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**UP AND DOWN WALL STREET** | FRIDAY, FEBRUARY 18, 2011

## Resurgent Flows Into U.S. Stock Funds: Warning Signal?

By RANDALL W. FORSYTH

*Investors pour money into domestic mutual funds with stocks at highs. Contrarians, beware.*

Now that the U.S. stock market has doubled from its lows of March 2009 and has gained nearly 30% just since the end of last August, American mutual-fund investors are, at long last, rushing into domestic mutual funds.

Indeed, Thomson Reuters' Lipper data show nearly the same amount flowed into domestic equities funds in the latest week as in all of 2010, roughly \$7 billion. That made for the best week of domestic and overall stock fund sales in the last three months.

The resurgent ebullience among individual investors who invest through mutual funds is consistent with the optimism among the pros. As noted here previously ("**The Bulls Are 'All In'**"), professional money managers also have the sunniest outlook they've had in over five years.

With the major market averages marching relentlessly higher, day in and day out, the greater risk would seem not to own U.S. equities. That's in contrast to 2010, when fund investors gave a cold shoulder to domestic funds and clambered into foreign funds, especially those in emerging markets.

According to Lipper, fund investors poured some \$74 billion into equity funds, of which more than 90% went into non-U.S. stock funds.

Meanwhile, the gusher into bond funds has turned into a dribble. In 2010, some \$247 billion rushed into fixed-income funds as \$423 billion exited money-market funds yielding virtually nil. In recent weeks, bond funds have continued to attract money, albeit vastly less than in previous years. And the exodus from municipal-bond funds continues, with another \$3 billion flowing out in the latest week.

The action remains in U.S. equity funds, which have seen ever-more relentless inflows as the major market averages move steadily higher and as Americans' ardor for investing abroad seems to be tempered by the realization that political risk still exists, as the events in Egypt and the rest of the Middle East graphically demonstrate.

Various sentiment indicators corroborate the rising tide of bullishness.

It is the late buyers that set market tops. They jump on the trend after it is underway and pay high prices to those who got on earlier.

As suggested here previously, it has been the injection of liquidity by the Federal Reserve that has driven up asset prices.

The beginning of the central bank's purchase of \$1.7 trillion in Treasury, agency and agency mortgage-backed securities coincided with the first phase of the bull market, when the Standard & Poor's 500 lifted off its evil low of 666.

Since Fed Chairman Ben Bernanke floated the idea of a second phase of Treasury securities late last August, U.S. stocks have appreciated 30% in anticipation of the impact of the central bank's incremental purchases.

That, in effect, took care of the financing of the federal budget deficit, which freed money to go into risk assets such as stocks.

Mutual-fund investors apparently are responding to the Fed's lure of liquidity that is sending the prices of equities ever higher. That liquidity also is lifting the prices of commodities higher.

Silver hit a three-decade high with the **iShares Silver Trust exchange-traded fund** (SLV) setting a record high on half-again the recent average volume Thursday.

Liquidity-driven markets go as long and as far as the liquidity takes them. That excess liquidity -- plus the growing confidence that the economy won't succumb to a double-dip but will continue to recover -- has lifted asset prices.

The question is what will happen when the spigot is turned off at the end of June. And what would happen if the Fed allows its balance sheet to shrink as its holdings of mortgage-backed securities run off?

Investors who are plowing into mutual funds implicitly see the greater risk in not buying, even with stock prices up 100% from their lows, on the lift from the updraft of Fed-provided liquidity.

Contrarians know to run in the opposite direction of the crowd, not with it.

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