Cash Inflow into the Stock Market:
Where's All the Money Coming From?

Every payday, like clockwork, the funds flow into a company's 401 (k) equity investment account managed by Bradley, Foster, and Sargent, Inc. It is not a big company - perhaps twenty employees - but the funds mount up surprisingly quickly when they come in month after month. Our client actually has four investment options in their 401 (k) plan. These include a money market mutual fund option, a bond mutual fund and an international equity mutual fund. But the majority of 401 (k) participants direct their investment flow into the high quality U.S. equity portfolio. So far, it has proved to be a good choice for them.

Every payday this process is repeated by millions of U.S. companies, month after month, year after year. The amount of money flowing into the U.S. stock market through this mechanism is astonishing. In 1985, the entire mutual fund industry had assets of $500 billion, of which $117 billion was invested in equity mutual funds. During 1995 alone, $117.2 billion was invested in equity mutual funds. In 1990, there were 883 equity related United States mutual funds; there are now 2,833 equity mutual funds. The Investment Company Institute released the following data about the funds flow into U.S. equity mutual funds since 1993:

YEAR	**DOMESTIC EQUITY FUNDS**	**INTERNATIONAL EQUITY**	**TOTAL FUNDS**
		($ Billions)	
1993	$91.1	$38.5	$129.6
1994	$75.4	$43.9	$119.3
1995	$117.2	$11.7	$128.9

During the first three months of 1996, $72 billion of new money came into domestic equity mutual funds - almost as much as was received as in all of 1994. The chart on the next page gives a portrait of the flood of money invested in equity mutual funds since 1991:

Why the Flood of Money?

There are a number of reasons for this flood of money, much of it related to contributions through 401 (k)s and other retirement plans. First, the "baby boom" generation is turning fifty. According to Bessemer Trust's April Investment Review, "every 7.5 seconds for the next 18 years, another member of the baby boom generation will mark his/her 50th birthday." They add that 76 million people will make this passage over the next 18 years, and most of them will be saving for retirement. Moreover, it is an article of faith with many of them that Social Security will not be around - at least not in the same form as now. Thus baby boomers are being transformed from spenders to savers.

Numerous studies going back to 1926 shows that the long-term performance of equities has been significantly better than bonds and money market funds. Moreover, due to the absence of a downturn of 10% or more in the stock market since 1981 (measured on a calendar year basis), many investors are persuaded that the volatility or market risk has disappeared from the stock market. Thus, the investment of choice is U.S. equities, and the money is invested in the form of IRAs, 401 (k) plans and a various other defined contribution pension plans - much of it into mutual funds, directly, through banks and through brokerage firms.

The Supply of Equities Is Shrinking

With all the new money coming into the U.S. stock market from mutual funds and from foreign investors in 1995, companies found lots of buyers for stock issued through initial public offerings and secondary offerings. While difficult to determine precise numbers on the supply and demand of equities in 1995, market analyst Steve Leuthold writes that approximately $132 billion in stock was sold in IPOs and secondaries. In his February newsletter, he states that stock buybacks by companies interested in improving earnings per share results, shareholder returns and supporting their company's stock, amounted to $30 billion in 1995. Additionally mergers and acquisitions (acquiring companies for cash) removed an estimated $200 billion more from the stock market. Thus in spite of the high volume of stock sold to the public, there was an actual net shrinkage of an estimated $100 billion.

Mutual Fund Shareholders' Behavior

A situation in which there is a shrinking supply of shares to purchase and an increasing demand for stocks is a perfect economic recipe for a rising stock market. However, some market observers say that many mutual fund investors are naive and inexperienced investors and pose a serious risk to the stability of the mutual funds, which could destabilize the entire stock market. In other words, what happens if they panic in a market correction and pull the plug on their investments.

Richard Marcis of the Investment Company Institute did an extensive study of mutual fund investors' behavior over the past 35 years. He found no foundation for these fears, asserting that during this period most mutual fund shareholders showed themselves to be neither naive nor inexperienced. Generally they were not first time investors. Moreover, they were not market timers, being more likely to slow the pace of new share purchases in a down market rather than to redeem shares. Some even consider a downturn a buying opportunity. Finally, he found that most mutual fund shareholders continue to say that they invest for the long term, especially in retirement - related accounts. The question, of course, is whether these shareholders, as well as new mutual fund shareholders who enter the market all the time, will behave this way in future market downturns.

What Does All This Mean for the Stock Market?

We believe that the strong flow of retirement funds into equities via the mutual fund route will continue in 1996 and in the foreseeable future. There is no evidence to suggest that this powerful flow of savings will be redirected into another asset class - even in the face of a major market drop as in 1987 - until an entirely new set of circumstances arises. Investors have become accustomed to buying stocks on corrections, and we estimate that only a prolonged stock market setback, accompanied by high interest rates, would shift the flow of funds into bonds and cash reserves and alter the currently favorable demand for equities. On the supply side of the equity equation, we also do not foresee major changes in the shrinking supply of equities in the near term. Only fundamental changes in the tax code which currently favors capital gains over dividends or a serious recession crippling many companies' free cash flow would alter the widespread corporate practice of stock buybacks. It is always possible for rich stock market valuations and speculation to encourage excesses in the IPO market, but we see little evidence of this behavior currently - except in the Internet sector. Thus, we believe that beneficial supply and demand factors and high levels of liquidity currently at work in the stock market exert an upward bias on stock prices, and we see no reasons at the moment why this should not continue in 1996.

1996 Investment Review and Strategy

During the first quarter of 1996, the S&P 500 Index (total return) was up 5.38%. On the other hand, the thirty year Treasury Bond was down 7.04%, while the Investment Grade Corporate Bond Index was down 4.74%. We do not believe that the current decoupling of U.S. stocks and bonds can persist very long. If the trend of the bond market is correct, with its implicit assumption of a stronger than expected economy causing higher inflation and rising interest rates, the stock market will follow the bond market down. On theother hand, if the stock market is correct and inflation stays under control leading to lower interest rates, then the bond market will rally. We continue, however, to believe that systemic inflation will not rise above 3.5%. At its current level, we believe that the stock market is fairly valued - with some sectors expensive and others more reasonable priced. A move of 10% in either direction is possible, depending on whether corporate earnings are anemic or robust and on the direction of the inflation and interest rates.

Perhaps the most worrisome external event is the coming elections in Russia in June. If the Communists and Nationalists team up to gain control of the Presidency and the Duma, and push to re-unite the former Soviet Union, the stock market could react very adversely. However it is best not to act precipitously on a worst case political scenario far on the horizon - especially in light of the positive effects that a Presidential election race has traditionally had on the stock market and the attractive supply/demand factors mentioned above.

In conclusion, with the risk/reward ratio for many sectors of the stock market pointing as much to downside risk as upside potential, we continue to allocate assets carefully and to be very selective in initiating new positions in the stock market. We continue generally to emphasize defensive sectors and to be willing to purchase equities in sound companies whose prices have been influenced more by short-term problems than by longer-term prospects. Whether the stock market or the bond market wins the current tug of war is less important than owning high quality companies with excellent long-term opportunities for growth, at reasonable values and with broad diversification.

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