Section 2:
Recent Mutual Fund Trends

This section describes recent U.S. mutual fund developments and examines the market factors that affect the demand for stock, bond, hybrid, and money market funds.

	PAGE
U.S. Mutual Fund Assets	**12**
Developments in Mutual Fund Flows	**14**
Demand for Long-Term Mutual Funds	**18**
Stock Funds	**20**
Bond and Hybrid Funds	**22**
Demand for Money Market Mutual Funds	**23**
Retail Money Market Mutual Funds	**23**
Institutional Money Market Mutual Funds	**25**

The U.S. mutual fund market, with a record $8.9 trillion in assets under management as of year-end 2005, is the largest in the world, accounting for half of the $17.8 trillion in mutual fund assets worldwide. Investor demand for mutual funds is influenced by a variety of factors, not the least of which is funds' ability to assist investors in achieving a wide variety of investment objectives. In particular, U.S. households' growing reliance on stock, bond, and hybrid mutual funds reflects investor desire to meet long-term personal financial objectives such as preparing for retirement. Furthermore, U.S. households, businesses, and other institutional investors use money market mutual funds as cash management tools because they provide a high degree of liquidity and competitive, short-term yields. Investors' reactions to U.S. and worldwide economic and financial conditions also play an important role in determining demand from year to year for mutual funds in general and for specific types of funds.

U.S. Mutual Fund Assets

Stock mutual funds accounted for a little more than half of U.S. mutual fund assets in 2005. This share has ranged from 50 to 60 percent since 1997, with the exception of 2002 when the share dropped to around 42 percent largely owing to the sharp decline in the U.S. stock markets that year. Domestic stock funds—

For the latest mutual fund statistics, visit the Institute's website at

www.ici.org/stats/mf/index.html

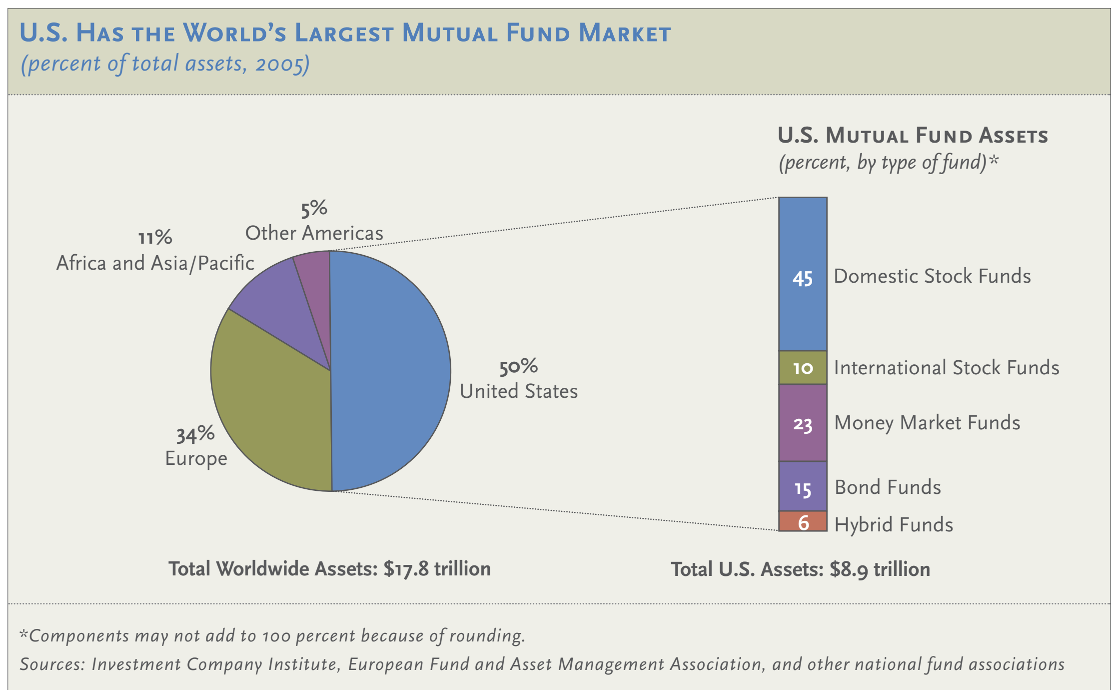
those that invest primarily in shares of U.S. corporations—held 45 percent of total industry assets; international stock funds—those that invest primarily in foreign corporations—accounted for another 10 percent. Money market funds (23 percent), bond funds (15 percent), and hybrid funds (6 percent) also held sizeable portions of total U.S. mutual fund assets.

More than 500 fund sponsors managed mutual fund assets in the United States in 2005. Many firms have entered and exited the fund industry since the mid-1980s, when the modern mutual fund market began to take form. For example, of the top 25 firms in 1985, only 16 remained in the top group in 2005. This ongoing competitive dynamic has prevented any single firm or group of firms from dominating the market. In addition, the share of assets managed by the largest firms in 2005 is comparable to the share managed by the largest firms in 1985.

Alternative measures of market concentration—including the Herfindahl-Hirschman index, which weighs both the number and relative size of firms in the industry to measure competition—also indicates that no one firm or group of firms dominate the mutual fund

U.S. Has the World's Largest Mutual Fund Market

(percent of total assets, 2005)



*Components may not add to 100 percent because of rounding.

Sources: Investment Company Institute, European Fund and Asset Management Association, and other national fund associations

Share of Assets at Largest Mutual Fund Complexes

(percent of total industry assets, selected years)

	1985	1990	1995	2000	2005
Top 5 Complexes	37	34	34	32	37
Top 10 Complexes	54	53	47	46	48
Top 25 Complexes	78	75	70	74	71

More Info: Long-Term Fund Inflows

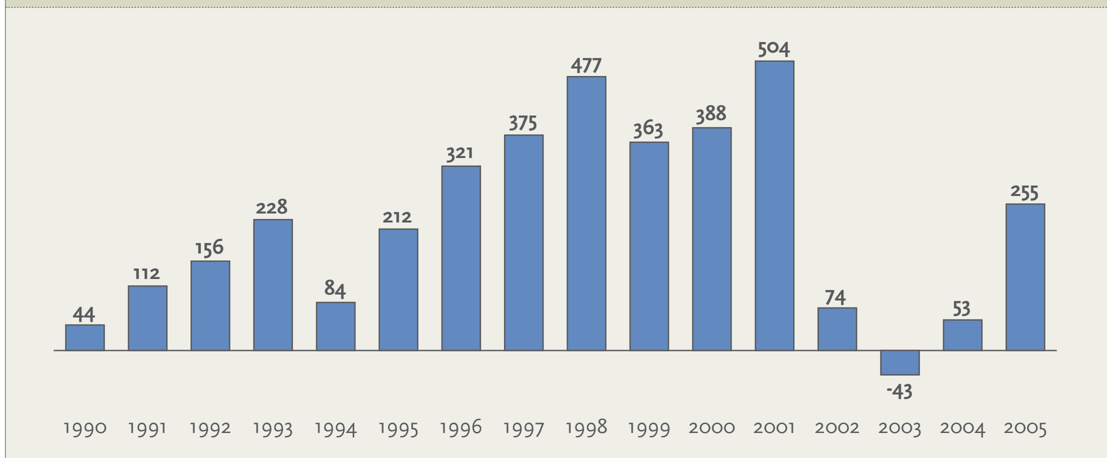
See pages 88–92 for detailed data on inflows to stock, bond, and hybrid funds.

market. The Herfindahl-Hirschman measure considers industries with index numbers below 1,000 to be unconcentrated industries. The mutual fund industry has a Herfindahl-Hirschman measure of around 400.

Developments in Mutual Fund Flows

As measured by net new cash flow—the dollar value of new fund sales minus redemptions, combined with net exchanges—investor demand for mutual funds picked up in 2005. Net new cash flow to all mutual funds was $255 billion, up from the pace of the previous three years. Inflows to international stock funds and money market mutual funds accounted for much of the increase. Abroad, many countries experienced economic growth in excess of that seen in the United States. In addition, foreign stock markets, especially those in emerging markets, outperformed U.S. stocks by a wide margin. U.S. short-term interest rates rose to around 4 percent by year-end, as the Federal Reserve steadily tightened monetary policy in response to strong underlying growth in productivity and heightened concerns about inflationary pressures.

Inflows to Mutual Funds
(billions of dollars, 1990–2005)



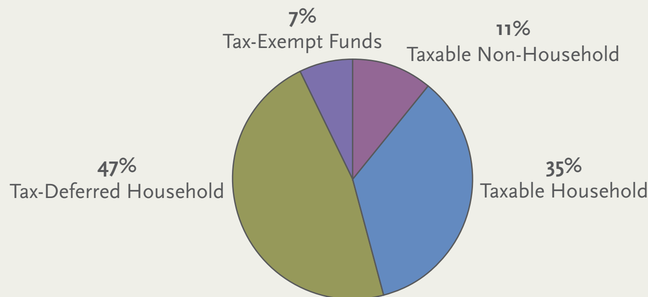
Mutual Fund Assets by Tax Status

Unlike most corporations, a mutual fund generally distributes all of its earnings—capital gains and ordinary dividends—each year to shareholders and is taxed only on amounts it retains. Fund investors are ultimately responsible for paying tax on a fund's earnings, whether they receive the distributions in cash or reinvest them in additional fund shares. Investors often attempt to lessen the impact of taxes on their investments by investing in tax-exempt funds and tax-deferred retirement accounts. As of 2005, 7 percent of all mutual fund assets were held in tax-exempt funds and 47 percent were invested in tax-deferred accounts held by households.

For more information on tax issues affecting mutual fund shareholders, visit the Institute's website at www.ici.org/issues/tax/index.html.

More Than Half of Mutual Fund Assets Held in Tax-Deferred Accounts and Tax-Exempt Funds

(percent, 2005)



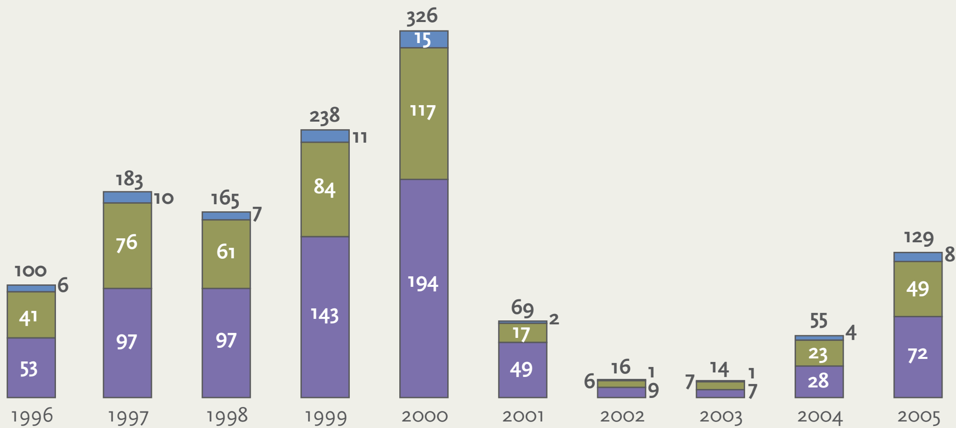
Mutual Fund Capital Gain Distributions

Capital gain distributions represent a fund's net gains, if any, from the sale of securities held in its portfolio. When gains from these sales exceed losses, they are distributed to fund shareholders.

Mutual funds distributed $129 billion in capital gains to shareholders in 2005. About 56 percent of these distributions were paid to tax-deferred household accounts, and another 38 percent were paid to taxable household accounts. Stock, bond, and hybrid funds can distribute capital gains, but stock funds typically account for the bulk of the distributions. In 2005, 35 percent of stock fund share classes made a capital gain distribution, and these share classes distributed an average of nearly 6 percent of their assets as capital gains.

Capital Gain Distributions

(billions of dollars, 1996–2005)



Note: Components may not add to the total because of rounding.

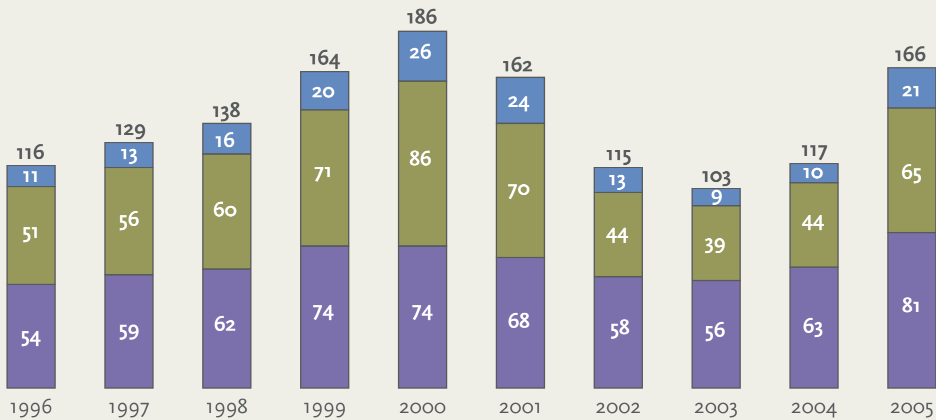
Mutual Fund Dividend Distributions

Dividend distributions represent income—primarily from the interest and dividends earned by the securities in a fund's portfolio—after expenses are paid by the fund.

Mutual funds distributed $166 billion in dividends to fund shareholders in 2005. Mutual fund dividends were boosted by higher short-term interest rates and an increase in dividend payments by corporations. Bond and money market funds accounted for 65 percent of all dividend distributions in 2005. About 49 percent of all dividend distributions were paid to tax-exempt and tax-deferred household accounts. Another 39 percent were paid to taxable household accounts.

Dividend Distributions
(billions of dollars, 1996–2005)

Taxable Non-Household
Taxable Household
Tax-Exempt and Tax-Deferred



Note: Components may not add to the total because of rounding.

Demand For Long-Term Mutual Funds

Investors added $192 billion in net new cash to stock, bond, and hybrid funds in 2005, down slightly from a year earlier, but still maintaining the recent robust pace of inflows to long-term funds. Investor demand for these funds, which slowed largely in response to the decline in the stock market from mid-2000 to the end of 2002, began to strengthen in early 2003. Between 2003 and 2005, net new cash to long-term funds totaled $618 billion. Moreover, during this same period, investors reinvested an additional $239 billion in dividend distributions back into the funds.

No-load share classes of stock, bond, and hybrid mutual funds continued to receive the bulk of net new cash, attracting $154 billion of the total $192 billion in inflows in 2005. Mutual fund sales to investors in employer-sponsored retirement plans account for a large portion of no-load fund sales. Also, no-load inflows likely were boosted by sales of funds of funds which often invest in underlying no-load funds. In 2005, funds of funds received $79 billion in net new cash, of which 25 percent was from sales of funds of funds with loads. Net new cash to load funds amounted to $20 billion. Class A and class C shares received more than all of the $20 billion, while class B shares had net outflows for the fifth consecutive year.

Net New Cash Flow to No-Load Funds Continues to Grow

(billions of dollars, 2000–2005)

	2000	2001	2002	2003	2004	2005
All Long-Term Funds	**229**	**129**	**121**	**216**	**210**	**192**
Load	**70**	**46**	**20**	**51**	**48**	**20**
A Shares	32	32	20	39	60	68
B Shares	26	-1	-16	-18	-35	-65
C Shares	27	22	24	29	22	25
Other Load	-14	-7	-7	1	1	-8
No-Load	**109**	**70**	**102**	**123**	**126**	**154**
Retail	80	37	53	78	84	86
Institutional	29	33	49	45	42	69
Variable Annuities	**51**	**13**	**-2**	**42**	**36**	**18**

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute; Lipper; ValueLine Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (312.263.6400/www.crsp.com); and Strategic Insight Simfund

Mutual Fund Share Classes

Mutual funds are often classified according to the class of shares that fund sponsors offer to investors: primarily load or no-load classes. Load classes generally serve investors who hold funds through financial advisers; no-load fund classes usually serve investors who purchase funds without the assistance of a financial adviser or who choose to compensate the financial adviser separately. More than half of all mutual funds offer two or more share classes. Funds that sell through financial advisers offer more than one share class to provide investors with several ways to pay for the services of financial advisers.

Load Share Classes

Load share classes—typically labeled class A, B, and C shares—usually include a sales load and/or a 12b-1 fee. The sales load and 12b-1 fees are used to compensate financial advisers for their services.

Class A shares represent the traditional means of paying for investment advice and assistance. Class A shares generally charge a front-end sales load at the time of the purchase as a percentage of the sales price or offering price. This share class also often has a 12b-1 fee of about 0.25 percent. Class A shares are sometimes used in employer-sponsored retirement plans, and funds usually waive the front-end sales load for these investors.

Class B shares typically do not have a front-end sales load. Investors using B shares pay for financial advisers through a combination of an annual 12b-1 fee, usually 1 percent, and a contingent deferred sales load (CDSL). The CDSL is triggered if fund shares are redeemed before a fixed number of years of ownership. The CDSL decreases the longer the investor owns the shares and reaches zero typically after shares have been held six or seven years. After six to eight years, B shares usually convert to A shares, which have a lower 12b-1 fee.

Class C shares generally do not have a front-end load. Investors in this share class compensate financial advisers with a combination of an annual 1 percent 12b-1 fee and a 1 percent CDSL paid directly by shareholders if they sell their shares within the first year after purchase. This share class, unlike B shares, typically does not convert to A shares.

No-Load Share Classes

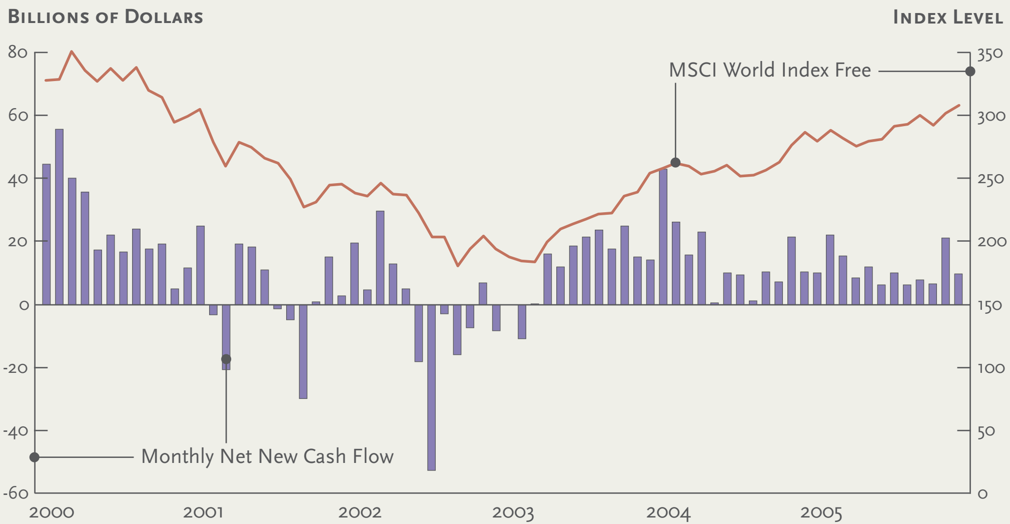
No-load share classes have no front-end load or CDSL and have a 12b-1 fee of 0.25 percent or less. Originally, no-load share classes were offered by mutual fund sponsors that sold directly to investors. Now, however, investors can purchase no-load funds through employer-sponsored retirement plans, mutual fund supermarkets, discount brokerage firms, and bank trust departments. Some financial advisers who charge investors separately for their services rather than through a load or 12b-1 fee also use no-load share classes.

Stock Funds

Investors added $136 billion of net new money to stock funds in 2005, somewhat below the pace of the previous two years, but still a sizeable amount. Domestic stock funds attracted $31 billion in new cash—down considerably from 2004—owing largely to the more limited gains in U.S. equity markets in 2005. Funds investing in foreign companies garnered a record $105 billion in new cash.

The strong demand for these funds reflected, in part, the outstanding performance of many foreign stock markets during 2005, especially when compared with returns in the U.S. stock markets. Total returns on U.S. equity indexes ranged from 5 percent to about 7.5 percent, while those on world stock indexes (excluding U.S. stocks) were about 15 percent. Total returns on stocks traded on emerging markets were close to 35 percent.

Flows to Equity Funds Related to Stock Market Performance
(2000–2005)



Sources: Investment Company Institute and Morgan Stanley Capital International

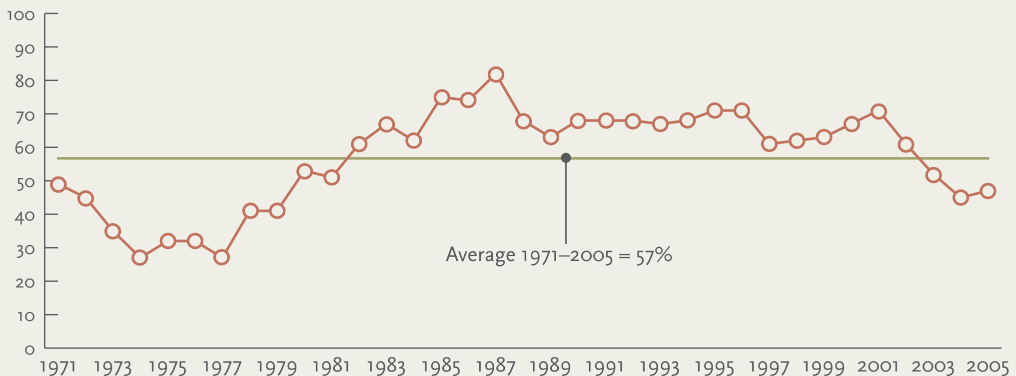
Investors tend to own mutual funds with relatively low fees, expenses, and turnover rates. Mutual fund assets are heavily concentrated in funds with below-median expenses and below-average turnover. The turnover rate—the lesser of purchases or sales (excluding short-term assets) scaled by average net assets—is a measure of a fund's trading activity. In 2005, the asset-weighted annual turnover rate experienced by stock fund investors edged up to 47 percent, but remained low when compared with the historical experience of the past 35 years.

More Info: Fund Fees and Expenses

For more information on fees and expenses of mutual funds, see Mutual Fund Fees and Expenses *on page 38.*

Two-thirds of stock fund assets were in funds with asset-weighted portfolio turnover rates under 50 percent. This reflects shareholders' tendency to own funds with below-average turnover and the propensity for funds with below-average turnover to attract more shareholder dollars.

Turnover Rate[1] Experienced by Stock Fund Investors Remains Low[2]
(percent, 1971–2005)



[1]*asset-weighted average*
[2]*excludes variable annuities*
Sources: Investment Company Institute; © CRSP University of Chicago, used with permission, all rights reserved (312.263.6400/www.crsp.com); and Strategic Insight Simfund

Asset-Weighted Turnover Rate

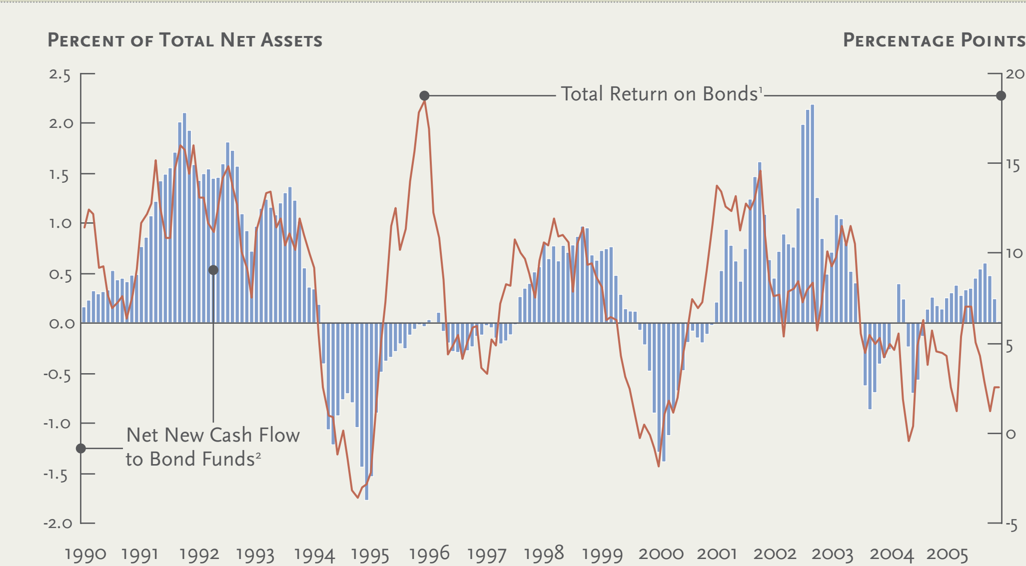
To analyze the turnover rate that shareholders actually experience in their funds, it is important to identify those stock funds in which shareholders are most heavily invested. Neither the simple average nor the median provides any indication of the turnover actually experienced by mutual fund investors because those measures do not take into account where stock fund assets are concentrated. For this purpose, a more appropriate measure is an asset-weighted average. This calculation gives more weight to funds with large amounts of assets and, accordingly, serves as a more reliable indicator of the average portfolio turnover actually experienced by fund shareholders.

Bond and Hybrid Funds

Investors added $31 billion to their bond fund holdings in 2005, following modest outflows the previous year. Cash flow into bond funds is highly correlated with the performance of bonds. Traditionally, the U.S. interest rate environment plays a prominent role in the demand for bond funds from year to year. Movements in short- and long-term interest rates can significantly alter the returns offered by these types of funds and, in turn, influence retail and institutional investors' demand for bond funds.

Falling interest rates between 2001 and 2003 led to significant returns for bond funds, spurring investor demand. In contrast, interest rates on intermediate- to long-term bonds moved in a narrow range over 2004 and 2005, eliminating the boost to bond fund returns from rising bond prices. As a result, money moved out of bond funds in 2004 and—based on the historical relationship between bond prices and demand for bond funds—one would have expected outflows to continue in 2005. A factor that may have contributed to the $31 billion in bond fund inflows in 2005 is the growing popularity of lifecycle and lifestyle funds. Net inflows to these funds—which often invest their net new cash in shares of other mutual funds—more than doubled in 2005 to $49 billion. Likely some portion of these flows was directed to bond mutual funds.

Flows to Bond Funds Related to Bond Returns
(percent, 1990–2005)



[1]*The total return on bonds is measured as the year-over-year change in the Citigroup Broad Investment Grade Bond Index.*

[2]*Net new cash flow to bond funds is plotted as a three-month moving average of net new cash flow as a percentage of previous month-end assets. The data exclude flows to high-yield bond funds.*

Sources: Investment Company Institute and Citigroup

Total annual flows to hybrid funds were $25 billion in 2005, down somewhat from the pace in 2004, but still substantial by historical standards. Over the past few years, investors increasingly have turned to this investment class by purchasing shares of hybrid funds of funds. These hybrid funds of funds invest in other mutual funds and the net new cash is reported as flows into the underlying funds. In 2005, hybrid funds of funds received $71 billion in net new cash with some part of these flows going towards underlying hybrid mutual funds.

Demand for Money Market Mutual Funds

Net new cash flow to money market funds turned positive for the first year since 2001, likely reflecting rising short-term interest rates in 2005.

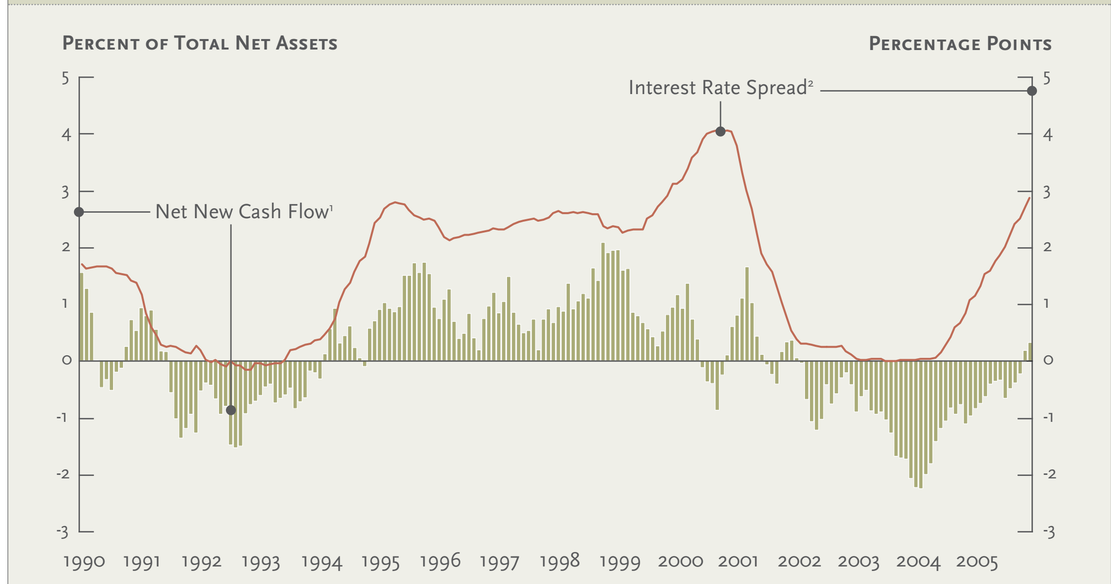
More Info: Money Market Fund Statistics

See pages 106–110 for more detailed data on money market funds.

Retail Money Market Mutual Funds

Retail money market funds, which are principally sold to individual investors, received net new cash of $2 billion in 2005, after net outflows totaling $319 billion over the period from 2002 to 2004. Money fund yields ramped up steadily during 2005 and outpaced any increases in yields on bank deposits. This relationship between rising short-term interest rates, the widening money market fund yield premium relative to bank deposits, and slowing outflows that eventually turn to inflows is a pattern that has been observed over the past 20 years.

Flows to Taxable Retail Money Market Funds Related to Interest Rate Spread
(percent, 1990–2005)



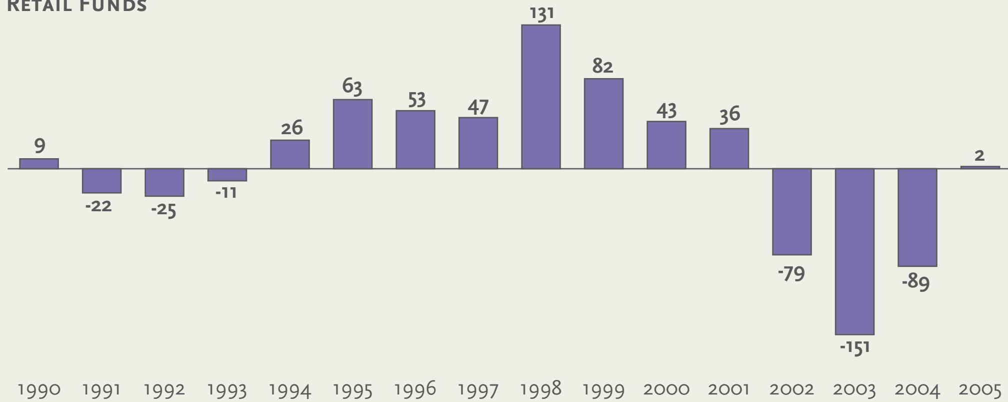
[1]*Net new cash flow is a percent of previous month-end taxable retail money market fund assets and is shown as a six-month moving average.*

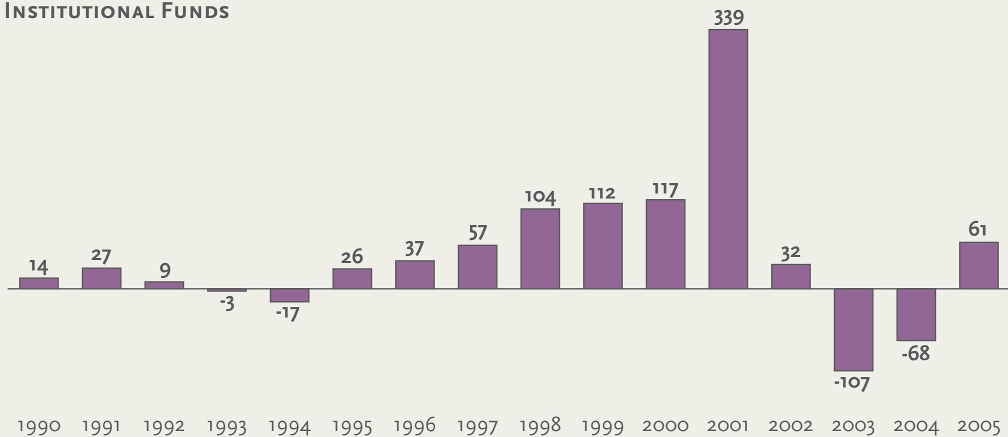
[2]*The interest rate spread is the difference between the taxable retail money market fund yield and the average interest rate on money market deposit accounts.*

Sources: Investment Company Institute, iMoneyNet, and Bank Rate Monitor

Nevertheless, households have continued to invest in bank deposits more heavily than expected based on this historical relationship. In 2005, they added about $400 billion to their holdings of time and savings deposits, despite the wide premium offered on money market funds. Changes in brokerage firms' cash management policies for their retail accounts likely have contributed to the increased use of bank deposits by households. In recent years, brokerage firms increasingly have relied less on money market funds and more on bank money market deposit accounts as cash management accounts for their retail clients.

Flows to Money Market Funds Turn Positive in 2005
(billions of dollars, 1990–2005)



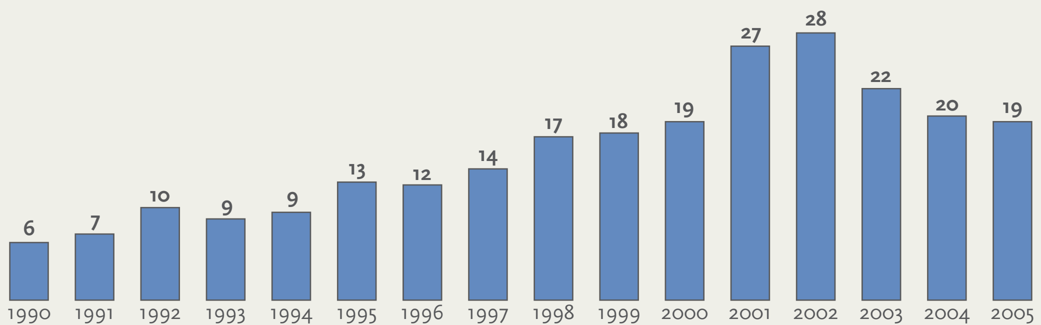


Institutional Money Market Mutual Funds

Institutional money market funds, used by businesses, pension funds, state and local governments, and other large investors had inflows of $61 billion in 2005, after substantial outflows the previous two years. Some of this reversal may reflect the diminished need for businesses to hold checking deposits at banks. Banks are prohibited by law from paying interest on demand deposits, but many institutional customers earn credits based on an implicit interest rate on their deposits. These credits can be used to pay for banking services. When interest rates decline, businesses often increase their checking deposits to earn sufficient credits to pay for their services. Over the period from 2002 to 2004, nonfinancial businesses added about $100 billion to their checking accounts, and some of this additional cash likely came from money market funds. In 2005, conversely, rising short-term interest rates may have triggered the shift of cash flow for some businesses away from checking accounts and into money market funds. U.S. businesses held about 19 percent of their short-term assets in money market funds as of year-end 2005.

Money Market Mutual Funds Managed 19 Percent of U.S. Business Short-Term Assets* in 2005

(percent, 1990–2005)



**U.S. nonfinancial business short-term assets consist of foreign deposits, checkable deposits, time and savings deposits, money market funds, repurchase agreements, and commercial paper.*

Sources: Investment Company Institute and Federal Reserve Board