

# PERSPECTIVE

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## Mutual Fund Developments in 1997

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and Kimberlee Millar<sup>1</sup>

### SUMMARY

The U.S. economy in 1997 once again provided a favorable setting for mutual funds. During the seventh year of the economic expansion, the unemployment rate fell to its lowest level since 1973, the core rate of inflation dropped to a 30-year low, and corporate earnings were strong. In financial markets, short-term interest rates changed little, long-term rates declined, and stock prices posted strong gains for the third consecutive year.

Against this backdrop, mutual fund assets rose 27 percent to \$4.5 trillion. More than half of the increase came from investment performance—primarily reflecting the strong showing of the stock market—while the remainder largely represented new investments by mutual fund owners.

This issue of *Perspective* reviews mutual fund asset growth and net flows in 1997. Highlights of the review include the following.

### Equity Funds

- ▶ Assets of equity funds increased 37 percent in 1997 to \$2.4 trillion. The increase was primarily attributable to rising domestic stock prices and secondarily to new investments.

- ▶ Net new cash flows to equity funds totaled a record \$231 billion, topping the 1996 record of \$222 billion. As a percentage of assets, however, the net inflow in 1997 was at the lowest level since 1990.
- ▶ Domestic stock funds garnered a larger share of the net inflows last year than in 1996, as inflows to foreign-related funds slowed somewhat. Among domestic funds, net inflows shifted to growth and income funds and away from aggressive growth funds.
- ▶ Households continued to shift away from holding stocks directly to holding them indirectly through mutual funds. In fact, even when purchases of equities through mutual funds are included, households were net sellers of stock in 1997. Nonetheless, the equity share of households' financial assets increased because of appreciation in stock values.
- ▶ The response of equity fund shareholders during the financial market turbulence in late October was muted. Domestic equity funds experienced a very small net outflow on the day of the 554-point decline in the Dow Jones Industrial Average. Relatively strong net inflows occurred thereafter. Foreign-related funds experienced outflows.
- ▶ A survey of individual mutual fund owners likewise pointed to a limited response to October's market developments. Only 7 percent of respondents conducted a stock fund transaction in response to market volatility, and the majority of those conducting a transaction purchased rather than redeemed stock fund shares.

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## Bond and Income Funds

- ▶ Assets of bond and income funds rose 16 percent in 1997 to \$1.031 trillion. Falling interest rates helped to stimulate net new cash inflows, which rose to \$44 billion, the highest level since 1993.
- ▶ The conversion of \$9.5 billion of bank common trusts into bond and income mutual funds also contributed to higher net inflow.
- ▶ The effect of the stock market turbulence during the fourth quarter on the net inflow to bond and income funds was minor.

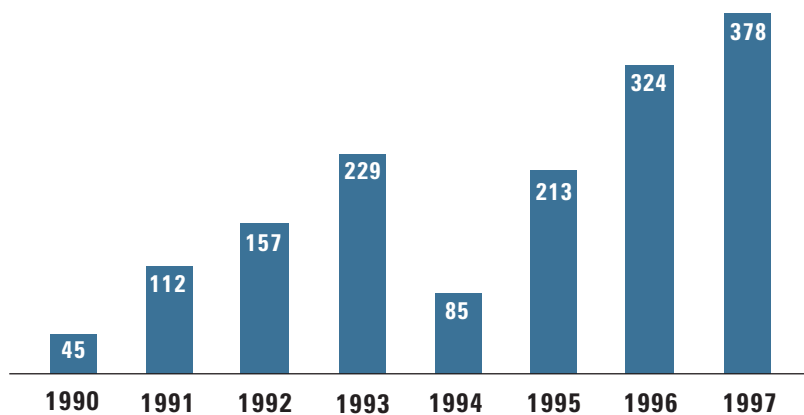
## Money Market Funds

- ▶ Assets in money market funds increased 17 percent in 1997 to \$1.059 trillion. Net new cash flow of \$102 billion broke the 1981 record of \$91 billion.
- ▶ Inflows to retail funds continued to respond to the favorable differential between yields on money funds and other short-term instruments. Inflows to institutional funds also rose, partly because of increased use of money funds for cash management services by businesses and pension funds.

FIGURE 1

### Net New Cash Flow to Mutual Funds, 1990-1997

(billions of dollars)



Source: Investment Company Institute

## Continuing Trends

- ▶ The growth in mutual fund inflows during the decade is partly attributable to increased sales through tax-deferred investment vehicles such as Individual Retirement Accounts, 401(k) plans, and variable annuities. Despite this growth, mutual funds still account for only about one-third of the defined-contribution market and less than half of the IRA market.
- ▶ Despite the large number of mergers and acquisitions involving mutual fund management companies during the 1990s, the concentration of industry assets among the largest fund management companies has decreased.

## MUTUAL FUND ASSETS AND FLOWS

### Overview

Assets in mutual funds increased 27 percent in 1997 to \$4.5 trillion. Investment performance—asset appreciation plus reinvested dividends and capital gains distributions—accounted for 56 percent of the increase.<sup>2</sup> Most of asset growth was attributable to higher stock prices; in fact, about 80 percent of the investment performance of all funds was concentrated in equity funds and hybrid funds investing in both stocks and bonds.

Net new cash flow rose for the third straight year to a record \$378 billion (Figure 1), as all three fund categories—equity, bond and income, and money market—experienced heavier inflows.<sup>3</sup> Stock fund inflows were supported throughout the year by higher stock prices and by the ongoing shift by households away from direct ownership of equities to indirect ownership through mutual funds. Market sell-offs in March, August, and late October temporarily slowed stock fund inflows. Inflows to global and international funds bore the brunt of the

<sup>2</sup>For a given fund, its change in assets equals net new cash flow plus investment performance. Net new cash flow is the difference between (1) sales of shares including those from exchanges from other funds within the same family of mutual funds but excluding those from reinvested distributions and (2) redemptions of shares including those through exchanges into other funds within the same fund family. Investment performance is the difference between a fund's change in assets and net new cash flow. On a yearly basis, performance roughly equals unrealized gains or losses plus reinvested dividends and capital gains distributions.

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 funds that did not report data for the previous month introduce a third component into the aggregate change in assets; that is, assets of new reporters.

<sup>3</sup>Unless otherwise noted, the term inflow refers to a positive value of net new cash flow and outflow refers to a negative value of net new cash flow.

slowdown in the last two declines, as crises in Asian markets damped investor interest in overseas markets. Higher net flows to bond and income funds and to money market funds primarily reflected favorable interest rate movements and were little affected by the stock market turbulence during the summer and fall.

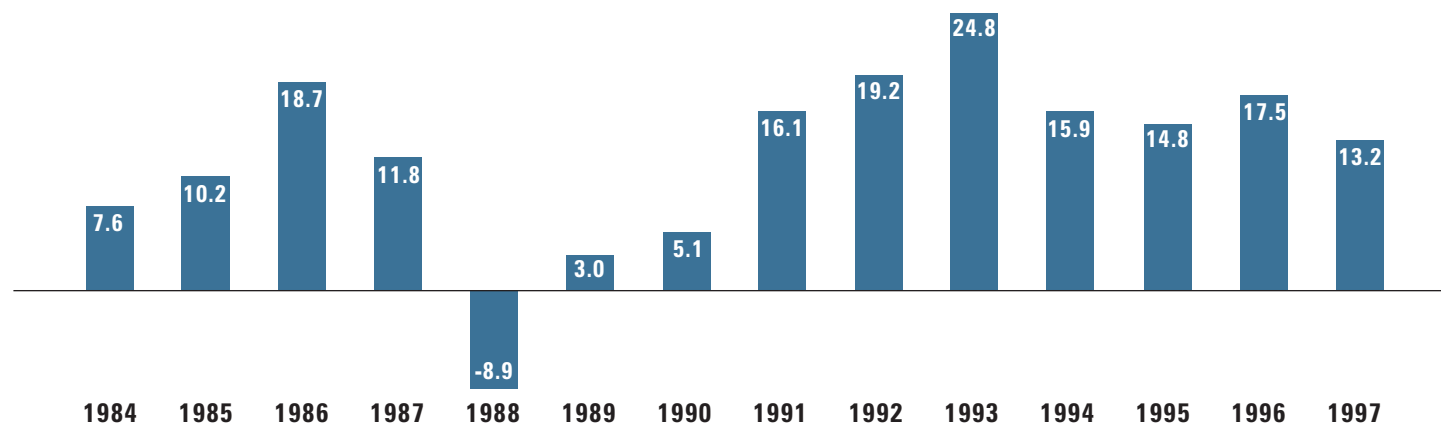
## EQUITY FUNDS

The 37 percent increase in equity fund assets in 1997 primarily was the result of strong fund performance, which accounted for about three-fifths of the increase. The record net new cash flow of \$231 billion also boosted fund assets, accounting for over one third of the increase.<sup>4</sup> Although the net inflow was a dollar record, it was only 13 percent of stock fund assets, the lowest percentage since 1990 (Figure 2).

FIGURE 2

### Net New Cash Flow to Equity Mutual Funds, 1984-1997

(percent of previous yearend assets)



Source: Investment Company Institute

FIGURE 3

### Net New Cash Flow to Equity Mutual Funds, 1984-1997

(billions of dollars)

	Domestic				Total	Foreign	Total	Total Equity Fund Assets
	Aggressive Growth	Growth	Growth & Income	Income				
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
1997	36.6	57.4	87.5	11.9	193.3	37.7	231.1	2,399.3

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.

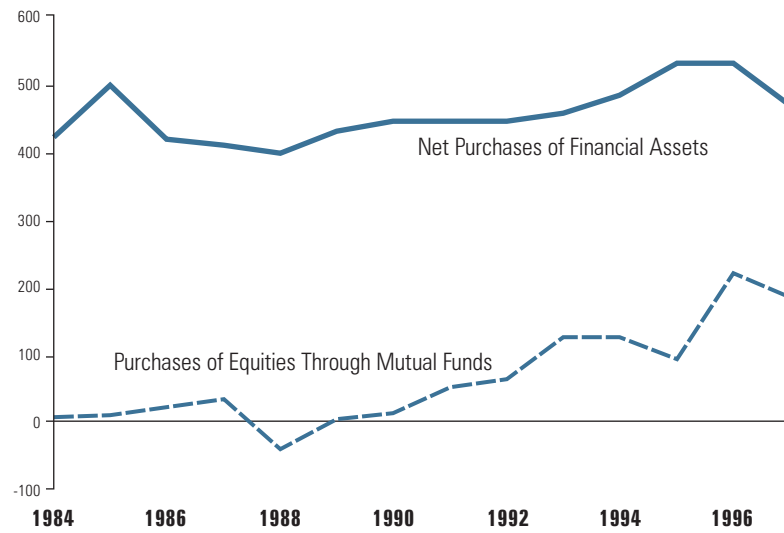
Source: Investment Company Institute

<sup>4</sup>The remaining increase reflects the assets of newly reporting funds.

FIGURE 4

**Household Net Purchases of Financial Assets, 1984-1997**

(billions of dollars)



Sources: Federal Reserve Board, Employee Benefit Research Institute, and Investment Company Institute

Net inflow to domestic stock funds rose from \$175 billion in 1996 to \$193 billion in 1997 (Figure 3). Growth and income funds led the way, posting a record inflow of \$88 billion. These more conservative stock funds captured 45 percent of all domestic stock fund inflows in 1997, up from 37 percent in 1996. The shift toward growth and income funds and away from higher-risk aggressive growth funds continued a movement that began in mid-1996. Over this period, investors generally favored stocks of large domestic companies, largely the investment domain of growth and income funds. As a group, these stocks outperformed those of smaller domestic companies in both 1996 and 1997.

Net inflow to international and global funds slowed to \$38 billion last year from \$46 billion in 1996, as turmoil during the second half of the

year in Asian and Latin American financial markets damped inflows to international and global funds generally and led to outflows from emerging market funds. Robust inflows to emerging market funds during the first half of the year, however, enabled these funds to post a net inflow of \$2.0 billion for the year, down from \$4.1 billion in 1996.

**Increase in equity fund flows.** The larger inflows to equity funds last year were part of a recent trend that has seen households direct an ever increasing share of their net purchases of financial assets to equity mutual funds. In 1997, households placed almost 40 percent of their net purchases of all financial assets in equities purchased through mutual funds (Figure 4).<sup>5</sup> This percentage was about unchanged from that in 1996 but was well above the 3 percent share recorded at the beginning of the decade.

On a dollar basis, net equity purchases through mutual funds have risen from \$13 billion in 1990 to \$185 billion in 1997. This increase has occurred even though household savings and net purchases of financial assets have risen only slightly.<sup>6</sup> Thus, households have funded the increase in equity fund flows primarily by reducing their net purchases of other assets.

Much of this substitution appears to be from equity holdings outside of mutual funds to indirect holdings through mutual funds (Figure 5).<sup>7</sup> During the 1990s, households on net sold \$1.2 trillion in equities held outside of mutual funds and purchased \$870 billion through mutual

<sup>5</sup>Household financial asset data were primarily obtained from the *Flow of Funds Accounts of the United States: Flows and Outstandings Third Quarter 1997* (December 11, 1997), Board of Governors of the Federal Reserve System, Washington, D.C. The *Flow of Funds Accounts* include asset holdings of nonprofit organizations in household assets. The *Flow of Funds Accounts* provide separate financial asset data for nonprofit organizations only for 1988-1994. In order to maintain consistency, the nonprofit data are not separated from the household financial data. In 1994, nonprofit organizations accounted for 5 percent of household financial assets.

Equity purchases through mutual funds include those purchases via mutual fund shares held in personal trusts and private pension plans. Equity purchases through variable annuities are included in equity purchases through mutual funds. The *Flow of Funds Accounts* treat variable annuities as a life insurance product.

<sup>6</sup>Household net purchases of financial assets rose only 6 percent between 1990 and 1997 while personal disposable income rose 44 percent. The much slower growth in household purchases of financial assets and personal savings is likely partly attributable to a wealth effect. Rising equity prices during the 1990s boosted household wealth, allowing households to direct a larger portion of their income to consumption and a smaller portion to savings. As a result, the savings rate fell from 5.0 percent of disposable income in 1990 to 3.8 percent in 1997.

<sup>7</sup>Equity purchases outside of mutual funds are only those purchases for which households bear the investment risk. Such purchases include direct purchases and those via closed-end funds, personal trusts, and defined-contribution plans. Because households do not bear investment risk with equity purchases through defined-benefit plans, equity purchases via these plans are not included.

For 1984 and 1985, the defined-contribution plan purchases are estimated by multiplying the net acquisition 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 Benefit Research Institute, *Pension Investment Report* Vol. 11, No. 1, July 1997.

funds.<sup>8</sup> Through the third quarter of 1997 alone, households sold on net \$343 billion of stock held outside of mutual funds at an annual rate, far in excess of their net purchases made through mutual funds. Last year marked the fifth straight year that households were net sellers of equity.

The share of household financial assets held in equities increased in 1997, even though households were net sellers of corporate stock (Figure 6).<sup>9</sup> This occurred because of the appreciation in value of the remaining stock holdings, including holdings through mutual funds. At the end of the third quarter of 1997, household direct and indirect holdings of equities were \$8.8 trillion and amounted to 33 percent of household financial assets. This share is up from 30 percent at the end of 1996 and represents a continuation of the trend that began in 1982 with the upward march in stock prices. The current equity share of financial assets is near the peak reached in 1968 following the extended runup in the stock market during the 1960s.

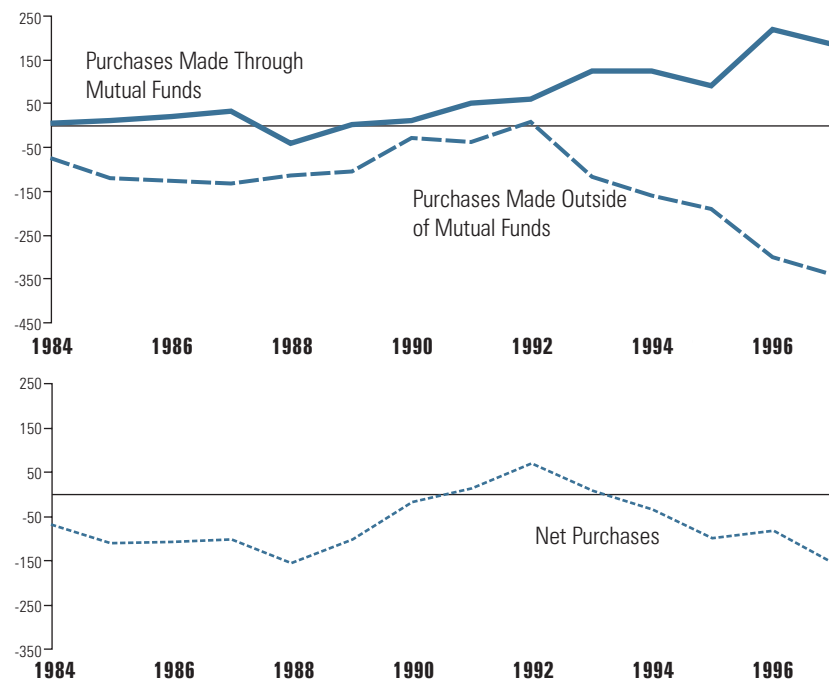
**Stock market volatility in October.** Sparked by extreme weakness in Asian financial markets, the Dow Jones Industrial Average posted its largest one-day point drop of 554 points, on October 27, 1997. Coupled with declines over the two previous trading days, the cumulative loss amounted to 10.9 percent and was the largest three-day decline since October 1987. The U.S. stock market also experienced its widest price swings in a decade.

The response of equity mutual fund owners to the sell-off in U.S. stock markets was limited and brief. Net inflows to domestic stock funds were strong through the first three weeks of October but slackened with the onset of the decline in

FIGURE 5

**Purchases of Equities by Households, 1984-1997**

(billions of dollars)

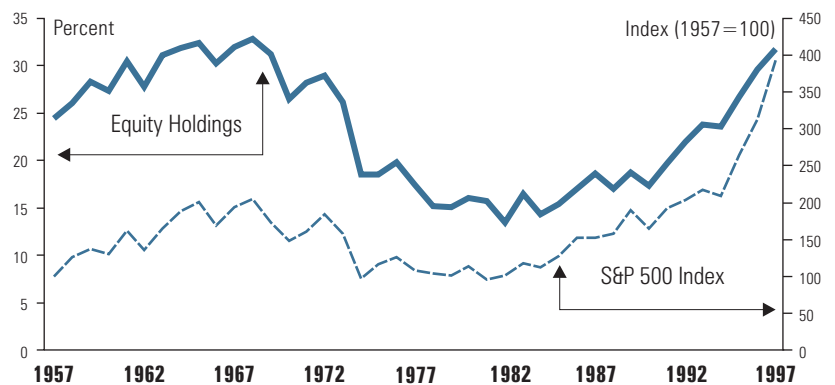


Note: Data for 1997 are annualized.

Sources: Federal Reserve Board, Employee Benefit Research Institute, and Investment Company Institute

FIGURE 6

**Total Holdings of Equities by Households as a Share of Total Household Financial Assets and the Real Value of the S&P 500, 1957-1997**



Sources: Federal Reserve Board, Employee Benefit Research Institute, U.S. Department of Labor, Bureau of Labor Statistics, Standard & Poor's Corporation, and Investment Company Institute

<sup>8</sup>Other than mutual funds, the largest net buyers of equities during the past four years have been life insurance companies with \$163 billion of net purchases, state and local government retirement funds with \$152 billion, and residents of foreign countries with \$100 billion.

In addition, U.S. corporations retired, on balance, \$240 billion of outstanding shares through corporate buybacks and through mergers and acquisitions. During the first three quarters of 1997 alone, corporations retired \$88 billion of equity at an annual rate. Net stock issuance excludes net issuance by closed-end funds, which is included in the net issuance data of the *Flow of Funds Accounts*. Closed-end funds on net issued \$20 billion of shares from 1994 through the third quarter of 1997.

<sup>9</sup>Only equity holdings for which households bear investment risk are included: direct equity holdings, holdings through defined contribution plans, holdings through mutual funds and closed-end funds, and holdings through bank personal trusts. Equity holdings of defined benefit plans are excluded because the plan sponsor bears the investment risk of holding equity. As noted in footnote 5, equity holdings of nonprofit organizations are included in the household data.

stock prices on October 23.<sup>10</sup> The net flow turned slightly negative on October 27, amounting to no more than one tenth of one percent of domestic stock fund assets. On the following day, net inflows returned with the recovery in stock prices and continued thereafter.

The late October turmoil in overseas markets, especially those in Asia, had a more lasting effect on foreign stock funds. After starting the month on a strong note, the net flow to these funds turned negative with the sell-off in Asian markets and continued so in November and December. The magnitude of the net outflow was small, however, cumulating during these two months to less than 0.4 percent of foreign fund assets.

A survey of individual mutual fund owners taken in late November and early December likewise pointed to a limited response to October's market developments.<sup>11</sup> Awareness of the market decline on October 27 was widespread among fund owners; 56 percent of the survey respondents indicated knowing of the sell-off as it occurred and another 23 percent learned of the drop that evening. Nonetheless, only 7 percent of respondents conducted a stock fund transaction in response to market volatility, with more than half having made the trade after October 28.<sup>12</sup> The majority of those conducting a transaction purchased rather than redeemed stock fund

shares, including those engaging in transactions on October 27.

**Bank common trust fund conversions.** Stock fund inflows were elevated last year by \$8.6 billion of conversions of bank common trust funds into stock mutual funds. Conversions are treated as an inflow because they result in new assets flowing into the mutual fund industry. Passage of the "Small Business Job Protection Act" in August 1996 facilitated such conversions by permitting the transfer of interests in a bank common trust fund to a mutual fund to occur without producing taxable capital gains. Most of the conversions occurred in the last half of 1997, as administrative and other considerations delayed conversions. The largest conversions occurred in November, totaling \$5.4 billion. Other large conversions occurred in September and January, totaling \$960 million and \$660 million, respectively.

FIGURE 7

**Net New Cash Flow to Bond and Income Mutual Funds, 1984-1997**

(billions of dollars)

	Hybrid	U.S. Government and GNMA	Global	Corporate Bond	High Yield	Income Bond	Municipal	Total	Total Bond & Income Fund 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
1997	20.0	-9.8	-1.1	1.0	16.8	17.1	0.5	44.5	1,031.5

Note: Hybrid funds include balanced funds, flexible portfolio funds, and income-mixed funds.

Source: Investment Company Institute

<sup>10</sup>Estimates of weekly and daily net flows are based upon a sample of large fund companies.

<sup>11</sup>The survey was conducted for the Investment Company Institute by Response Analysis Corporation in Princeton, New Jersey. The survey consisted of 1004 telephone interviews with randomly selected mutual fund owners. All interviews were conducted with the individual in the household who was the most knowledgeable decisionmaker for saving and investment choices.

<sup>12</sup>The 7 percent figure includes those respondents who conducted a transaction between October 25 and the time of the survey. The standard error of this estimate is one percentage point.



## BOND AND INCOME FUNDS

Assets of bond and income funds rose 16 percent in 1997 to a record \$1.031 trillion (Figure 7). About two thirds of the increase resulted from fund performance, and most of the remaining increase represented a net inflow of \$44.5 billion, the highest since 1993 and well above the \$12.6 billion net inflow in 1996.

### *Interest rate movements and net flows.*

The step-up in net flow to bond and income funds last year primarily was the product of lower long-term interest rates. After rising through early spring,

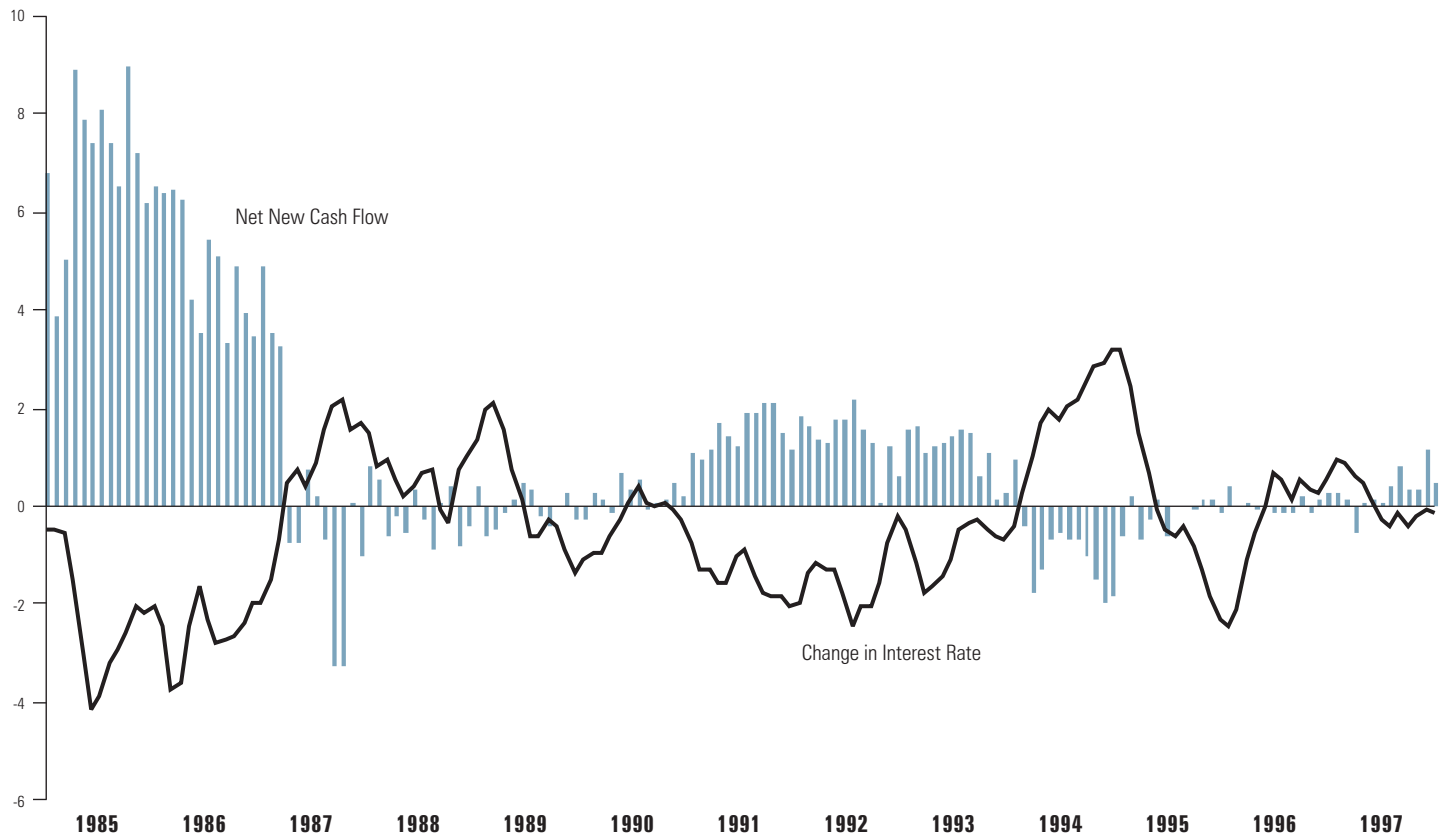
long-term rates declined 1.30 percentage points through year-end. In the past, bond funds have experienced the heaviest net inflows during periods of falling interest rates (Figure 8), and last year proved to be no exception.<sup>13</sup> Bond fund inflows averaged \$3.1 billion per month between May and December when interest rates were declining, compared with outflows of \$176 million per month in the first four months when rates were rising (Figure 9).

**Additional factors.** A total of \$9.5 billion in bank common trust fund conversions to bond and income funds added to the higher level of net flow in 1997. The largest conversions occurred in August and November, amounting to \$3.3 billion and \$4.3 billion, respectively. Smaller-sized conversions, ranging between \$400 million and \$600 million, took place in January, February, and April.

FIGURE 8

### Net New Cash Flow to Bond Funds as a Percent of Assets and Interest Rate Changes, 1985-1997

(percent)



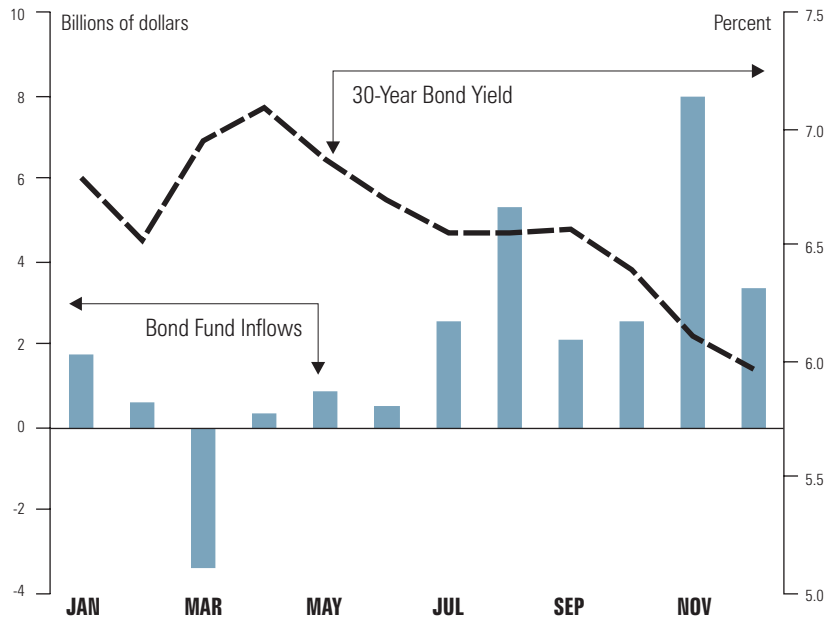
Note: Net new cash flow is shown as a percentage of the previous month's outstanding assets. Interest rate changes are year-over-year changes in the constant maturity yield on the three-year Treasury Note.

Sources: Federal Reserve Board and Investment Company Institute

<sup>13</sup>For a more complete discussion of the effect of interest rate cycles on net flows into bond funds, see Brian Reid, "Growth and Development of Bond Mutual Funds," *Perspective*, Vol. 3, Number 2 (June 1997). The positive association between bond returns and net flows into bond funds has also been documented by others, including Vincent A. Warther, "Aggregate Mutual Fund Flows and Security Returns," *Journal of Financial Economics*, 29 (1995) pp. 209-235, and Eli M. Remolona, Paul Kleiman, and Debbie Gruenstein, "Market Returns and Mutual Fund Flows," *Federal Reserve Bank of New York Economic Policy Review*, July 1997, pp. 33-52, among others.

FIGURE 9

**Net New Cash Flow to Bond Funds and the Yield on the 30-Year Bond, 1997**



Sources: Bloomberg and Investment Company Institute

The substantial increase in stock market volatility in August and over the fourth quarter of 1997 appeared to have little effect on net flows to bond and income funds. The vast majority of the net inflows to bond and income funds was concentrated among hybrid funds, high-yield bond funds, and income-bond funds. These three were among the higher-risk groups of bond and income funds as well as among the better performing groups. In contrast, the more conservative government and Ginnie Mae bond funds continued to post net outflows over the last half of the year, although the pace of net redemptions was slower.

**MONEY MARKET FUNDS**

Assets in money market funds rose \$157 billion, or 17 percent, in 1997 to a record \$1.059 trillion (Figure 10). Most of the increase in assets consisted of a record \$102 billion in net new cash flow, which surpassed the previous record of \$91 billion in 1981.

FIGURE 10

**Net New Cash Flow to Retail and Institutional Money Market Funds, 1984-1997**

(billions of dollars)

	Retail			Institutional			Total Taxable	Total Tax-exempt	Total	Total Money Market Fund Assets
	Taxable	Tax-exempt	Total	Taxable	Tax-exempt	Total				
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	1.6	23.7	-14.3	-0.7	-15.0	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
1997	45.4	9.7	55.1	41.3	5.6	46.9	86.7	15.3	102.0	1,058.9

Source: Investment Company Institute



**Retail funds.** The net inflow to retail money funds—those offered primarily to individuals with small-sized accounts—remained strong last year. The net inflow was supported by a further widening in the already appreciable gap between yields on retail money funds and on bank and thrift saving deposits (Figure 11).

Like those of bond funds, money fund net flows were not much affected by stock market volatility in the fourth quarter. The pickup in net flow in October, November, and early December was in line with normal increases associated with the seasonal buildup in household cash balances in advance of December holiday expenditures.

**Institutional funds.** The net inflow to institutional money funds—those held primarily by

businesses, governments, institutional investors, and high-net worth households—rose for the third straight year to \$46.9 billion in 1997. The strength in institutional net flow is due in part to the ongoing outsourcing of cash management services to money market funds by businesses, municipalities, and pension funds. In addition, the narrow difference between long-term and short-term yields may have led some institutional investors to shift from bond funds to money funds.

## CONTINUING TRENDS

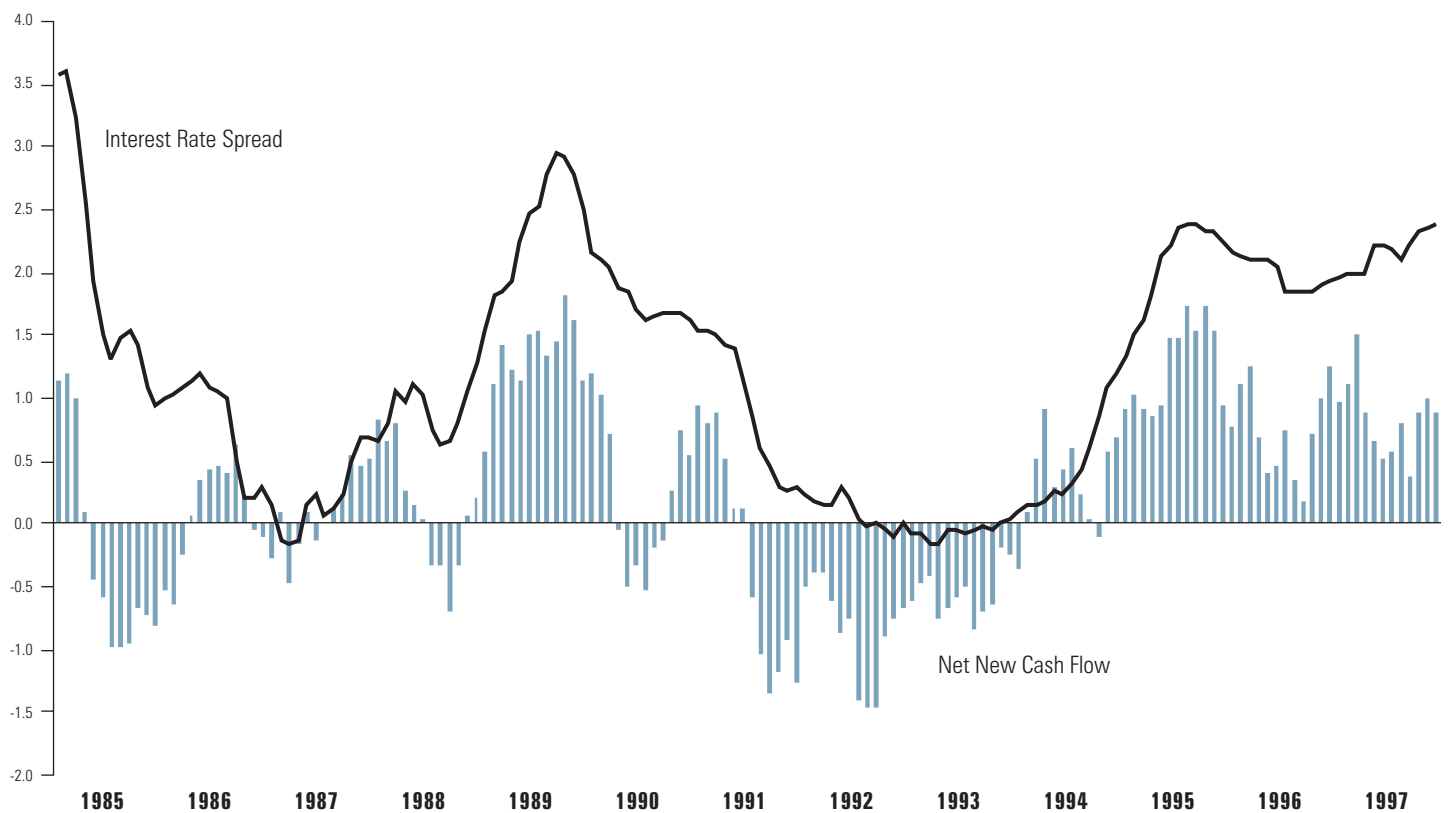
### **Tax-deferred Investments and Mutual Funds**

Tax-deferred investment vehicles have become of increasing importance during the past decade in household investment decisions. These vehicles include Individual Retirement Accounts (IRAs), defined-contribution retirement plans, and fixed and variable annuities. All of these vehicles generally defer taxation of investment income and realized capital gains. As a share of all household financial assets, investments in tax-deferred

FIGURE 11

### Interest Rate Spread and Net New Cash Flow to Retail Money Market Funds, 1985-1997

(percent)



Note: Net new cash flow is a percentage of retail money market fund assets and is shown as a six-month moving average. 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.

Sources: IBC Financial Data, Inc., Federal Reserve Board, and Investment Company Institute

accounts have increased steadily during the past decade and reached 17 percent in 1996 (Figure 12).

The increased importance of tax-deferred investing is reflected as well in household holdings of mutual funds. At the end of 1996, households had placed 56 percent of their mutual fund assets in tax-deferred vehicles, up from 21 percent in 1985 and only 30 percent as recently as 1990.<sup>14</sup> The direction of fund investments to these vehicles has been even more pronounced with equity funds; at the end of 1996, 70 percent of equity fund assets were tax-deferred vehicles. Smaller but still significant percentages of household assets in bond and income funds and money funds were in tax-deferred accounts. With the increased use of mutual funds in these vehicles, the share of all tax-deferred investments held in mutual funds had risen to 35 percent in 1996. Most of the tax-deferred assets not invested in

mutual funds are in life insurance companies and banks or are invested directly in stocks.

The increased popularity of mutual funds in tax-deferred vehicles is due to several developments. Perhaps of greatest importance are the growth of the defined-contribution plans generally and 401(k) plans in particular and the gain in market share made by mutual funds. Although only about one-third of the defined-contribution market, the mutual fund share has grown from less than 10 percent in 1985.<sup>15</sup>

Another factor is that IRA assets have grown rapidly, despite the limits enacted by Congress in 1986 on eligibility for tax-deductible contributions.<sup>16</sup> The growth in the IRA market is partly attributable to asset appreciation from the rising stock prices and to rollovers from defined contribution plans. Furthermore, the mutual fund share of the IRA market increased from 16 percent in 1985 to 47 percent in 1996.

Finally, variable annuities outside of retirement plans have grown in popularity as individuals have turned to them for long-term purposes, such as retirement planning.<sup>17</sup> Variable annuities have grown at almost a 50 percent annual rate during the 1990s, reaching \$457 billion at the end of 1997.

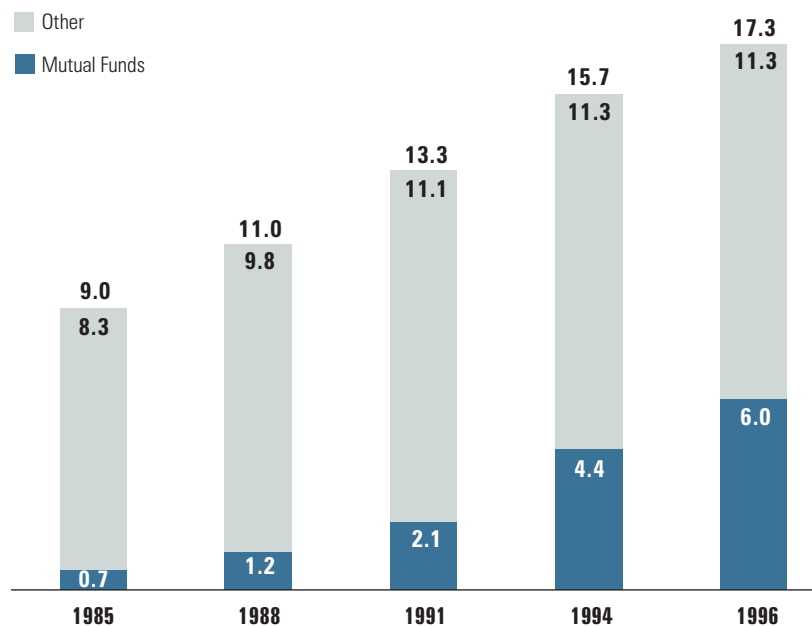
### Industry Concentration

The 1990s have witnessed a large number of mergers and acquisitions involving mutual fund management companies. Nonetheless, the concentration of industry assets among the largest fund management companies has decreased rather than increased. The five largest fund organizations in 1990 held 36 percent of all industry assets, whereas the five largest in 1997 held 34 percent (Figure 13). This decline continued a trend in evidence since 1984 when the

FIGURE 12

### Tax-deferred Investments as a Share of Total Household Financial Assets

(percent)



Sources: Federal Reserve Board, Employee Benefit Research Institute, and Investment Company Institute

<sup>14</sup>At the end of 1996, mutual fund assets held by households totaled \$2.66 trillion or 74 percent of all fund assets. The remaining assets were held by fiduciaries, businesses, state and local government units, endowments, foundations and financial institutions.

<sup>15</sup>The growth rate of defined-contribution plans is based on data from the *Flow of Funds Accounts*. The mutual fund share of the defined-contribution market is an ICI estimate and is based on data from the ICI, *Flow of Funds Accounts, Pension Investment Report* and *The Cerulli-Lipper Analytical Report, "The State of the Defined Contribution-401(k) Market, 1996,"* Cerulli Associates, Inc., Boston.

<sup>16</sup>The Taxpayer Relief Act of 1997 provided for two new types of IRAs—the Roth IRA and the Education IRA—and expanded the eligibility for tax-deductible IRAs. While this legislation should boost IRA contributions in the future, it had no impact on 1997 contributions.

<sup>17</sup>Such variable annuities are registered investment companies and are included in statistics on the mutual fund industry.

five largest accounted for 42 percent of industry assets. Asset concentration also has declined for the 10 largest organizations and the 25 largest organizations.

Assets of long-term funds (stock funds and bond and income funds) also have not become significantly more concentrated in larger fund organizations during this decade. The percentage of long-term assets held by the five largest fund management companies was unchanged between 1990 and 1997, while concentration of long-term assets among the 10 largest moved slightly higher and slightly lower among the 25 largest. In contrast to the movement over the 1990s, concentration among long-term assets moved significantly higher between 1984 and 1990, a period characterized by a much lower volume of merger and acquisition activity than the 1990s.

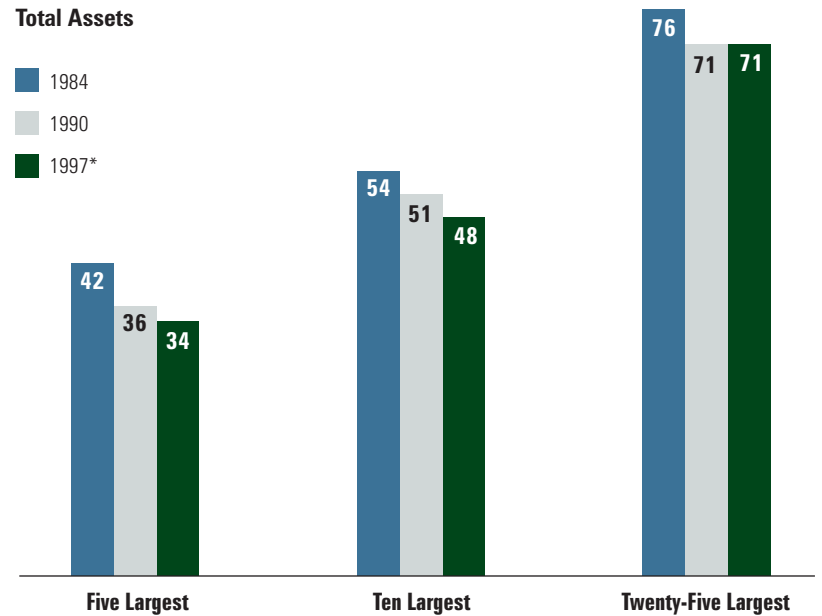
The absence of a significant increase in asset concentration during the merger and acquisition wave of 1990s is due to a number of factors. Perhaps of greatest importance is that very few acquisitions or mergers involved two sizable fund organizations.

In addition, the development and expansion of nontraditional distribution channels, such as fund marketplaces, wrap accounts, and fee-based financial planners, enabled many smaller-sized, high-performing funds to grow significantly. Furthermore, the strong performance of the stock market relative to bond and money markets resulted in a loss of market share for several large companies with a disproportionate percent of assets in bond and money funds. Finally, with barriers to entry being low in the fund industry,<sup>18</sup> the overall growth of the industry assets brought in a significant number of new fund organizations, including commercial banks.<sup>19</sup> In sum, all of these developments worked to offset the effect of mergers and acquisitions on the concentration of industry assets.

FIGURE 13

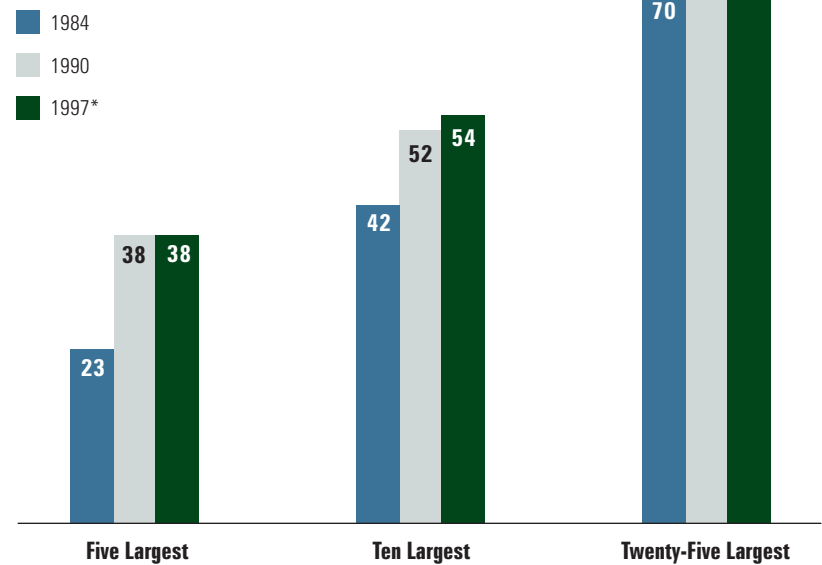
**Share of Mutual Fund Assets Under Management at the Largest Mutual Fund Management Companies**

(percent, end-of-period)



\*May

**Long-Term Assets**



\*May

Source: Investment Company Institute

<sup>18</sup>A new fund requires \$100,000 in initial capital. Furthermore, all administrative and other services needed to operate and manage a mutual fund are readily available from third-party companies. Partly reflecting the low barriers to entry, the common measure of industry concentration, the Herfindahl index, stood in 1997 at 329, well below the threshold of 1,800 used by the Department of Justice to indicate excessive industry concentration. The Herfindahl index takes into account the asset shares of all companies in the industry, not just the largest companies. The maximum level of the index, 10,000, occurs when the industry consists of a single firm.

<sup>19</sup>The number of independent fund management companies increased from 191 in 1984 to 491 in 1997.

## SUMMARY

Assets managed by mutual fund companies increased by more than 25 percent for the third consecutive year in 1997. Although asset growth primarily reflected investment performance, new investments by mutual fund owners were a record. New investments continued to be driven by

households' shift away from direct stock holdings to indirect holdings through mutual funds, the growth of mutual funds in tax-deferred investment vehicles, and favorable interest rate movements that boosted inflows to money and bond and income funds.

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