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The Great Rotation: Are We There Yet?

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(as published in NBR's Voices on August 9, 2013)

The following special commentary was written by Brian Reid, chief economist at Investment Company Institute.

Though there has been a lot of anticipation of a “great rotation”—an investor exodus from bonds and into equities—I continue to believe that those who await its coming will be disappointed, while those who think it has already arrived are misreading the data.

Since the beginning of 2008, investors have purchased more than $1.7 trillion in bond mutual fund and ETF fund shares. Many claim that the money coming into bond funds demonstrates that investors have turned to a “risk-off” trade because they fear investing in the stock market.

In fact, the data tell a more complex story: Investor portfolio diversification and an aging population are also having long-term effects on investors’ portfolio decisions.

Baby Boomers Are Driving Long-Term Bond Fund Demand

Undoubtedly, a lower tolerance for risk among some investors since 2008 has contributed to the demand for bond funds. ICI surveys find that households’ willingness to take on investment risk has declined, particularly for households in their prime savings and investing years.

However, proponents of the great rotation storyline are missing an even greater force in the markets—the demographic shift under way among Baby Boomer investors. As investors age, they tend to allocate more of their portfolios to fixed-income securities.

People over the age of 45 hold about 80 percent of outstanding stock and bond mutual fund assets. As they continue to age, they will gradually allocate larger portions to fixed-income funds, which will provide long-term demand for bond funds.

Investors Remain in the Stock Market

In addition, the idea of a great rotation assumes that investors pulled out of the stock market in the wake of the financial crisis. In reality, few investors completely pulled out of the market. ICI and Federal Reserve surveys show that the percentage of households invested in stocks have declined by only a few percentage points since the mid-2000s.

Instead, investors reacted to the financial turmoil in 2007 and 2008 by diversifying their portfolios—using more types of funds with diverse strategies to produce a return. During this time, investor demand for stocks was concentrated in funds investing in foreign countries, in exchange-traded funds (ETFs), in stock mutual funds modeled on indexes, and in balanced funds that invest in both stocks and bonds.

Hence, while investors were investing heavily in bond funds, they also were purchasing more than $290 billion in stock mutual fund and ETF shares, and nearly $195 billion in funds that invest in both stocks and bonds.

In other words, the data don’t suggest that there was a widespread investor pullback from the stock market. Rather, investors seem to have been diversifying their portfolios, while baby boomers were undertaking the usual rebalancing that is typical as people age.

Has the Great Rotation Started?

We have seen investors pull some money out of bond funds in the past two months, following the sharp rise in interest rates in May and June. Such outflows from bond funds are typical when interest rates rise. Initially, investors parked this money in cash, such as

bank deposits and money market funds.

In recent weeks, inflows to stock funds and ETFs have picked up, suggesting that some investors did put this money to work in the stock market. More recently, however, outflows from bond funds have slowed, and investors seem to be adjusting to rising interest rates.

Even if investors do become more willing to take on investment risk and allocate more of their portfolios to stocks, it's unlikely that this factor alone will undo the effects of aging investors and their desire to diversify their portfolios. Any increased desire to hold stocks is unlikely to reverse a significant portion of the inflows to bond funds in recent years.

Finally, the effect on stock prices of any inflows to stock funds will be very modest. The global value of stock markets is huge—at the end of June, the World Federation of Exchanges reported its value as $56 trillion—and Americans became global investors years ago. It would take more than some modest portfolio rebalancing by American investors to push up stock prices globally.

Instead, stock prices will continue to be driven largely by investor expectations of future corporate profits, rather than flows between stock and bond funds.

Those expecting a great rotation out of bonds to fuel a stock market boom are looking in the wrong direction, and will miss the important signals on the recovery of global economies and corporate profits.

Brian Reid is chief economist at the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.3 trillion and serve more than 90 million shareholders.

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