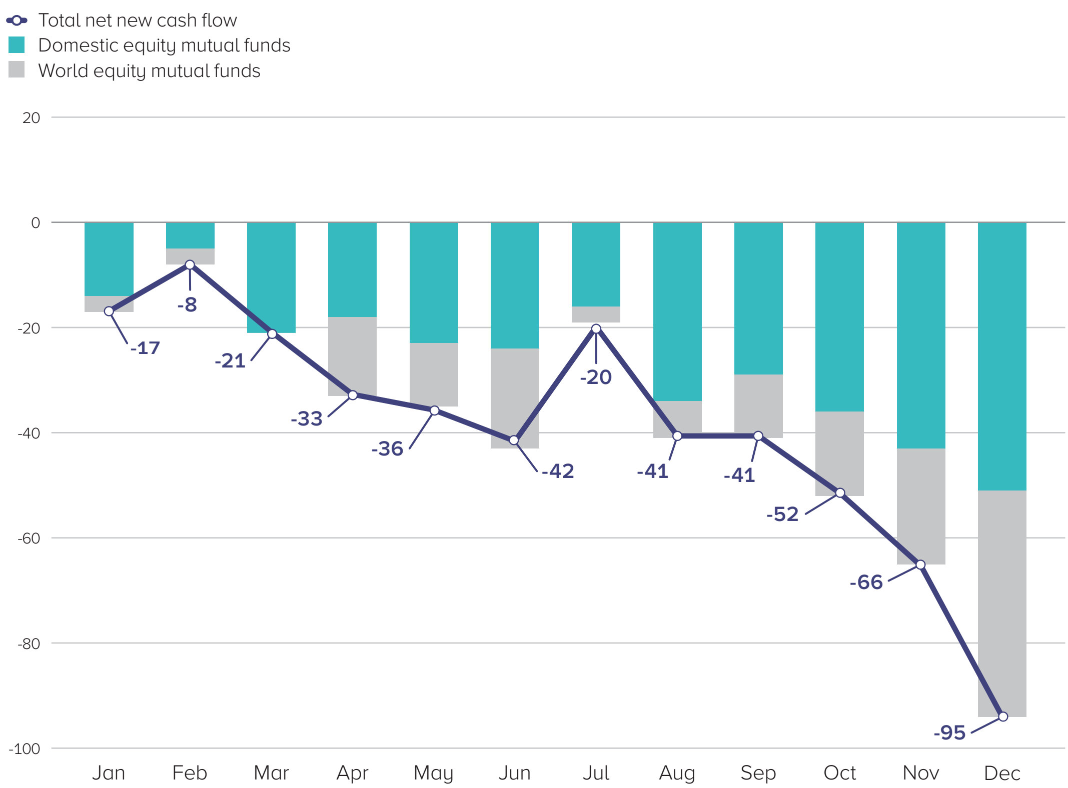
Following the decline in stock market performance around the globe, equity mutual funds experienced net outflows totaling $472 billion in 2022 (3.2 percent of year-end 2021 total net assets).

Equity mutual funds had net outflows in every month in 2022 (Figure 3.4). In the first three months of the year, investors had redeemed, on net, a modest $46 billion from equity mutual funds. Flows to mutual funds, in general, tend to be bolstered in the first quarter of the year because investors who receive year-end bonuses may invest that money relatively quickly in the new year. In addition, some investors wait to make contributions to their individual retirement accounts (IRAs) before filing their tax returns. As the year progressed, net outflows from equity mutual funds accelerated, with investors redeeming, on net, $425 billion from April through December.

FIGURE 3.4

Equity Mutual Funds Had Net Outflows in 2022

Billions of dollars; monthly, 2022



Note: In March 2022, world equity mutual funds had net inflows of less than $500 million.

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From December Outflows to January Inflows: Seasonal Factors in Mutual Fund Flows

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In addition to declining stock prices, net outflows from domestic equity mutual funds in 2022 may have also been driven by investor demand for domestic equity exchange-traded funds (ETFs). As discussed in chapter 4, demand for ETFs has been very strong over the past several years. Except for April, domestic equity ETFs had net creations in every month of 2022, which resulted in $317 billion in net share issuance over the year (see Figure 4.4). In contrast, domestic equity mutual funds had net outflows of $316 billion in 2022 (Figure 3.4).

Demand for world equity mutual funds weakened considerably in 2022, with investors redeeming $156 billion (Figure 3.4), compared with net redemptions of $16 billion in 2021. Outflows were broad-based across emerging market equity, global equity, international equity, and regional equity funds.

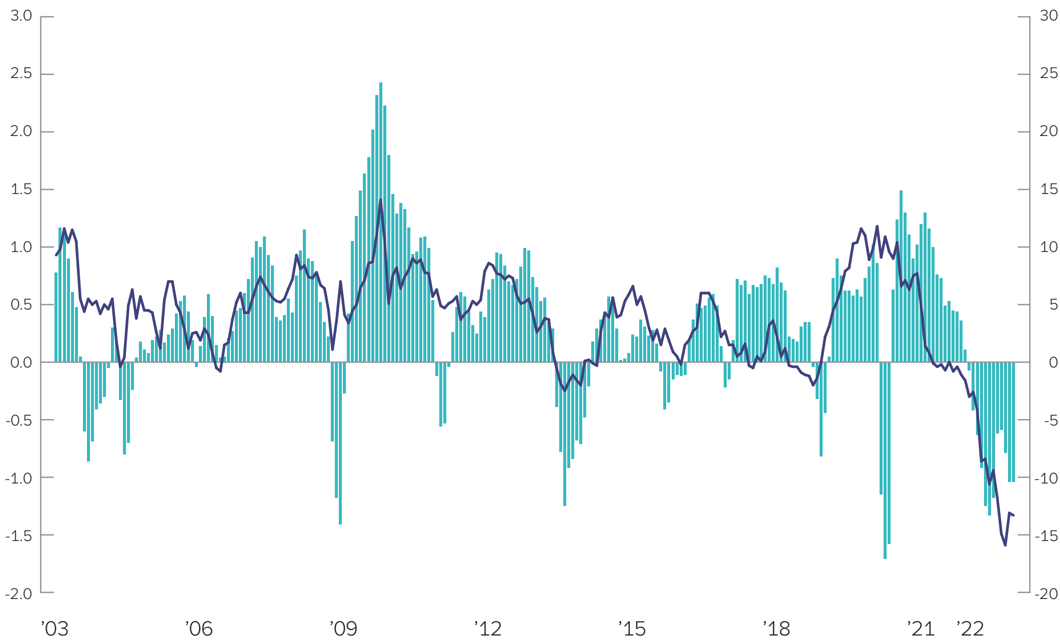
Bond Mutual Funds

Bond mutual fund net new cash flows typically are correlated with the performance of US bonds (Figure 3.5), which, in turn, is largely driven by the US interest rate environment. Long-term interest rates increased considerably in 2022, reflecting the aggressive tightening of monetary policy by the Federal Reserve to tame inflation. The yield on the 10-year Treasury started 2022 at 1.52 percent and increased to 4.25 percent in October before falling to 3.88 percent by year-end. The sharp increase in interest rates resulted in significant capital losses on US bonds in 2022.

FIGURE 3.5

Net New Cash Flow to Bond Mutual Funds Is Typically Related to Bond Returns

Monthly



[1] Net new cash flow is reported as a percentage of previous month-end bond mutual fund total net assets, plotted as a three-month moving average. Data exclude high-yield bond mutual funds.

[2] The total return on bonds is measured as the year-over-year percent change in the FTSE US Broad Investment Grade Bond Index.

Sources: Investment Company Institute, FTSE Russell, and Refinitiv

Taxable bond mutual funds experienced net outflows in each month of 2022 totaling $393 billion, or 8.5 percent of their year-end 2021 total net assets (Figure 3.6). Portfolio rebalancing may have also contributed to these outflows. With stocks underperforming bonds in 2022, investors and target date funds following asset allocation strategies would have needed to sell bond funds and buy equity funds to remain at their target allocations.

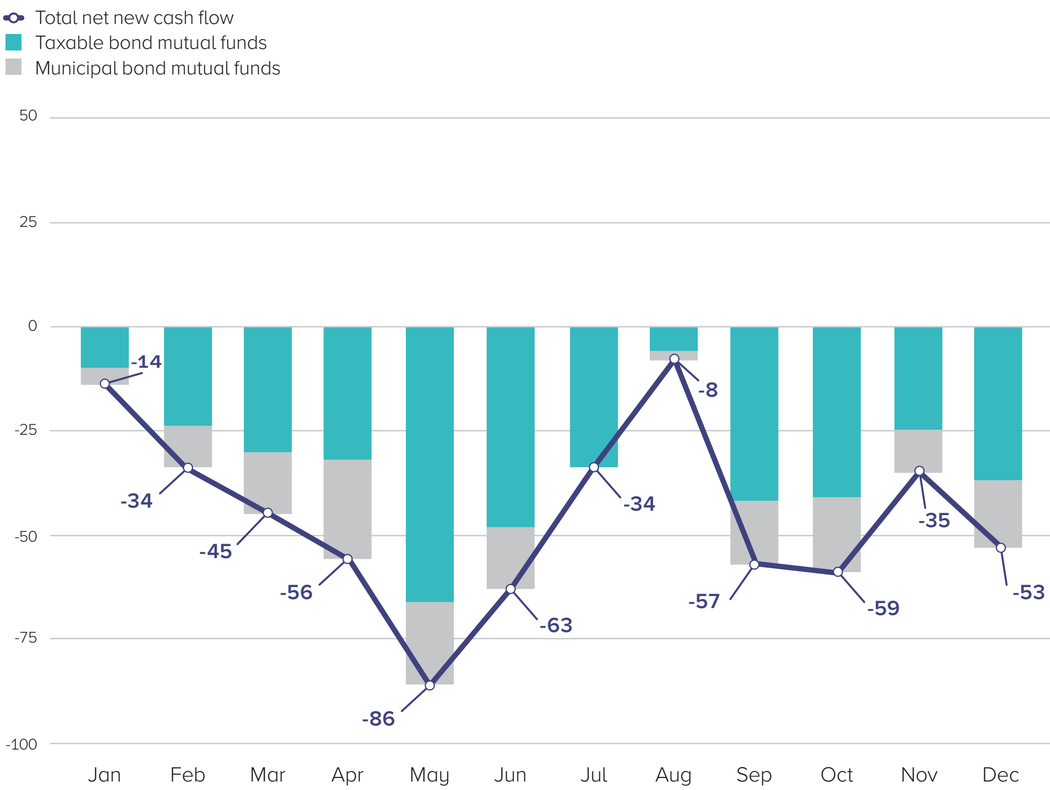
Investor demand weakened across all categories of taxable bond mutual funds in 2022, with investment grade bond funds experiencing the bulk of outflows ($198 billion), which represented 7.5 percent of their year-end 2021 total net assets. Multi-sector bond mutual funds saw outflows of $67 billion (or 10.8 percent of their net assets at year-end 2021); world bond mutual funds, which typically hold a mix of bonds denominated in US dollars and foreign currencies, saw net outflows of $50 billion (8.6 percent); high-yield bond funds saw net outflows of $46 billion (11.7 percent); and government bond mutual funds saw net outflows of $33 billion (8.0 percent).

Demand for municipal bond mutual funds also weakened in 2022, with net outflows in nearly every month totaling $148 billion for the year, or 15.2 percent of their year-end 2021 net assets.

FIGURE 3.6

Net New Cash Flow to Bond Mutual Funds

Billions of dollars; monthly, 2022



Note: In July 2022, municipal bond mutual funds had net inflows of less than $500 million.

How Bond Mutual Funds Manage Investor Flows

When meeting redemptions, fund managers' actions are guided by market conditions, expected investor flows, and other factors. A fund might decide to sell some of its holdings to raise the cash needed to fulfill redemptions. But its choice of which particular securities to sell may depend on market conditions. For example, during a market downturn, with liquidity at a premium, some fund managers might seek to add shareholder value by selling some of their funds' more liquid bonds (which, being in high demand, are trading at a premium to fundamental value). Other fund managers may conclude that it is necessary and appropriate to sell a representative "slice" of their funds' entire portfolios.

Bond mutual fund managers have other ways of meeting redemption requests. For example, a fund might already have cash on hand. Or, the fund may use the cash that bond mutual funds receive each day in the form of interest income from bonds held in the portfolio, proceeds from matured bonds, or new sales of fund shares.

In addition, bond funds often use derivatives or hold liquid assets other than cash. For example, a high-yield bond fund might hold some portion of its assets in equities, because equities are very liquid, and the return profiles of high-yield bonds and equities can be similar. Derivatives can be more liquid than their physical counterparts, and funds are required to segregate liquid assets to support their derivatives positions. As these positions are closed, this cash collateral provides a ready source of liquidity to meet redemptions. This is especially true for many of the funds commonly called liquid alternative funds, as these funds are explicitly designed to allow frequent investor trading and do so in large measure through the use of derivatives.

Long-Term Demand for Bond Mutual Funds

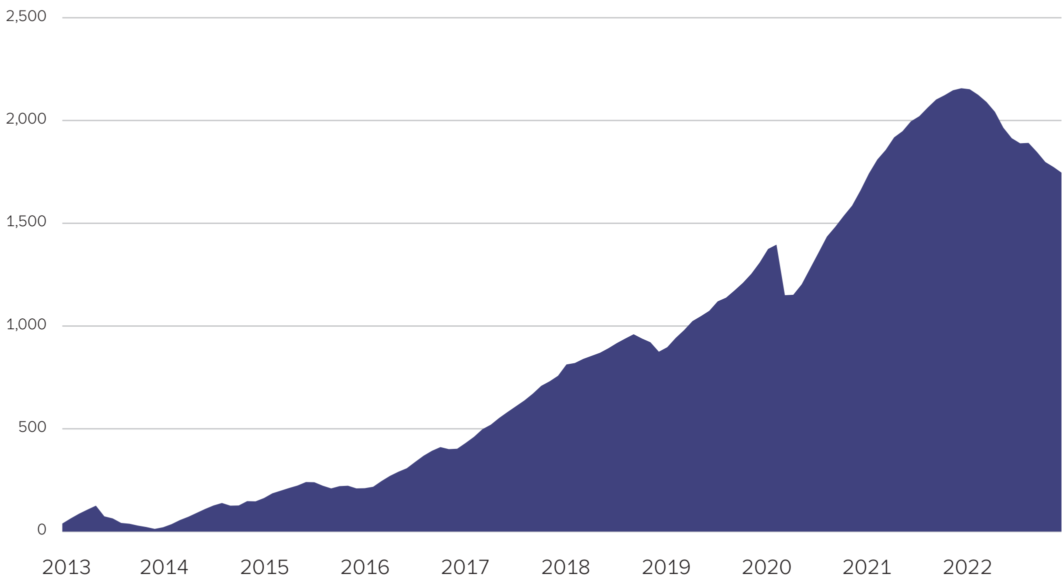
Despite outflows in 2022, bond mutual funds have received $1.7 trillion in net new cash flow and reinvested dividends in the past decade (Figure 3.7).

A number of factors have helped contribute to this long-term demand for bond mutual funds, including demographics. Older investors tend to have larger account balances because they have had more time to accumulate savings and take advantage of compounding. At the same time, as investors age, they tend to shift toward fixed-income products. Over the past decade, the aging US population has boosted flows to bond funds.

FIGURE 3.7

Bond Mutual Funds Have Experienced Net Inflows Through Most of the Past Decade

Cumulative flows to bond mutual funds, billions of dollars, monthly



Note: Bond mutual fund data include net new cash flow and reinvested dividends.

The popularity of target date mutual funds has also contributed to strong demand for bond mutual funds during this period. Target date funds invest in a changing mix of equities and fixed-income investments. As the fund approaches and passes its target date (which is usually specified in the fund's name), the fund gradually reallocates assets from equities to fixed-income investments, including bonds. Over the past 10 years, target date mutual funds have received net inflows of $405 billion. At year-end 2022, target date mutual funds had total net assets of $1.5 trillion. Investor interest in these funds likely reflects their automatic rebalancing features, as well as their inclusion as an investment option in many defined contribution (DC) plans (see Figure 8.10).

These long-term factors, combined with mostly positive annual returns on bonds and inflows from portfolio allocation strategies, have caused bond mutual fund total net assets to increase from $3.4 trillion at year-end 2012 to $4.5 trillion at year-end 2022. However, long-term mutual funds' share of bond markets—most of which is held by bond mutual funds—has stayed relatively stable in recent years (see Figure 2.4).

Hybrid Mutual Funds

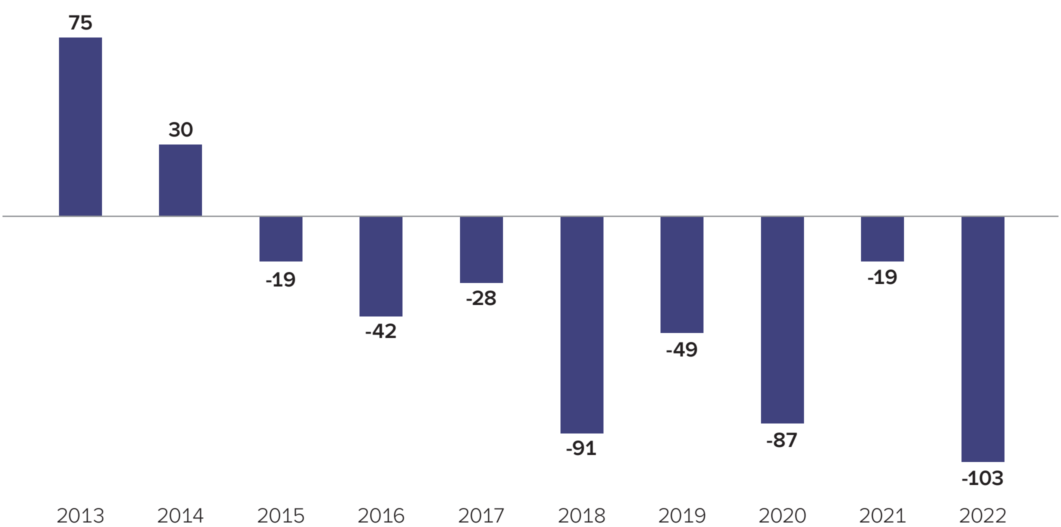
Hybrid funds (also called asset allocation funds or balanced funds) invest in a mix of stocks and bonds. This approach offers a way to balance the potential capital appreciation of stocks with the income and relative stability of bonds over the long term. The fund's portfolio may be periodically rebalanced to bring its asset allocation more in line with prospectus objectives, which could be necessary following capital gains or losses in the stock or bond markets.

Over the past eight years, investors have moved away from hybrid mutual funds, which had been a popular way to achieve a managed, balanced portfolio of stocks and bonds (Figure 3.8). In 2022, hybrid mutual funds had net outflows of $103 billion (or 5.7 percent of their net assets at year-end 2021). Many factors have likely contributed to this change. For example, investors may be shifting out of hybrid funds and into portfolios of ETFs that are periodically rebalanced, often with the assistance of a fee-based financial adviser. In addition, investors may be shifting assets toward target date funds as an alternative way to achieve a balanced portfolio.*

FIGURE 3.8

Net New Cash Flow to Hybrid Mutual Funds

Billions of dollars, annual



* ICI generally excludes funds of funds from total net asset and net new cash flow calculations to avoid double counting. Although target date funds are classified as hybrid funds by ICI, 97 percent of target date fund assets are in funds of funds, and therefore, their flows are excluded from the hybrid mutual fund flows presented in Figure 3.8.

Growth of Other Investment Products

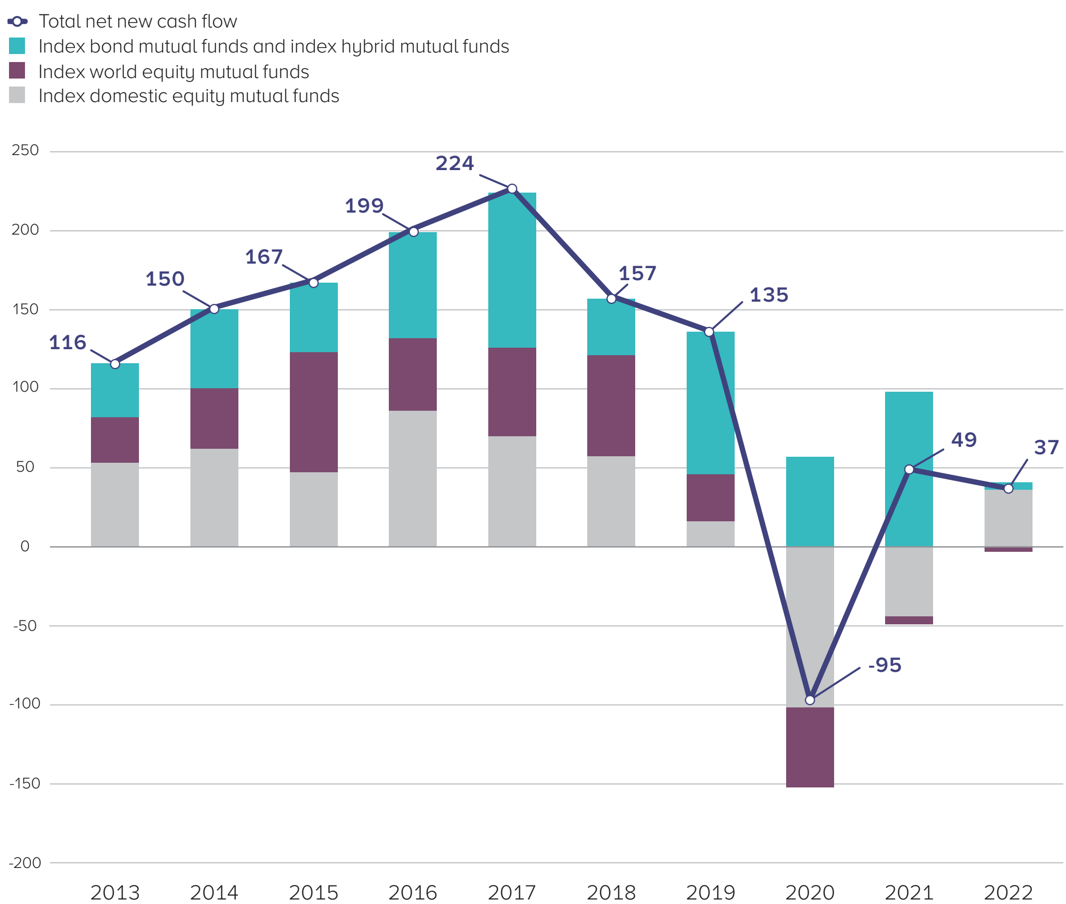
Outflows from some long-term mutual funds over the past decade reflect a broader shift, driven by both investors and retirement plan sponsors, toward other pooled investment vehicles. This trend is reflected in the outflows from actively managed mutual funds and the growth of index mutual funds, ETFs, and collective investment trusts (CITs) since 2007.

Index mutual funds—which hold all (or a representative sample) of the securities in a specified index—are popular among investors. Of households that owned mutual funds, 48 percent owned at least one index equity mutual fund in 2022. As of year-end 2022, 517 index mutual funds managed total net assets of $4.8 trillion. For 2022 as a whole, investors added $37 billion in net new cash flow to these funds (Figure 3.9). Outflows from index world equity mutual funds ($3 billion) were more than offset by inflows into index domestic equity mutual funds and index bond and hybrid mutual funds ($36 billion and $5 billion, respectively).

FIGURE 3.9

Net New Cash Flow to Index Mutual Funds

Billions of dollars, annual

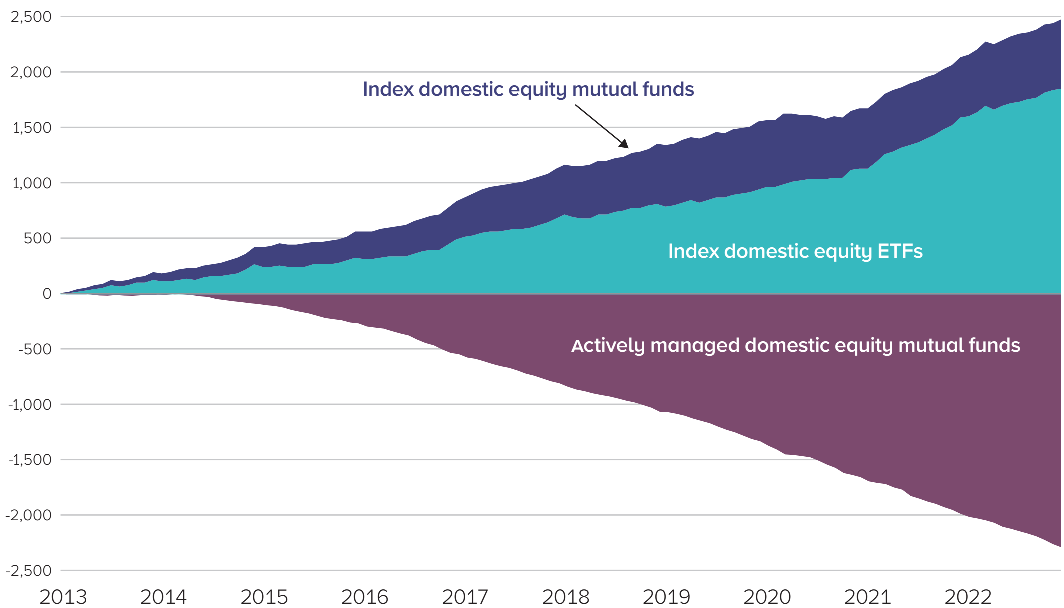


Index domestic equity mutual funds and ETFs have particularly benefited from the overall increased investor demand for index-based investment products. From 2013 through 2022, index domestic equity mutual funds and ETFs received $2.5 trillion in net new cash and reinvested dividends, while actively managed domestic equity mutual funds experienced net outflows of $2.3 trillion (including reinvested dividends) (Figure 3.10). Index domestic equity ETFs have grown particularly quickly—attracting nearly three times the amount of net inflows of index domestic equity mutual funds since 2013. Part of the recent increasing popularity of ETFs is likely attributable to more brokers and financial advisers using them in their clients' portfolios. In 2021, full-service brokers and fee-based advisers had 28 percent and 41 percent, respectively, of their clients' household assets invested in ETFs, up sharply from 6 percent and 10 percent in 2011 (Figure 3.11).

FIGURE 3.10

Some of the Outflows from Domestic Equity Mutual Funds Have Gone to ETFs

Cumulative flows to domestic equity mutual funds and net share issuance of index domestic equity ETFs, billions of dollars, monthly

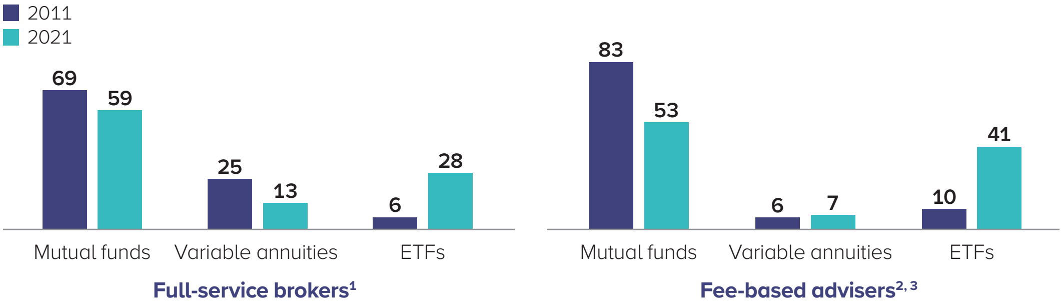


Note: Mutual fund data include net new cash flow and reinvested dividends; ETF data for net share issuance include reinvested dividends.

FIGURE 3.11

Fee-Based Advisers Are Investing Larger Portions of Client Portfolios in ETFs

Percentage of household assets invested in investment category by adviser type



[1] This category includes wirehouses as well as regional, independent, and bank broker-dealers.

[2] This category includes registered investment advisers and dually registered investment adviser broker-dealers.

[3] This category excludes an unknown portion of assets from investors who received fee-based advice but implemented trades themselves through discount brokers and fund supermarkets.

Source: Cerulli Associates, "The State of US Retail and Institutional Asset Management, 2022"

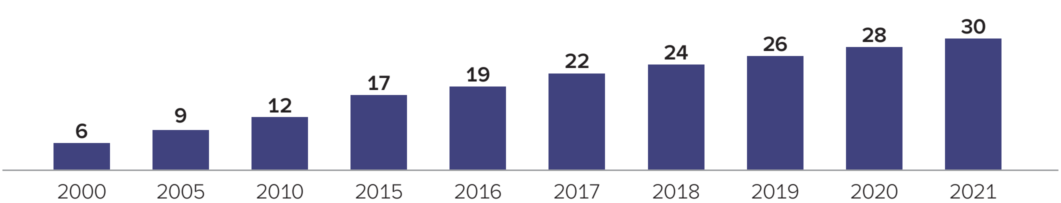
CITs are an alternative to mutual funds for DC plans. Like mutual funds, CITs pool the assets of investors and (either actively or passively) invest those assets according to a particular strategy. Much like institutional share classes of mutual funds, CITs generally require substantial minimum investment thresholds, which can limit the costs of managing pooled investment products. Unlike mutual funds, which are regulated under the Investment Company Act of 1940, CITs are regulated under banking laws and not marketed as widely as mutual funds; this can also reduce their operational and compliance costs as compared with mutual funds.

More retirement plan sponsors have begun offering CITs as options in 401(k) plan lineups. As Figure 3.12 demonstrates, this trend has translated into a growing share of assets held in CITs by large 401(k) plans. That share increased from 6 percent in 2000 to an estimated 30 percent in 2021. This recent expansion is due, in part, to the growth in target date CITs.

FIGURE 3.12

Assets of Large 401(k) Plans Are Increasingly Held in Collective Investment Trusts

Percentage of assets in large 401(k) plans*



* Large 401(k) plans are those that filed Form 5500 Schedule H (typically plans with 100 participants or more).

Note: Assets exclude Direct Filing Entity assets that are reinvested in collective investment trusts. Data prior to 2021 come from the Form 5500 Research data sets released by the Department of Labor. Data for 2021 are preliminary, based on Department of Labor Form 5500 latest data sets.

Source: Investment Company Institute calculations of Department of Labor Form 5500 data

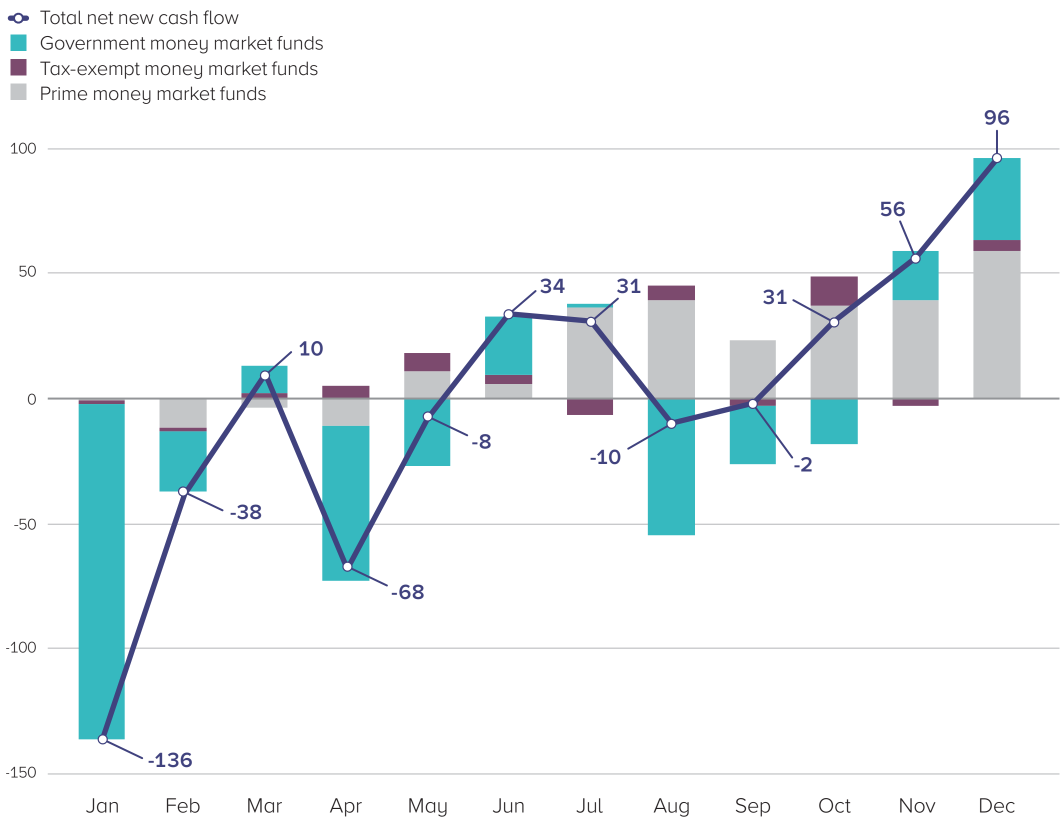
Money Market Funds

In 2022, money market funds saw net outflows of $4 billion (Figure 3.13). Prime money market funds and tax-exempt money market funds received inflows ($224 billion and $25 billion, respectively), but these flows were offset by outflows from government money market funds ($253 billion).

FIGURE 3.13

Net New Cash Flow to Money Market Funds

Billions of dollars; monthly, 2022



Most of the demand for money market funds in 2022 was from retail investors. Retail money market funds had net inflows of $254 billion while institutional money market funds had net outflows of $258 billion (Figure 3.14). In 2022, short-term interest rates ramped up quickly amid aggressive monetary tightening and by year-end were higher than longer dated fixed-income securities. Retail investors were particularly attracted to rising yields and extremely low interest rate risk offered by money market funds, especially in light of significant capital losses in stock and bond markets. To mitigate these losses, retail investors may have shifted some of their bond fund positions into money market funds to shorten the duration of their fixed-income investments.

In contrast, institutional investors, on net, redeemed cash from money market funds—a development that is consistent with previous monetary policy tightening cycles. Because of their size and investment knowledge, some institutional investors can easily invest directly in short-term instruments. This allows those institutional investors to capture higher yields immediately when the Federal Reserve raises the federal funds rate—rather than waiting for yields on money market funds to catch up as older, lower-yielding short-term securities mature and are replaced with newer, higher-yielding paper.

FIGURE 3.14

Inflows into Retail Money Market Funds Mostly Offset Outflows from Institutional Money Market Funds

Billions of dollars, 2022