U.S. Open-End Funds State a Strong Third Quarter

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The third quarter proved to be a big comeback month for inflows into U.S. open-end mutual funds. During the three-month period, investors contributed $144.7 billion to funds, taking the year-to-date total to $273.2 billion. Meanwhile, $188.2 billion exited U.S. money market funds.

Bond funds continued to capture the vast majority of the inflows in the third quarter. Meanwhile, flows into equity funds have been tepid in spite of the broad stock market recovery. Although the S&P 500 has gained more than 19% so far this year, investors have placed only a net $3.8 billion back into U.S. Stock funds.

After the market's nosedive last year, many have sought safety in lower-volatility investments like bond funds. However, investors may be in for a shock when rates eventually rise, and they definitely shouldn't get used to the double-digit returns that many core bond funds have notched so far in 2009. We're not forecasting an imminent rate hike; however, when rates do eventually move, the most likely direction will be up and that will put pressure on bond prices and fixed-income fund returns.

Estimated Net Flows $Mil

	Sept 2009	Q3 2009	YTD 2009	2008
U.S. Stock	(3,102)	741	3,840	(96,497)
International Stock	3,848	17,074	10,681	(71,669)
Balanced	783	3,138	(6,138)	(25,953)
Taxable Bond	35,590	93,146	197,734	26,350
Municipal Bond	10,728	27,586	56,906	7,269
Alternative	1,436	3,027	10,158	3,740
Total	**49,283**	**144,712**	**273,180**	**(156,759)**

American Funds Spring a Leak

The outflows for U.S. stock funds in September can largely be attributed to American Funds. Among the least-popular U.S. equity funds in September were Washington Mutual, Growth Fund of America, and Investment Company of America, which saw outflows of $620 million, $334 million, and $417 million, respectively.

In total, investors pulled $1.8 billion out of American Funds in September, continuing a trend that has plagued the firm all year. Year to date through September, the firm has registered outflows of $19.3 billion, while the other major firms had inflows.

Like most other firms, American Funds' bond offerings have experienced strong inflows. So far this year, its fixed-income offerings have taken in $9.2 billion. But that hasn't been enough to offset the flood of dollars exiting the firm's equity and balanced fund offerings.

American Funds' business mix has worked against it this year. Its key rivals, Vanguard and Fidelity, have a more diversified menu of funds, while American Funds' mutual fund lineup is significantly skewed toward equities. Just over 11% of the firm's mutual fund assets are in bond funds (both taxable and municipal). Meanwhile, equity funds make up around two thirds of the firm's mutual fund assets, with the remaining going to balanced funds.

Granted, with $880 billion in total mutual fund assets, American remains the second-largest U.S. fund firm. But its market share has definitely been under pressure in 2009.

Vanguard Tightens Its Grip on Number One

Meanwhile, Vanguard has solidified its place atop the U.S. fund charts. The firm came through 2008 in better shape than its competitors, and it has continued to gather assets in 2009.

That said, Vanguard 500 was the least popular U.S. fund in September, with outflows of $631 million. However, this may not be a story of investors abandoning S&P 500 indexing. More than $445 million of those outflows were attributable to the Signal share class, which requires a minimum investment of $1,000,000. Meanwhile, Vanguard Institutional Index Fund, which also tracks the S&P 500, saw inflows of $497 million. So it's certainly possible that an institutional shareholder was swapping out its Vanguard 500 Signal shares for the cheaper Vanguard Institutional Index Fund.

As you might expect, flows into Vanguard this year have been heavily skewed toward bond funds. In fact, only two of the firm's 10 most popular funds in 2009 are equity funds—Vanguard Total Stock Market and Vanguard Institutional Index.

In total, investors poured $27.4 billion into Vanguard funds during the third quarter and $74.2 billion so far this year. The pace of the inflows prompted Vanguard to post a warning on its Web site, cautioning investors against "using short-term performance figures—however attractive—to guide [their] investment decisions." The firm singled out four funds in particular—Vanguard Capital Value (inflows of $239 million through September), Vanguard Emerging Markets Stock Index (inflows of $1.4 billion), Vanguard Precious Metals and Mining (inflows of $481 million), and Vanguard High-Yield Corporate (inflows of $1.7 billion). Vanguard has a long record of staving off hot money into its funds, not only through warnings like these but by raising investment minimums and occasionally closing funds.

Sure enough, only a few days after posting the warning on its Web site, Vanguard announced that it was closing Vanguard Capital Value to new investors in what the firm called a "cooling off period" intended to protect existing shareholders from transaction costs incurred when short-term performance-chasers move in and out of a fund.

Granted, the vast majority of new inflows this year have gone into staid bond funds, but that's masked performance-chasing that's been going on just under the surface. As evidence, the two most popular equity categories this year are diversified emerging markets and natural resources, which have experienced strong inflows of $12.7 billion and $9.3 billion, respectively.

PIMCO Won't Turn Off the Spigot

Given its track record, we weren't surprised to see Vanguard close a fund to keep hot money out. However, the same can't be said for the hottest fund on the market, PIMCO Total Return. Bill Gross, the fund's manager, recently said that he doesn't plan to close the fund as long as it's beating the market and the competition.

Vast sums have been flowing into PIMCO Total Return all year, and September was no exception. It was once again the most popular fund this month with $5.3 billion in inflows. So far this year, the fund has taken in an amazing $36.3 billion, and it now stands at $185.7 billion in total assets.

Although the growth of Total Return has been astounding, it's not the only fund in PIMCO's lineup that has taken in scads of cash. PIMCO Commodity Real Return has gathered $5.1 billion so far this year, and PIMCO Short-Term has had inflows of $4.7 billion. PIMCO Investment Grade Corporate and PIMCO Low Duration Fund have also been popular, with each taking in around $3.3 billion.

Other Fund Company Highlights

JP Morgan had a strong third quarter. The firm saw $8.2 billion in inflows for the quarter and has pulled in $16.8 billion for the year to date. JPMorgan Core Bond has been the firm's big winner this year, with $4.7 billion in inflows. That fund is managed by a veteran team that has witnessed all sorts of market conditions. That experience paid off in 2008, when the fund weathered the extreme conditions much better than most competing funds, and that's earned them new fans this year even though the fund has underperformed so far in 2009.

A fund run by another experienced manager has also helped lift BlackRock's results. BlackRock Global Allocation has taken in $4.1 billion through September, helping push the firm's total year-to-date inflows to $6.6 billion. Dennis Stattman, who has run the fund since its 1989 inception, grew cautious about corporate debt and the financial sector at just the right time, and the fund held up much better than the competition in 2008 as a result.

Another veteran manager, and early contender for fixed-income fund manager of the year, Jeffrey Gundlach, has also seen noteworthy inflows into his fund, TCW Total Return Bond. That fund, which has experienced $6.7 billion in inflows so far this year, is the 800-pound gorilla in TCW's lineup. At $10.0 billion in total assets, it accounts for the bulk of the firm's $13 billion in mutual fund assets.

	YTD Sept. 2009		
	Total Net Assets	**Mkt Share**	**Est. Flows**
Fund Family	$ Bil	**%**	$ Mil
Vanguard	1,002	15.3	74,214
American Funds	880	13.4	(19,267)
Fidelity Investments	709	10.8	17,161
PIMCO Funds	295	4.5	55,613
Franklin Templeton Investments	268	4.1	11,310
T. Rowe Price	203	3.1	10,288
OppenheimerFunds	119	1.8	(3,762)
Dodge & Cox	110	1.7	(582)
John Hancock	103	1.6	3,996
Columbia	99	1.5	(328)

Exchange-Traded Funds

September U.S. ETF Flows Reveal Concerns About Inflation and a Weak Greenback

John Gabriel, ETF Analyst

The ETF industry broke through another barrier in September, as industrywide assets under management topped $700 billion, compared with about $670 billion in assets under management at August month-end. Investors poured roughly $5.4 billion into U.S. ETFs in September, bringing the year-to-date total to approximately $56.3 billion in net new inflows. ETF industry flows have been quite strong so far in 2009, with positive flows in every month except February, when investors yanked roughly $5.5 billion out of ETFs.

Estimated Net Flows $Mil

	Sept 2009	**Q3 2009**	**YTD 2009**	**2008**
U.S. Stock	(4,349)	1,313	(30,359)	111,283
International Stock	2,880	5,335	16,391	13,108
Balanced	59	135	174	57
Taxable Bond	3,210	8,094	26,676	17,000
Municipal Bond	329	1,036	2,617	1,582
Alternative	1,804	3,986	19,350	876
Commodities	1,435	2,123	21,409	12,764
Total	**5,368**	**22,022**	**56,258**	**156,670**

Fixed Income Takes the Cake

Among the broad asset classes, taxable-bond ETFs attracted the most new assets in September. Last month taxable-bond ETFs raked in about $3.2 billion in net inflows, bringing total assets under management in taxable-bond ETFs to about $85.2 billion.

The shift into fixed-income ETFs has been an ongoing theme thus far in 2009; year to date the category has brought in about $26.7 billion of new assets, which makes it the most popular ETF category so far in 2009. For some perspective, consider that taxable-bond ETFs attracted approximately $17 billion in all of 2008.

Investors' heightened interest in the bond market—particularly for the shorter end of the yield curve—has resulted in increased product development from various ETF sponsors. There have been 17 new fixed-income products launched this year (with several more filings still in registration with the SEC), as all the major providers are looking to round out their product portfolios.

Aside from hunting for low-duration bond ETFs in an effort to avoid excessive interest-rate risk, it appears that investors are also bracing their portfolios for a potential long-term bout of inflation. After enjoying more than $6.5 billion in net inflows year to date, iShares Barclays TIPS Bond has doubled in size and currently stands at well over $16 billion in assets after closing out 2008 at roughly $8 billion. High-grade corporate bonds have also been in favor; year to date through September month-end, iShares iBoxx $ Investment Grade Corporate Bond has attracted $4.9 billion in new assets and currently has about $13.3 billion in total net assets.

This year we've also seen investors rush into "junk bonds" with hopes of cultivating equitylike returns and generous yields, thanks to the historic widening of yield spreads in recent months. SPDR Barclays Capital High Yield Bond, which has roughly $2.7 billion in total net assets, has experienced more than $1.4 billion in inflows. Similarly, iShares iBoxx $ High Yield Corporate Bond, which has about $4 billion in total net assets, has brought in about $1.5 billion in new assets so far this year.

Commodity ETFs Shine, Despite Concerns over the CFTC's Ongoing Probe
Along with the rush into Treasury Inflation-Protected Securities, investors have also been pouring into commodity ETFs. Strong interest in commodity markets is likely a function of both: tactical strategies looking to join in on the popular "reflation" trade and more folks allocating a portion of their portfolios to commodities for the longer-term diversification benefits that this non-correlated asset class can provide.

After seeing more than $1.4 billion flow into the category in September, commodity ETFs' year-to-date total net inflows have reached $21.4 billion. Net inflows thus far in 2009 represent about one third of the category's total $63 billion in total net assets, as of Sept. 30, 2009.

Precious-metals ETFs, particularly those that achieve their target exposure by actually storing physical bullion in a vault, have really bolstered asset growth for the category. For instance, SPDR Gold Shares (the world's second-largest ETF at more than $35 billion in total net assets) alone has brought in more than $9.7 billion in 2009. Again, this can be partly attributable to investors' expectations for inflation and/or a weak dollar.

Blistering Rebound in Emerging-Markets Stocks Propels International Stock ETFs
International-stock ETFs were another bright spot for the industry, making up more than $16 billion in net inflows so far in 2009, including the $2.9 billion in September. Strong investor interest in emerging markets has driven growth for international-stock ETFs, which have a total of $170 billion in total net assets invested across about 150 ETFs.

Just two ETFs—iShares MSCI Emerging Markets EEM and Vanguard Emerging Markets Stock ETF VWO—accounted for about $7 billion (or 44%) of the category's total year-to-date net inflows. Interestingly, VWO, which levies a net annual expense ratio of 0.27% versus 0.73% for EEM, has been steadily gaining ground on its much larger rival. VWO, which saw $1.5 billion in net inflows last month, has seen its total assets grow to more than $14 billion from about $4 billion at the start of the year. Meanwhile, EEM, which saw $680 million in net inflows last month, has grown to $33.7 billion in total assets from approximately $17.5 billion at the beginning of the year. Obviously, the impressive 60%-plus rally in those indexes through the first nine months of the year was also a major factor behind the total net asset growth.

Outflows From SPDRs Cause U.S. Stock ETF Flows to Dip into the Red
Interestingly, the only category to show net redemptions so far in 2009 is U.S. equity, which has experienced more than $30 billion in outflows year to date through September month-end. However, before declaring that ETF investors have thrown in the towel for U.S. stocks, consider that the S&P 500 tracking SPDRs SPY, which at the end of September still had well over $70 billion in assets, has shed more than $30 billion thus far in 2009. Excluding the SPDRs, U.S. stock ETF flows would have actually been flat to slightly up in both September and the year-to-date period.

It's worth noting that SPY is often used by institutional investors as a cash substitute or to "equitize" assets when managing inflows and outflows. As a result, SPY consistently turns over more than 30% of its total assets daily. Considering its massive size and the fact that it is the most heavily traded security on the planet, we think it's worth looking at U.S. stock ETFs both with and without its heavily influential impact. For a better gauge on investor sentiment on the S&P 500, we like to focus more on iShares S&P 500, which has raked in about $1.4 billion year to date and currently has almost $20.5 billion in total net assets.

Leveraged and Inverse ETF Flows Reverse Course
So far this year, leveraged and inverse ETFs have attracted $11.5 billion in net new assets. This controversial category saw net inflows of just over $1 billion in September, and currently it has about $30 billion in total net assets spread across 146 funds that offer leveraged, inverse, and inverse leveraged exposure to various benchmarks. This marks a turn for the group, as we saw $3.4 billion run for the exits in July and August following the now infamous investor notice issued by FINRA.

ETF Provider Highlights

Among the major ETF providers, Vanguard stood out in September with month-over-month total asset growth of 10%. Furthermore, Vanguard's $17.8 billion in year-to-date inflows represents about 23% of the firm's total ETF assets at September month-end. For perspective, iShares' inflows over the same period represented 8% of the firm's total net assets. On the other hand, the outflows experienced by SSgA thus far in 2009 (attributable to SPY) represented approximately 10% of the firm's total ETF assets. Over the past 12 months, total asset growth for the industry leaders--iShares, SSgA, and Vanguard--was 23.5%, negative 4.6%, and 66.0%, respectively.

Also, some may notice that ProShares' asset growth has trailed its net inflows by $7.5 billion over the past year. This is an astounding figure for a firm with just $25 billion in total assets. While many individuals overlooked the impact of negative compounding and volatility drag, FINRA certainly noticed this impressive erosion of wealth.