

Inside Market Data

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Know the Flows

Information on the flow of assets between asset classes, sectors and regions is increasingly being used as a tactical data input for investment strategies. But does it have the value to become a mainstream indicator of market movements? By Brad Durham, managing director, EPFR Global

In recent years, investment analysts, strategists, money managers and other investment professionals globally have been incorporating data into their analysis and investment processes showing net investor flows into and out of funds focused on various asset classes globally. This data, which shows underlying investor demand for funds aggregated by fund group both geographically and by asset class, provides signals of changing investor sentiment, availability of liquidity from capital sources, and future market performance.

Fund flow data has been an input in US and global equity and fixed income market analysis by sell-side analysts and money managers for some time. But the injection of unprecedented liquidity into the global financial system by the US Federal Reserve and other central banks in response to the 2000 tech bubble and ensuing recession, focused attention on fund flows as a market-moving dynamic. With so much “easy money” around the globe responding to the changing fortunes of geographic regions, sectors and asset classes, tracking the flow of funds has become a key variable in analysis, trading and investment decisions.

Even a few years ago, few investment professionals or individual investors appreciated the value of tracking fund flows, which were widely considered a perpetually lagging indicator. But today there is broad awareness of fund flows as a liquidity indicator with important predictive information for equity and bond market performance. An August 2006 report by Deutsche Bank’s European equity strategy team said “money flows are the ultimate driver of asset prices.”

Flows data is also correlated with currency market fluctuations, and even countries’ financial stability. A country’s attractiveness to investor flows is an indication of whether its policymakers’ decisions are keeping the country and its underlying companies on a sustainable growth track.

Investors have come to realize that following flows into funds is extremely important for predicting market movements

across sectors, capitalization and style groups within specific countries or regions. It is also important for a range of fixed income asset classes such as global bonds, emerging markets and higher-yielding corporate and sovereign bonds, and for interpreting investor reaction to developments in timely asset classes such as real estate funds, financial sector funds, and funds of mortgage-backed securities.

What has this data told us in recent months? On a broad level, investors continue to reduce their home-country bias and increase their global allocations, a trend that has been underway for several years. They are fleeing funds in countries and sectors with the greatest exposure to sub-prime and the global credit crisis, and have been increasing their exposure to countries and sectors best able to withstand the crisis. In 2007, investors poured \$140 billion into combined global and emerging market equity funds tracked by EPFR Global, while removing \$101 billion from the combined US, Europe and Japan equity funds. A record \$240 billion was stashed in money market funds, which helped push down short-term bond yields since these funds invest in a range of short-term instruments, including US treasuries.

According to investors, in a global credit crisis, it is better to be invested in faster-growing emerging markets that are net creditor nations rather than slower-growing developed markets that collectively are net debtors. The data also shows that investors prefer geographic diversification over excessive exposure to one country.

On a sector level, investors have flocked to commodities-related funds, contributing to—and in response to—record commodity prices, and since mid-2007 have retreated dramatically from commercial and residential real-estate funds, moving into more defensive sectors such as health-care and utilities. They are undecided about financial sector funds, contributing to volatile fund flows that reflect the ongoing struggle in investors’ minds between eye-catching valuations and a perception



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that the sky will continue to fall on financial firms as the sector comes to grips with credit-related losses.

Fund flows data also provides currency analysts and traders with an explanation for the dramatic depreciation of the US dollar, and a tool for tracking the future prospects of global currencies. Conventional wisdom suggests the dollar has declined due to the Fed’s rate cutting, large trade and fiscal deficits and central banks diversifying their foreign currency reserves, but fund flow data shows that US investor assets dwarf global currency reserves, and that this shift to higher global allocations to gain more exposure to globalization has been the real driver of the weakening dollar.

Fund flows data also contains momentum information that can be useful to practitioners of tactical asset allocation. Investment managers incorporate high-frequency fund flows data into their investment process as a signal of shifting liquidity and sentiment towards geographic regions and asset classes, market timing, and as a contrarian indicator, since excessive flows have been a reliable predictor of market reversals. In addition, investment management marketing and product development departments can use fund flows to determine which types of fund products globally are attracting fresh money from investors, which is useful intelligence for developing attractive fund vehicles.

While once thought to be a perpetually lagging indicator—which may yet be the case in data tracking US retail investor flows—broader fund flows data that captures global institutional and individual investor activity has also emerged as a widely tracked indicator of current investor sentiment, which can be a portent of future market performance.